Financial Liberalization in East Asia: Lessons from Financial Crises and the Chinese Experience of Controlled Liberalization

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Financial Liberalization and Regulation in East Asia: Lessons from Financial Crises and the Chinese Experience of Controlled Liberalization

Jiangyu Wang

I. Financial Liberalization: The Relationship between Capital Flows and Financial Services Trade
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This paper studies the experiences of East Asian countries in conducting financial liberalization. Financial liberalization has two components, which are capital account liberalization and financial services liberalization. It is important to stress that the two components should not be confused, so are their respective consequences on a country’s economic growth and financial stability. Both the theoretical and empirical studies have established that premature capital account liberalization was the direct cause of various financial crises, including the 1997-98 Asian Crisis. It is highly advisable that countries delay capital account liberalization or maintain capital controls before they put into place effective domestic regulatory framework and financial infrastructure. Based on the experiences of Malaysia and China in managing the Asian crisis, the paper argues that, in addition to having appropriately sequenced, gradualist reforms on capital account liberalization, a country should keep certain regulatory space for itself and maintain independently the financial policy-making power.

However, financial services liberalization should not be retarded by these factors. An analysis of the four modes of GATT’s services supplies suggests that trade in financial services does not necessarily involve massive capital flows and that financial services liberalization does not require abandonment of capital controls. Financial services liberalization improves the capabilities of a country’s financial sector, enhances efficient capital reallocation, and brings tremendous benefits to consumers. Moreover, unlike capital account liberalization, trade liberalization in financial services will not contribute to financial instability and crises. The paper surveys the liberalization measures of financial services in selected Asian countries and concludes that more broad-based liberalization should be promoted. The paper argues that, however, it is understandable that a country wishes to provide certain protection to its domestic financial services sector at the initial stage of its development. After all, no country is born with a strong financial industry. However, the government providing protection should be wise enough to know at which point the protection should be terminated. In this regard,

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Singapore’s experience of developing into a leading international financial center is an illustrating example.

I. FINANCIAL LIBERALIZATION: THE RELATIONSHIP BETWEEN CAPITAL FLOWS AND FINANCIAL SERVICES TRADE

In the discussion of financial liberalization a distinction needs to be made between capital account liberalization and financial services liberalization. Confusion arises frequently, especially in the post-Asian Financial Crisis (1997-1998) era, when the debate on the causes of the crisis did not recognize the difference between cross-border capital flows and the financial services transactions through which capital is transferred between countries.1 The Asian Crisis happened in an age featuring enormous expansion of international capital flows and dramatic market opening to foreign financial services providers. Naturally, much blame was drawn on the massive financial liberalization programme implemented by countries in this region.2 To a large extent this allegation is not totally unfounded: premature financial liberalization was one of the major factors responsible for East Asia’s sudden descent into the 1997-1998 financial crisis.3 However, populist resentment against the entirety of financial liberalization can be easily mobilized if the distinction between the free flow of capital and the trade in financial services is not made clear.

Capital Flows and Capital Account Liberalization

Capital flows involve the cross-border movement of capital. Capital inflows occur when there is a receipt of payment from foreigners, including an increase in foreign assets in the country or a reduction in the country’s assets abroad. Capital outflows, on the other hand, take the form of either an increase of the country’s assets held abroad or a reduction in foreign assets in the country, both involving a payment to foreigners. In the country’s balance of payment statement, those credit and debit items arising from the inflow and outflow of capital in the course of international receipts and payments, including direct investment, loans, and securities investment, are recorded under the “capital account”, as opposed to the “current account” which records the transaction items recurrent in the course of international exchange of goods and services as well as unilateral transfers.4

The post-World War II period has a long history of control over capital account transactions. Many developed countries retained certain forms of capital control until the 1980s. In many developing countries, capital controls are used to limit short-term capital inflows. Although the tools of capital controls are wide-ranged and diversified,

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they can be broadly categorized into two types: (1) “administrative” or direct controls and (2) “market-based” or indirect controls. Measures of first type “restrict capital transactions and/or the associated payments and transfers of funds through outright prohibitions, explicit quantitative limits, or an approval procedure.” Market-based controlling measures often “discourage capital movements and the associated transactions by making them more costly to undertake” through various forms such as dual exchange rate regimes or taxation of international capital flows.

