UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

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The Contribution of Trade in Financial Services to Economic Growth and Development

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Outline

1. Financial services as economic infrastructure
2. The contribution to growth & development
3. Regulatory reform
4. Financial services & the international trading system

UNCTAD's Work on Financial Services

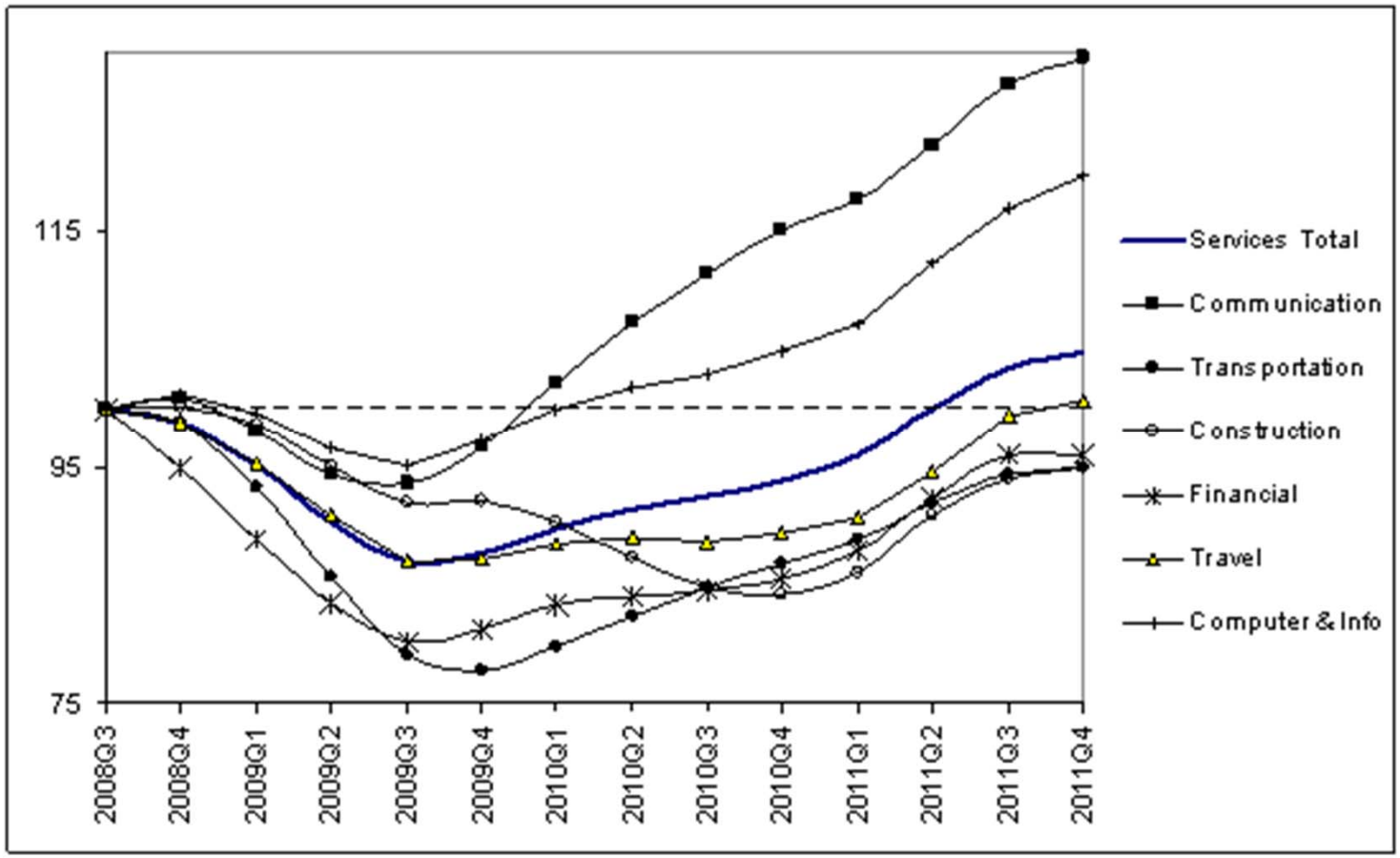
- ***Multi-Year Expert Meeting on Services, Development and Trade: the Regulatory and Institutional Dimension* (2009-2012)**
  - http://unctad.org/en/Pages/Meetings/Expert-Meetings.aspx
- **Publications**
  - *Services, Trade and Development* (UNCTAD/DITC/TNCD/2010/5) http://unctad.org/en/Docs/ditctncd2010d5_en.pdf
  - *The Regulatory and Institutional Dimension of Infrastructure Services* (UNCTAD/DITC/TNCD/2010/4) http://unctad.org/en/Docs/ditctncd2010d4_en.pdf

