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GATS and Banking in the Pacific Basin

Over the past three decades, economies in the Pacific Basin have grown rapidly by strengthening their links with other economies through trade and foreign investment. However, rapid economic growth and closer economic links with other countries have led to increased demand for a wide variety of banking and other financial services, posing a dilemma for Pacific Basin economies. On the one hand, these economies would like to develop their domestic financial markets to provide more efficient financial services that can foster continued economic growth. Since banks from industrial countries like the U.S. have the resources and expertise to provide needed financial services, there is an incentive for Pacific Basin economies to liberalize and open the financial markets to entry by foreign banks. On the other hand, policymakers in these economies are concerned that competition from foreign banks will adversely affect the position of domestic banks. This creates pressures to limit the entry of foreign banks.

The adoption of the General Agreement on Trade in Services (GATS) at the Uruguay round of multilateral trade negotiations, concluded in December 1993, raises hopes that Pacific Basin economies will become more open to international banking. However, the precise extent to which the financial services provisions of GATS will be applied remains uncertain and is likely to involve negotiations that will extend into 1995. This *Weekly Letter* briefly discusses the principles of GATS and the factors that may affect its implementation in Pacific Basin banking markets.

GATS and financial services

The GATS agreement sets out a number of general principles governing the treatment of foreign banks; among the most important nondiscrimination and market access. To implement nondiscrimination, countries would grant *national treatment* to foreign banks, that is, they would treat foreign banks in the same way they treat their domestic banks. Countries would also grant *most favored nation status* to foreign banks, meaning that all foreign banks from countries subscribing to GATS are to be treated equally (in terms of regulations, access to domestic markets, and so forth).

As national treatment and nondiscrimination may not fully eliminate barriers to the entry of foreign banks, GATS also identifies steps countries are to take to enhance market access. For the financial services sector, these include: (i) listing monopoly rights in financial services and trying to eliminate them or to reduce their scope; (ii) allowing foreign financial services suppliers the right to establish or expand in their domestic financial markets, including through the acquisition of existing enterprises; (iii) allowing foreign suppliers of financial services to offer any new financial services; (iv) trying to remove or to limit any nondiscriminatory measures that adversely affect the ability of foreign financial services suppliers from operating, competing, or entering domestic financial markets.

If fully implemented, GATS would significantly enhance international banking in the Pacific Basin. However, the precise extent of implementation depends on commitments by individual countries, and it is expected that further negotiations will be needed to bring most countries' schedules in closer compliance with GATS principles. In particular, it is unclear how much of GATS will be adopted by Pacific Basin economies and how soon because it could entail significant changes for these economies. At present, Asian Pacific Basin economies that are members of the General Agreement on Tariffs and Trade (GATT), under whose auspices GATS was formulated, include Hong Kong, Indonesia, Japan, South Korea, Malaysia, the Philippines, Singapore, and Thailand.

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To shed light on the types of changes that might be needed to achieve GATS objectives in the banking sector, it is useful to examine two aspects of international banking in the region, namely: (i) external borrowing by banks in Pacific Basin economies, which provides business opportunities for foreign banks, and (ii) the participation of foreign banks in domestic banking markets.

External borrowing

Reflecting robust and stable growth in the Asian Pacific Basin, external bank borrowing has grown much more rapidly in that region than in the rest of the world. According to International Monetary Fund statistics, the foreign liabilities of banks in Asian countries—other than Japan—grew at an annual rate of 18 percent between 1983 and 1992, compared to 9 percent for developing countries as a group, and 13 percent for industrial countries; and in 1992, banks in Asia (excluding Japan) held 12.5 percent of the world's total foreign liabilities.

But to some Pacific Basin countries, unrestricted external borrowing is not necessarily desirable, and they impose controls designed to regulate such borrowing. Two main reasons are typically offered for such controls. First, governments may want to limit external credit to avoid possible debt repayment problems in the future while at the same time directing such credit to preferred sectors (for example, Indonesia, South Korea, and the Philippines).

Second, governments at times restrict, or seek to discourage, external borrowing in response to surges in foreign capital inflows that threaten macroeconomic policy objectives, such as a exchange rate target. Taiwan, which is not currently a GATT member, provides a good illustration. In 1987, Taiwan froze the external liabilities of its banks in response to a surge in capital inflows that put upward pressure on the exchange rate and threatened monetary control. Although restrictions on inflows were gradually liberalized, they persisted in some form for years after the episode. More recently, in January 1994, Malaysia, which is a GATT member, responded to speculative capital inflows by limiting banks' holdings of foreign funds that are not trade-related or intended for investment in plant, equipment, or stocks. It took measures that effectively raised reserve requirements on foreign deposits, set a ceiling on the net external liabilities of domestic banks, and prohibited the sale of short-term financial instruments to foreigners.

As Pacific Basin economies develop, it is likely that external borrowing restrictions based on concerns about debt repayment, or designed to direct credit to preferred sectors, will decline, as they have in the developed economies.