When a country removes the restrictions on cross-border capital movement, it can be said that this country has conducted capital account liberalization, which can be defined as “freedom from prohibitions on transactions in the capital and financial accounts of the balance of payments.”

**Trade in Financial Services and the Role of GATS**

The importance of the financial services sector as well as financial services trade in the economy should never be underestimated. The financial services sector is important on its own: its accounts for a significant share of total employment in many countries, ranging from 3 percent in France, Canada and Japan to 5 percent in Singapore, Switzerland and the U.S. Value-added in the financial services sector as a share of GDP reached, by the mid-1990s, 13.3 and 7.3 percent in Switzerland and the U.S.. For emerging economies like Singapore and Hong Kong, the value-added share of financial services in GDP is roughly above 10 percent. However, as a WTO study points out, this sector is far more important than its direct share in the economy implies:

Financial services are the backbone of modern economies. It is difficult to think of any economic activity, except perhaps those that remain largely outside the money economy in less well-off countries, that does not depend in a significant way (either directly or indirectly) upon services provided by the financial sector.

International trade in services, including financial services, is governed by the General Agreement on Trade in Services (GATS) under the auspice of the World Trade Organization (WTO). Ranking among the chief achievements of multilateral trade diplomacy at the end of the 20th century, GATS “for the first time extends internationally-agreed rules and commitments, broadly comparable with those of the GATT, into a huge and still rapidly growing area of international trade”. The GATS consists of three core components. The first is its main text, containing general obligations and disciplines. Second, the annexes to GATS dealing with rules for specific sectors (transportation, financial services, telecommunication, etc.). The third part

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6 ibid. 7.
7 ibid.
9 M Kono et al ‘Open Markets in Financial Services and the Role of the GATS’ (Special Studies No. 1 WTO September 1997) 7.
10 ibid.
11 ibid.
concerns individual countries’ specific commitments on market access. The reach of GATS rules extends to all forms of international trade in services, except those relating to air traffic rights and services supplied in the exercise of governmental authority. GATS defines the term “trade in services” in terms of the so-called “modes” of supply of services, the understanding of which is essential for distinguishing cross-border capital flows and financial services trade.\(^{13}\)

- **Mode 1**, known as “cross-border supply,” refers to the supply of services “from the territory of one Member into the territory of any other Member.”
- **Mode 2**, officially known as “consumption abroad,” is the supply of services “in the territory of one Member to the service consumer of any other Member.”
- **Mode 3**: labelled as “commercial presence”, is the supply of services “by a service supplier of one Member, through commercial presence in the territory of any other Member.”
- **Mode 4**, the “presence of nature persons”, is the supply of services “by a service supplier of one Member through presence of nature persons in the territory of any other Member.”

As noted by the WTO, this comprehensive definition of trade in services set out by GATS “is crucially important” since it “helps in understanding the special problems and regulatory issues that arise in international trade in services, and that have shaped the principles and rules embodied in the GATS, as well as the specific commitments that WTO members have undertaken in their schedules”.\(^{14}\) Further, it has become the standard understanding of services trade in the international arena and “the key to much of the jargon habitually used by negotiators and others at home with the GATS.”\(^{15}\)

**Relationship between Capital Flows and GATS Obligations on Financial Services**

Trade liberalization in financial services under GATS does not necessarily entail capital account liberalization. GATS defines a financial service as “any service of a financial nature offered by a financial service supplier of a [WTO] member,” which include “all insurance and insurance-related services, and all banking and other financial services (excluding insurance).”\(^{16}\) However, under certain circumstances financial services trade and international capital flow may overlap. Using the examples of commercial lending by domestic or international banks to domestic clients Table 1 demonstrates the basic differences between capital flow and trade in financial services.\(^{17}\)

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\(^{14}\) WTO 1999 (n 11) 2.

\(^{15}\) ibid.

\(^{16}\) GATS (n 13), Annex on Financial Services, Art. 6.