  Trade and Development Report (various issues)
  - Including TDR 2011, Chapters IV "Financial re-regulation and restructuring"

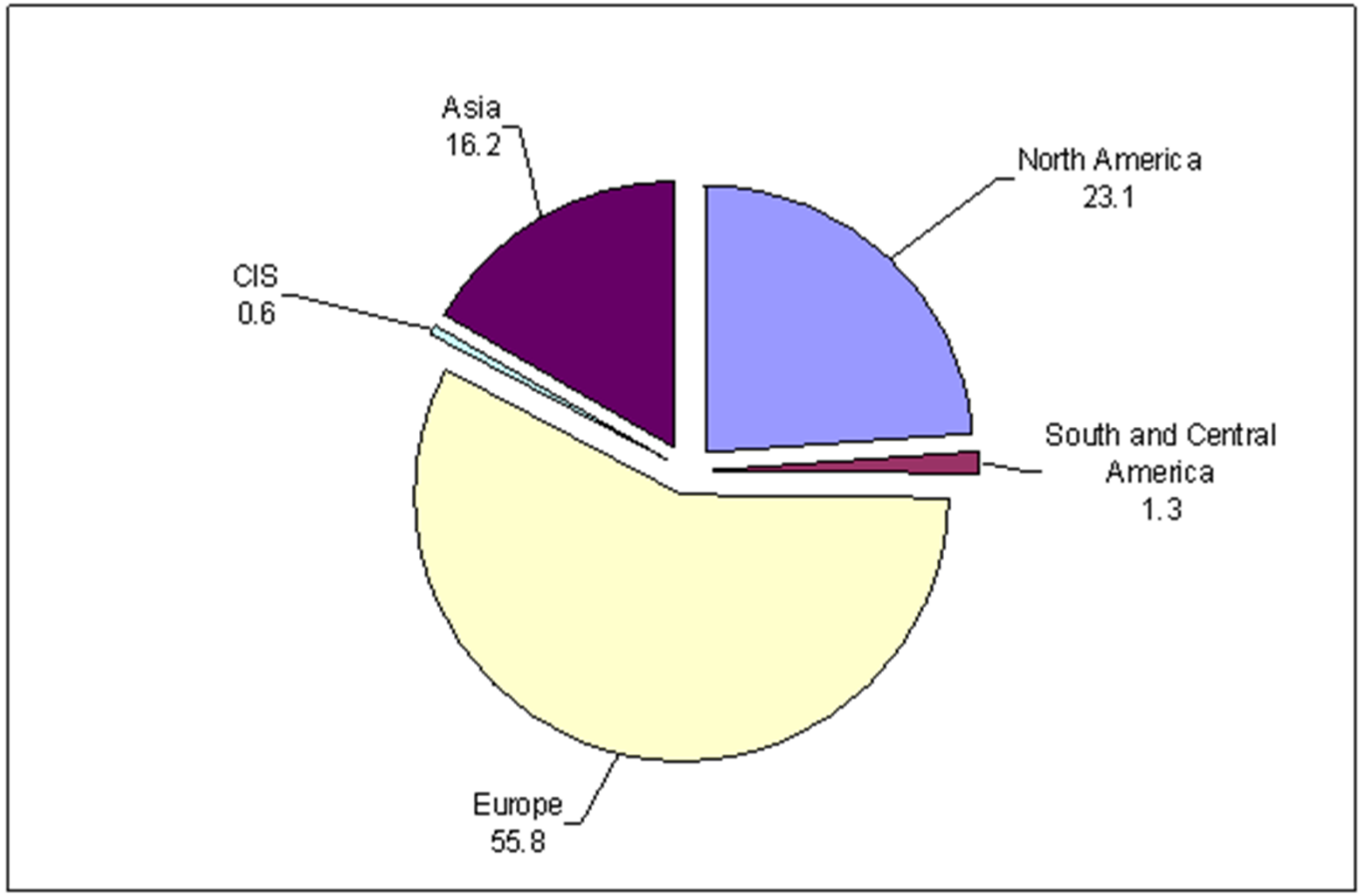
Trends in Financial Services

- Financial services are an essential component of infrastructure
  - Financial development contribute to output growth (up to a level – eg. Marginal contribution becomes negative when the credit to the private sector reaches 110% of GDP (Panizza)
- Financial services are the largest component of infrastructure services
  - $3.2 trillion globally (or 5% of the world GDP), $0.5 trillion in developing countries (2.7% of GDP)
  - DCs' share is relatively small & represent 17% of the world output
- World trade in financial services has expanded rapidly
  - 10% of total world services exports & 5% of DCs' total services exports (2009)
- DC participation has increased but only to a limited extent to***14.7% in 2009***
- Significant potential to be realized
  - DCs' have specialized less in financial services exports than developed countries, & their share in FS exports remains below their share in merchandise exports (44%) = low specialization
  - FS exports are yet to fully recover the pre-crisis levels
  - Developed countries remain predominant exporters (EU= 56%, North America = 23%). Asia also significant.

World Exports of Selected Services Categories (2008Q3=100)



World Financial Services Exports by Region (2010)



Major Financial Services Exporters (2010)

	Share in top 10	Export Growth Rate (%)	
	2010	2005-09	2010
European Union (27)	53.0	8	1
United States	23.9	9	5
Switzerland	23.6	4	-2
Hong Kong, China	6.4	16	12
Singapore	5.1	20	31
Japan	4.9	-1	-25
India	1.5	34	64
Canada	2.4	7	31
Korea, Republic of	1.3	8	25
Norway	1.2	21	-13

The Role of Financial Services

- **Instrumental for growth & development**
  - Mobilize resources for efficient allocation for productive investment, including through risk diversification and risk management ("maturity transformation")
  - Facilitate the exchange of goods and services by reducing transaction costs, including by providing insurance against low probability but high-cost events
  - Improve capital allocation through the production of *ex ante* information about investment opportunities