In contrast, restrictions on external borrowing designed to curb large speculative capital flows may persist, or may be imposed from time to time. A vivid example of such speculation in developed countries is the attack on the European exchange rate mechanism in the fall of 1992. In particular, there may at times be a trade-off between the desire to maintain free international financial and banking flows and the desire to peg the exchange rate.

Foreign bank access

Foreign bank market shares vary widely in the Pacific Basin. Foreign banks play a major role in Hong Kong, and for historical reasons, they are also important in the onshore banking markets of Singapore and Malaysia, in spite of restrictions to entry. In other markets, however, the participation of foreign banks is more limited. Foreign banks have recently accounted for 25 percent of total bank assets in Malaysia, around 8 percent in Indonesia and South Korea, and less than 3 percent in Japan. By way of comparison, foreign banks account for around 23 percent of total bank assets in the U.S. However, foreign banks in the Pacific Basin are *similar* in that they tend to specialize in certain areas, such as foreign exchange transactions, international lending, or financial innovation, and generally do not engage in traditional commercial banking, particularly at the retail level.

The limited activities of foreign banks in most Pacific Basin countries can be explained in part by regulatory constraints. For example, a number of countries believe that their banking markets are adequately served by existing banks and choose to restrict the issuance of more bank licenses. While such restrictions may not single out foreign banks, they effectively bar their entry. Foreign banks have also faced restrictions on the number of branches that they may open, the types of business they may engage in, and in their ability to take over domestic banks.

Restrictions on foreign bank access to domestic markets appear to be motivated by concerns that entry by well-capitalized, more efficient, and innovative foreign banks may lead to the failure of weaker domestic banks. Such failures could have

a destabilizing effect on domestic financial institutions and may result in the domination of the banking system by foreign banks. These concerns are particularly important in economies with small and undeveloped financial systems that have been sheltered from vigorous competition. To obtain some of the benefits of a foreign banking presence while sheltering domestic banks, restrictions are designed to limit, but not completely prevent, foreign bank presence or access to domestic financial markets. In some cases, tax and regulatory incentives may encourage a foreign banking presence in an offshore banking market, rather than in the local banking market. Regulations insulate domestic banking markets by limiting offshore business to foreign currency transactions with nonresidents. Offshore markets exist in Singapore, Malaysia, the Philippines, Taiwan and Thailand.

Competitive disadvantages

Apart from explicit regulatory barriers to entry by foreign banks, three other factors have placed foreign banks at a competitive disadvantage with respect to domestic banks, namely, controls on financial transactions, institutional barriers to entry, and high entry costs.

Controls on financial transactions. In some Pacific Basin economies, controls on interest rates limit the ability of foreign banks to compete on the basis of price, a significant consideration if foreign banks are more efficient than domestic banks. Foreign bank entry also may be affected by other controls, such as credit guidelines, that require banks to allocate a certain proportion of their loans to certain sectors, regardless of profitability.

Institutional barriers. As new entrants, foreign banks need to develop a strong domestic customer base in order to compete effectively. However, institutional arrangements may make it very difficult to develop such relationships. For example, a number of banking markets in the Pacific Basin have regulated financial systems dominated by state-owned banks or by a small number of banks that receive government support. Such banks tend to attract most depositors and borrowers. Even when banks are privately owned, institutional arrangements that tend to link banks with a well-defined group of customers (such as *keiretsu* groupings in Japan) will tend to limit opportunities for outsiders.

High entry costs. It is often costly to develop the infrastructure (such as branching networks) that could lead to a greater banking presence. One way of reducing this cost is to acquire an existing domestic bank, but merger restrictions sometimes prevent this. Foreign banks also find it more costly to raise funds in some of the domestic markets of the Pacific Basin than do local banks.

Starting in the 1980s, many Pacific Basin economies have adopted measures to liberalize their financial sectors. In particular, interest rates have been deregulated, credit targets have been lifted, some banks have been privatized, and efforts have been made to strengthen the capitalization of domestic banks (by meeting Basle capital standards) in order to improve their competitiveness. These developments tend to enhance the attractiveness of these markets for foreign banks, and may therefore be seen as broadly consistent with GATS objectives of improving market access. However, institutional barriers and high entry costs are likely to remain important deterrents to entry, and GATS is not likely to alter this.

Prospects

International banking plays an important role in financial markets in the Pacific Basin. However, regulatory constraints and other factors have tended to limit entry and the scope of foreign banking activity. Thus, there is some way to go before the objectives of GATS will be fully achieved in the region.

Concerns about speculative capital flows, the stability of domestic banking markets, and the foreign bank domination of domestic markets will have to be dealt with before GATS principles are fully adopted in Pacific Basin economies. This process is likely to take time. Nevertheless, increasing economic prosperity may help Pacific Basin economies overcome these concerns and recognize that competition with foreign banks is a prerequisite for achieving greater efficiency in financial markets.

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