Table 1: Comparison of International Capital Flows and Financial Services Trade

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<th>Domestic capital only</th>
<th>International capital only</th>
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<tr>
<td><strong>Lending by domestic bank</strong></td>
<td>(a) Neither international capital flow nor financial services trade</td>
<td>(b) International capital flow only</td>
</tr>
<tr>
<td><strong>Lending by foreign bank abroad</strong></td>
<td>(c) Financial services trade only</td>
<td>(d) International capital flow and financial services trade</td>
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<tr>
<td><strong>Lending by foreign resident bank</strong></td>
<td>(e) Financial services trade plus inward FDI</td>
<td>(f) International capital flow, financial services trade, and FDI</td>
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As can be seen from the table above, pure cross-border capital flow is involved when a domestic supplier (i.e. a bank) provides a loan to a domestic client using foreign money, which is what is illustrated in situation (b). If an overseas established foreign bank lends to domestic clients using capital in the clients’ country, as situation (c) shows, this is financial services only, involving no international capital flow. Situation (d) is one activity involving both capital flow and financial services trade, as it is that a foreign established bank provides lending services to a domestic client using foreign capital. Situations (e) and (f) demonstrate that the lending activities by foreign funded banks incorporated in the host country to domestic clients can be either financial services trade only, or a combination of financial services trade and international capital flow, depending on whether foreign capital is used.

It is the essence of the distinction between financial services liberalization and capital account liberalization that the former does not necessarily entail the latter. Under GATS, mode 1 related market access commitments by a WTO Member will require that Member to allow cross-border movement of capital only if the capital flow is “an essential part of the service itself.” That is to say, the capital should only be used to operate the liberalized service, but it cannot be the subject matter of the said service. Regarding mode 3 (commercial presence) commitments of a Member, GATS mandates that the Member “is thereby committed to allow related transfer of capital into its territory.” Note that only capital inflow, but not capital outflow, is allowed under this provision. It is however not clear, as it is not further specified in GATS rules, “whether this refers only to capital and equipment to ‘set up shop’ or whether this also includes capital inflows related to service provision.” Either way, it does not refer to the liberalization of the subject matter of the services which is the international capital not related to the service itself, i.e. a loan to be transferred through the service of a financial institution.

In summary, respecting the relationship between financial services liberalization and capital account liberalization the following conclusions can be drawn:

18 GATS, footnote 8.
19 ibid (emphasis added).
20 Kono and Schuknecht (n 1) 5.
• Financial services liberalization and capital account liberalization are basically two separate things; even a full liberalization in financial services does not imply full capital account liberalization.
• Opening up of financial services market can co-exist with capital controls.
• Nevertheless, capital account liberalization and financial service liberalization are closely linked in economic sense as “they are both elements of an efficient, market-based economy.”

II. CAPITAL ACCOUNT LIBERALIZATION: LESSONS FROM FINANCIAL CRISES AND COUNTRY EXPERIENCE

Capital Account Liberalization and Financial Crises

Capital account liberalization enables international capital mobility, which, according to economists, will generate some classic benefits generally because free capital movements “permit a more efficient global allocation of savings and direct resources toward their most productive uses.” Specifically, capital mobility brings about the following major benefits. For one, as a tool of efficient allocation of resources, capital flow represents the trade of money between two countries – “they allow a country that has excess savings in a given period to transfer these savings to another country which has excessive investment opportunities.” Secondly, capital movement enables risk diversification. “By holding claims on foreign countries, households and firms can diversify risks associated with disturbances that impinge on the home country alone.” Thirdly, capital inflow in many cases is associated with gains from foreign direct investment (FDI), which might be technology, know-how, managerial expertise, access to markets, etc.

The classic benefits argued in favor of capital movement liberalization are however weakened by the intrinsic deficiencies of financial markets arising out of two factors: the presence of asymmetric information and domestic distortions. Asymmetric information occurs when “one party to an economic relationship or transaction has less information about it than the other party.” There are three consequential problems under asymmetric information: adverse selection, moral hazard, and herding behavior. Asymmetric information gives rise to adverse selection because “lenders have incomplete knowledge of borrower quality and borrowers who are bad credit risks have a strong incentive to seek out loans.” Thus because of this “a liberalized capital market will not deliver an efficient allocation of resources.” Moral hazard is created when the benefits and risks are borne asymmetrically between the parties to a transaction. Thus “borrowers will wish to invest in relatively risky projects in which they do well if the project succeeds