  - Increase investors' willingness to finance new projects through *ex post* monitoring and corporate governance
- **Can be a means for speculation without directly contributing to economic development**
  - Excessive & unwarranted deregulation could result in "casino" activities without link to real economy
  - Financialization through securitization, financial trading & new financial instruments
  - Disconnected from the original purpose of FS
  - Financial innovation & globalization also generated trends towards uniform financial structure around the world

Evolution in the Financial System

- **Financial markets are prone to market failure (Information asymmetry, externality & imperfect competition), as well as herd behaviour & self-fulfilling prophecies**
- "Efficient" financial markets did not work in reality because:
  - Financial markets are plagued with uncertainty rather than quantifiable risks, can **create cost for society**
  - De-regulation has led to increasing **concentration** of banking activities & unregulated **"shadow banking system"** (holding liabilities of $20 trillion in the US by 2010 as compared to $11 trillion held by traditional banks)
  - Traditional commercial banks gave way to **investment banks**, relying more on capital markets, short-term basis, & **new financial instruments** (securitization)
- Despite the governments/CB' role as **the lender of last resort** (liquidity support & capital injection in time of crisis, deposit insurance), governments' **regulatory supervision** was not sufficient to curb risk-taking by the financial sector

The Role of Financial Regulation

- **Financial deregulation & regulatory failure as a major factor behind the financial crises**
  - Pro-cyclical bias in Basel frameworks
  - High concentration of markets & oversized banks
  - The cost of regulatory failure (e.g., the crisis-related loss of €1 trillion to European banks 2007-2010)
- **Case for post-crisis re-regulation, regulatory reform & financial restructuring**
  - To restore the original function of FS to support productive activities in the real economy
  - To enhance the contribution to growth & employment, in DCs & SMEs
  - To enhance resilience & diversity of FS (public & cooperative banks, separation of investment vs commercial banks)