21 ibid.
22 Eichengreen (n 8) 12.
24 Eichengreen (n 8) 12.
25 Williamson (n 23) 6.
26 Eichengreen (n 8) 14.
27 ibid 3.
28 ibid 13.
29 ibid.
but the lender bears most of the loss if the project fails.\footnote{ibid.}
This discourages lenders to make loans and hence retard capital mobility. Asymmetric information is also the source of the so-called herding behavior of investors. Investors in financial markets tend to come and leave together. Thus despite that many financial text books suggest the assumption that international capital market is efficient, herd behavior demonstrates that investors’ decisions are not always rational and they are influenced irrationally by those of others. Herding behavior leads to sudden market movements and volatility.\footnote{ibid.14}

Benefits of capital mobility are also weakened by the presence of domestic distortions. In many developing countries, labor is abundant while capital-intensive sectors are protected by government policies. “Because of protection of these relatively capital-intensive industries boosts the rate of return on capital invested in the country, capital will flow in, leading to capital-intensive sectors to expand and labor-intensive sectors to contract.”\footnote{ibid 14.} This obviously magnified the situation of misallocation of resources that already exists.

The intrinsic deficiencies of free capital movement provide channels through which financial crises may be caused or amplified. The herding effect in the 1997 Asian Financial Crisis is a good example. Although the five affected nations (South Korea, Indonesia, Malaysia, Thailand and Philippines) received tremendous net capital inflow in the previous years (e.g. 93 billion in 1996), they suffered, for the first time in many years, a net outflow of capital of 12 billion in 1997, and even more in 1998.\footnote{Asian Development Bank (ADB) \textit{Asian Development Outlook 1998} (ADB Manila 1998) 33.}
The herding behavior is accompanied and magnified by massive short-term capital flows that was usually the direct cause of financial crises. As Lawrence Summers observed:

> I have been struck … as we have looked at the various crises, that in almost every case where those problems appear most central, policy created a substantial bias in favor of short-term capital flows, whether through the issuance of short-maturity debt with Mexican Tesobonos, through tax breaks for short-term offshore bank deposits in Thailand, through the tailoring of financial instruments to be perfectly attuned to hedge fund preferences as with the Russian GKO treasury bills, through discriminatory capital controls that favor short-term capital and oppose long-term capital in the Republic of Korea.\footnote{L H Summers ‘Six Questions for Development Researchers and Policymakers’ in B Pleskovic & J Stiglitz (eds) \textit{Annual World Bank Conference on Development Economics 1999} (World Bank Washington DC 2000) 21, 22.}

John Williamson, the former Chief Economist of the South Asia Region of the World Bank, examined in a lecture at the WTO the following popular explanations about how the East Asian countries got into the crisis\footnote{Williamson (n 23) 11.}: (1) cronyism; (2) exchange rate policy; (3) weak macroeconomic fundamentals; (4) open capital account; (5) poor regulation and supervision of financial institutions; (6) lack of transparency; and/or (7) weak banks. He then put Asian countries which experienced the crisis into two groups. Those that succumbed to the crisis and had negative growth in 1998 are Indonesia, Korea, Malaysia, Thailand and Hong Kong. Those that survived the crisis with positive growth in 1998
were Bangladesh, China, India, Nepal, Pakistan, Sri Lanka, Taiwan and Viet Nam. Asking what distinguishing the two groups, Williamson reasoned and concluded:

Was cronyism more of a problem in Hong Kong than in Bangladesh? Were the banks weaker in Indonesia than in China? Were the macroeconomic fundamentals worse in Korea than they were in India? Was regulation and supervision of financial institutions weaker in Malaysia than in Nepal? Was transparency less in Thailand than in Pakistan? Quite evidently, none of these explanations work. The only explanation that works systematically is the openness of the capital account. Hence I conclude that it was the openness of the capital account that created the vulnerabilities which permitted the financial crisis to spread in the way we saw in East Asia.  

Nobel laureate Joseph Stiglitz reached the same conclusion:

I believe that capital account liberalization was the single most important factor leading to the [Asian Financial] crisis. I have come to this conclusion not just by carefully looking at what happened in the region, but by looking at what happened in the almost one hundred other economic crisis of the last quarter century….. it has also become increasingly clear that all too often capital account liberalization represents risk without a reward. Even when countries have strong banks, a mature stock market, and other institutions that many of the Asian countries did not have, it can impose enormous risks.37

Thus an IMF study hints that domestic and international financial liberalization, “if not supported by consistent and rigorous prudential supervision and regulation and appropriate domestic macroeconomic policies,”38 will heighten the risk of crises.