Financial Regulatory Reform (1)

- Reform efforts at national, regional & global levels
- Aimed at expanding regulatory supervision & transforming micro-prudential supervision of individual banks into macro-prudential supervision
  - Include macro & micro-prudential objectives
  - Internalize negative externalities by individual banks (“shadow banking”, derivatives trading)
  - Improved bank capital & liquidity standards to enhance bank’s resilience to financial shocks (Basel III; IAIS)
  - Separation of retail banking from investment banking
    - “Volcker rule” – Prohibit proprietary trading
    - UK’s Vickers Commission - “Ring-fencing” retails banking from investment banking

Financial Regulatory Reform (2)

- **Systemically important banks (G-SIBs)** = “too big to fail”
  - Implicit government subsidies ($60 billion)
  - Reduce probability of failure through increased capital requirements
  - Mitigate impact of failure through *ex ante* safe resolution regimes
- Proposed **financial transaction taxes** (eg, EU) to internalize risk-taking by individual banks (institutional solidarity mechanism)
- **Economic cost of regulatory reform** (higher cost, reduced credit) to be offset by gains from lower probability of a financial crisis
  - G-SIB framework to provide annual benefit of 40-50 bp to GDP
- Banks focused on **traditional banking** resilient to the crisis
  - The **diverse financial institutions** cushions the system from shocks & is more effective in serving growth and equity
  - **State-owned bank, national development banks, community banks**
    - Provide productive investment, reduce the cost of services (e.g remittances) & serve for financial inclusion
    - Can compensate credit crunch, support activities that bring greater social benefits, & promote competition in situations of oligopolistic private banking structure
  - Example **–** Brazil’s correspondent banks supported by postal networks facilitating financial integration

Development Implications

- Despite long-term gains, adverse effect from possible increase in the cost of credit & lower availability
  - More stringent information requirements increases cost of business (e.g., significant fall in trade financing for DCs)
  - Higher capital requirements increase the cost of holdings in emerging markets' banks, reduces cross-border investment and lending
  - New risk weights could render loans to SMEs/ project finance more costly
  - Regulatory requirement of parent bank transferred to subsidiaries
  - Uncoordinated tighter rules may lead to “jurisdiction shopping", making DCs more exposed to international volatility
- Importance of ensuring linkage between real economy & financial sector & development objectives
  - Traditional banking (community, public & development banks) (eg Brazil), prudent regulatory approaches, Islamic finance (eg. Indonesia)
  - Universal access obligations (eg. India’s licensing scheme)
- Need to adjust the rules to national circumstances (financial & regulatory sophistication)
  - Implementation of the new rules should not risk DCs financial stability & developmental objectives
  - Many DCs yet to adopt Basel II, Basel III not mandatory

Towards a "Best-Fit" Regulatory Regime (1) Examples of India

- India further strengthen its financial regulatory regime based on macroprudential regulation, centered around the expanded role of the central bank
  - In 2004, the Reserve Bank of India included financial stability in its objectives, bringing macroprudential regulation within its scope
  - The Reserve Bank has substantially extended the regulatory regime to include, among others, rules covering the management of exposures to risk, permission for new financial products (derivatives), regulatory capital requirements, shadow banking, securitization and OTC derivatives transactions.
  - Reformed rules have been accompanied by strengthened guidelines for supervision, and of new institutional arrangements for the coordination of different sectoral regulators, most recently in the form the Financial Stability and Sector Development Council.
  - The Financial Stability and Development Council was to address issues relating to financial stability, financial sector development (including financial literacy and inclusion), inter-regulatory coordination, macro-prudential regulatory framework (including regulation of SIFIs) and interface with international regulatory bodies.
- Given limited regulatory skills, small economic size and the centrality of the central bank in financial regulations, it was deemed adequate to have several regulatory functions concentrated in the central bank