**Dealing with Financial Crisis: Country Experiences of Capital Controls**

As noted previously, countries can impose capital controls, including administrative or market-based measures, to restrict cross-border capital flows. 39 Theoretically, capital controls can be justified on the grounds that they can improve economic welfare by curing financial market imperfections resulted from asymmetric information. 40 Eventually, restrictions on capital account can be used to protect the stability of the financial system through, most significantly among a variety of policy means, imposing limit on short-term capital flows. This includes especially capital outflow control during financial crises. As an IMF study points out, there are multiple motivations for imposing capital outflow control during financial crises:

|\[S\]uch restrictions have mainly been applied to short-term capital transactions to counter volatile speculative flows that threatened to undermine the stability of the exchange rate and deplete foreign exchange reserves. These restrictions have also served at time as an alternative to the prompt adjustment of economic policies and

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36 ibid 10 (emphasis added).
38 Eichengreen (n 8) 21.
39 Texts to n 5, 6, and 7.
thus helped the authorities “buy time.” They have also been employed to insulate the real economy from volatility in the international financial markets.41

Countries including China and Malaysia had imposed stringent capital controls during the Asian Crisis. The following parts examine the experiences of these two countries in respect of capital account liberalization and control.

1. Malaysia. Before the Asian Crisis Malaysia had a highly open economy which started capital account liberalization as early as 1968.42 For years prior to September 1998 Malaysia liberally allowed cross-border transactions of the ringgit, Malaysia’s currency in offshore markets. Portfolio capital inflows and portfolio outflows for corporate residents with domestic borrowings were both unrestricted, so were foreign debt activities of authorized dealers and merchant banks. Inward foreign direct investment was encouraged and outward foreign direct investment was not subject to any substantial restriction.43

When the Asian Crisis occurred, a number of East Asian countries came to seek help from the IMF. Malaysia was one of them.44 Malaysia initially followed the suggestions of the IMF, as did Thailand, Indonesia and Korea. However, as Kaplan and Rodrik (2001) observed, “the Malaysia economy failed to respond to the orthodox policies” and the financial crisis deteriorated in that country.45 In September 1998, a year after the start of the crisis, Malaysia altered its policies by imposing capital control and other financial measures, including significant reduction of interest rate to provide the supply of funds, reduction of statutory reserve requirement to increase liquidity, expanded government spending, and fixed exchange rate. Significantly, in terms of financial regulation, introduced were measures including shutting down offshore trading of Malaysia currency, the ringgit, restrictions on capital flows, particularly short-term capital flows for foreigners and local citizens, creation of state-backed institutions to deal non-performing loans and recapitalize troubled financial institutions, as well as ceiling restrictions on foreign ownership of assets.

It is not to say that all the measures taken by Malaysia during the Crisis were appropriate. However, those measures were proved be largely suitable for Malaysia’s economic situation and helped the country recovery from the crisis.

2. China. The Chinese economy has achieved one of the world’s fastest growth rates in the past two and half decades, even during the period of the Asian Crisis, which plunged many of Asia’s once vibrant economies, used to decades of rapid growth, into deep recession. As noted previously, to a large extent, financial crises were caused by short-term capital flow, which reflects the tension between a rapid buildup of bank credit and a significant deterioration of loan quality.46 In a run-up to the 1994 Mexico Peso Crisis, bank credit to the private sector increased from 13 percent of Mexico’s GDP in 1988 to 36 percent in 1994. Similarly, “the Thai financial crisis that emerged in the

41 ibid 18.
42 ibid 94.
43 ibid 95-96.
44 Others were Indonesia, South Korea, and Thailand.
46 Text to n 34 and 35. See also N. Lardy China’s Unfinished Economic Revolution (Brookings Institution Press Washington D.C. 1998) 194.
summer of 1997 grew out of a five-year period in which bank lending expanded at an annual rate of 25 percent, three times the rate of real economic growth. China was no better prior to the Asian Financial Crisis. The run-up in credit by financial institutions in China was by no means slower and had been accumulated for twenty years. China’s banks, due to the notorious existence of non-performing loans, were faced with systemic problems. Despite the excessive reliance on expanding bank credit, China has largely escaped the 1997-98 crisis and has not yet so far experience any financial crisis.

Lardy concludes that, “in the short run, China is unlikely to experience a crisis like that of Mexico in 1994-95 or that of several Southeast Asian countries and Korea in 1997” because of five reasons, most of which are related to government control on the pace and sequence of financial liberalization and domestic financial regulation. First—and foremost, China’s capital account was strictly controlled—namely China’s currency, the Renminbi, is not convertible for capital account transactions. Therefore, the possibility of moving funds out of China in the expectation of a crisis is very limited. This restriction also closed substantially the door of China’s domestic stock market to foreigners, meaning that they were not able to trade renminbi-denominated shares (“A shares”) on China’s stock exchanges. Instead, foreign investors who were interested in China’s capital markets could only purchase and trade the so-called B shares of the same underlying company, which, subscribed in foreign currency and traded in the very small B shares Market, is isolated from the A shares market. The effect is that, would-be sellers were not able to exist the market unless they found a foreign buyer who will pay U.S. or Hong Kong dollar for their shares. In contrast, in other Asian countries during the crisis, “foreign portfolio managers all rushed for the exits simultaneously, contributing to a sharp decline in local currency shares.” They also contributed to the plummet of currency values of these countries by dumping the local currencies in order to run away.

China’s various laws on foreign exchange control also limited speculative activities in the foreign exchange markets. Second, for two decades, foreign direct investment had been the predominant form of capital flow into China. “Direct investors differ fundamentally from financial investors since they invest with a long time horizon and their investments are illiquid.” Third, a majority of China’s external debt was medium and long term. Fourth, China had record trade surpluses for a number of years prior to the crisis, eliminating the need for finance trade deficit with foreign capital inflow. Finally, prior to the crisis, China had amassed huge foreign exchange reserves, enough to finance a full year of imports. In short, “the limited ability of foreign speculators and lenders to precipitate or even contribute to crises seems, at least superficially, to be to China’s advantage compared with countries with capital account convertibility.”

**Policy Implications on Capital Account Liberalization**

(1) **Preserving National Regulatory Space and Flexibility on Capital Account Regulation.** To offset the native impact of liberalization, it is important for national governments to preserve some regulatory space and flexibilities in their own hands. For example, individual governments need to keep the power to regulate—and restrict if necessary—short-term capital flows as well as the herding behavior. This is worth reminding because national

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47 Lardy (n 45) 194.
48 ibid 195.
49 ibid 197.
50 ibid 198-199.
governments are often under international pressure to take more liberal approach to deal with the problems they face. In this regard, the experiences of both Malaysia and China in dealing with the Asian Crisis provide valuable lessons. Although it was suggested Korea and Thailand, receiving the IMF’s reform package almost in full, recovered in parallel from the Crisis, using a time-shifted difference-in-difference technique, Kaplan and Rodrik (2001) found that, "compared to IMF programs, the Malaysia policies produced faster economic recovery, smaller declines in employment and real wages, and more rapid turnaround in the stock market." Stiglitz (2002) also noted that “though Prime Minister Mahathir’s policies – trying to keep interest low, trying to put brakes on the rapid flow of speculative money out of the country – were attacked from all quarters, Malaysia’s downturn was shorter and shallower than that of any of the other countries.”

One of the lessons can be learnt from the Malaysia experience is that, according to one commentator, “having policy space and flexibility is important to a developing country” in order to offset the negative aspects of the one-size-fits-all policies of some international organizations.

China’s experience during the Crisis is also an example supporting national regulatory space and flexibility. As the Chinese experience shows, apart from the strong surplus in current accounts as well the medium and long term nature of its external debts, China’s regulatory measures implemented – to restrict capital flow – before and during the Crisis played a significant role in minimizing the risks posed by the Crisis to China.

It is important to stress that the preserved regulatory space should not be abused. It should however be used only when the maximum gains can be realized and the risks can be minimized. For example, fearing of the herding effect should not be used also as an excuse to delay the introduction of competition at least from the domestic private sector. If the said space is used to implement restrictive regulations, the national government concerned should be wisely advised to know the delicate point where it should relinquish those restrictions. In the Malaysia case, the government made changes in controls a few months after they were implemented. As of 15 February 1999, the year-long moratorium on repatriation of investments were abolished. In July 1999, Malaysia unilaterally relaxed its regulation restricting offshore bank’s capacity in lending in local currency, thus allowing some of them to grant medium- to long-term financing denominated in ringgit to specific groups of resident companies. Restrictions in other aspects were also gradually – albeit to a limited extent – liberalized thereafter. In the case of China, it employed the time saved by the restrictive measures to introduce prudential and risk management regulations in the financial sectors, laying the foundation for a more market-based financial regulatory framework. China’s financial markets were also significantly opened after the Crisis, to a large extent as a result of its WTO accession. In fact, China’s banking sector will be fully liberalized by the end of 2006.