Towards a "Best-Fit" Regulatory Regime (1) Examples of China

- To develop its financial sector in a post-crisis period & make China's banking industry more competitive and efficient, China set supervisory goals in accordance with new international standards
  - Some of standards were set even at a higher level (eg, capital adequacy, loan loss provisioning, liquidity coverage ratio). Counter-cyclical buffers & tighter regulations on SIFIs also introduced
  - The China Banking Regulatory Commission (CBRC) supervised all banking institutions' operations
  - CBRC also contributed to increasing public knowledge about modern financial products, services and the related risks, and combating banking-related crimes.
  - CBRC combined consolidated and risk-based supervision with risk management and internal control systems, enhanced transparency
- Measurable improvements in terms of total assets/capital, profits and return on capital/assets of the banking industry
  - By end of 2010, 84 Chinese banks were among world's top 1,000 banks compared with 15 in 2003
  - Service quality also improved, evolving from a products-focused to a customers-focused approach, and from wholesale banking services to diversified banking services.

Financial Inclusion – Example of Remittances

- **High DC dependence on remittances**
- **The formalization of remittance** as a precondition for channeling remittances to productive uses
  - Financial education and financial inclusion
  - Financial education could raise awareness of and trust in the financial instruments to be used in remittance flows, and could promote a culture of savings & entrepreneurial skills
  - Diversity of financial providers can be leveraged for financial inclusion – postal services, community banks
- **Remittance flows can be improved by financial sector development**
  - High transaction costs, lack of financial access including due to financial illiteracy, the use of informal channels, low levels of competition in the money transfer markets (e.g. exclusivity agreements), taxation on remittance transactions, and information asymmetry were serious impediments to remittance flows.(G-20 had set the reduction of remittance costs as one of its targets in its multi-year action plan)
  - Informality arises as many migrants do not have bank accounts & remittances can take diverse forms (e.g. informal credit and remittances in kind)
  - Need to make formal channels more accessible, affordable, efficient, competitive, user-friendly and transparent

Financial Services under the ITS (1)

- **Issue** - Should financial services liberalization be pursued given that financial bailout created distortion and costs; financial services are already open; liberalization is difficult to be canceled?
  - Greater case for prudential / precautionary regulation
  - Focus on host country regulation, requiring foreign banks to establish subsidiaries rather than direct branches (eg. Russia's WTO accession commitments)
- **Financial bail-out led to distortion / concentration**
  - Large government support to financial sector in developed countries (0.8%-18.9% of individual GDP) while many DCs lack fiscal capacity to provide such support
  - Led to consolidation/concentration of large institutions, rescued unviable institutions
  - Subsidies mostly unregulated by GATS: No explicit definition of subsidies under GATS & measures considered to fall within prudential carve-outs

Financial Services under the ITS (2)

- **Flexibility under trade agreements for new regulation ("right to regulate")**
  - Need for adequate content, pace & sequence
  - Concern with the exact scope of prudential "carve-outs"
  - Concern that GATS commitments may limit the DC ability to introduce capital control (implied by Modes 1&3 commitments)
- **Possible regulatory reforms may conflict with GATS provisions** (eg, market access)
  - Proposed financial transaction tax, *de facto* separation of commercial & investment bank, DC ability to regulate large foreign firms
  - FS Understanding – standstill, new financial services affecting reregulation (replicated in WTO accession & RTAs)

Conclusion
Lessons from UNCTAD's MYEM discussions

- Financial services regulatory framework
  - Address the diversity of suppliers – Public, community or regional banks can support resilience & bring greater social benefits (eg. China)
  - Be anchored in a comprehensive development strategy coherent with accompanying policies
  - Adapt to local realities, economic & technological evolutions - Need for national regulatory frameworks to match with financial sophistication and regulatory skills (eg. India's regulatory approach)
  - Compensate market failure (by promoting competition) & address clearly defined social objectives (eg. Brazil)
  - Regulators need to be independent, transparent & credible
  - Privatization & liberalization of ISS need to be preceded by the establishment of RIFs & national capacity
  - MTS & RTAs to factor in public policy goals of RIFs
- The way forward
  - Governments to be equipped with capacity & skills to regulate, monitor & enforce RIFs
  - Building human, regulatory & institutional capacity is a major DC challenge
  - All forms of partnerships to be leveraged, incl South-South cooperation
  - Further research, impact assessment, services policy reviews for best practices and best-fit RIFs

THANK YOU

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