(2) Pace and Sequencing of Liberalization of Capital Account. Having mentioned the usefulness of regulatory space and flexibility, it is still important to stress that efforts to preserving

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51 Kaplan & Rodrik (n 44) in “abstract”.
52 Stiglitz (n 37) 93.
54 WTO “Schedule of Specific Commitments on Services of the People’s Republic of China”, WTO Doc No. WT/MIN(01)/3/add.2 (hereinafter China’s Services Schedule).
national regulatory space can never be made for the sake of preserving that space. After all, voluminous literature has established that both developing and developed countries can realize potential gains from capital mobility. The key points are that the pace and sequence of liberalization should be carefully designed and that appropriate regulatory space should be preserved for the national government involved.

The pace (or speed) of reform refers to the time elapsed from the initiation of the reforming measures to the point that they are made operational and accepted in general. The sequencing of reforms means “the order in which either macroeconomic policy actions or specific reforms are introduced.” \(^{56}\) With respect to the pace of reform, there are two suggested strategies: shock therapy (or “big bang”) and gradualism (or incrementalism). \(^{57}\) In the literature economists have been remarkably divided on which is the better strategy. \(^{58}\) As an IMF study notes, “[t]here are cases where fast and gradual reformers have succeeded and where they have failed.” \(^{59}\) The choice of a particular strategy might very much depend on the initial conditions as well as the development stage of a country, together with other factors. However, in carrying on capital account liberalization East Asian countries generally followed the gradualist approach, albeit some countries moved faster – with painful cost suffered during the financial crisis – than the others.\(^ {60}\)

The sequencing of reforms is never an easy job. There are two important reasons for sequencing. First, there are limitations on any government’s time, focus and resources and thus priority must be decided. Secondly, maximize economic and social benefits as well as minimum economic and social risks relating to the liberalization of one area can only be achieved after the liberalization in another area was completed. Appropriate sequencing of reforms can be realized without necessarily indulging the gradualism versus shock therapy debate. \(^{61}\) However, inappropriate sequencing can be very damaging to the economy. In terms of the sequencing relating to capital account liberalization, it is generally agreed that capital account liberalization should come be preceded by domestic institutional reform, trade liberalization, domestic macroeconomic stabilisation (including domestic financial system reform). Williamson (1999) noted that Indonesia liberalized its capital account prematurely before trade related current account liberalization, which contributed heavily to the country’s loss during the Asian Crisis. \(^ {62}\)

China provides a good example of gradualism and, arguably, appropriate sequencing. As Joseph Stiglitz observes,

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\(^{57}\) ibid 3.


\(^{59}\) ibid 4.

\(^{60}\) This choice of gradualism was also influenced by the initial conditions. An IMF working paper has pointed this out: “The different experiences in Asian and Latin American countries … suggest that countries with high saving rates, such as those in Asia, may find it easier to pursue an gradual approach. In contrast, countries with low saving rates may be forced to move faster, because the urgency to encourage domestic savings is higher.” Nsouli et al (n 56) 21.

\(^{61}\) ibid 10.

\(^{62}\) Williamson (n 23) 7 and 12.
Historically, the Chinese were not immune to the Bolshevik mentality [of radical shock therapy change], but they seem to have gotten it out of their system in the Great Leap forward and the Cultural Revolution. They learned the hard way where that mentality would lead. In choosing a path to a market economy, they opted for the path of incrementalism (“crossing the river by groping for stones”) and nonideological pragmatism (“the question is not whether the cat is black or white but whether it catches mice”). Chinese policymakers had the wisdom to know that they did not know what they were doing, so they did not jump off a cliff after being assured by experts that they would clear the chasm in just one more great leap forward.63

Far from being able to satisfying neoclassical economists, China’s capital administration regime has nevertheless experienced in general a deregulation and liberalization process. At the earlier stage of China’s Reform era, under the 1980-made foreign exchange regulations, the foreign exchange receipts of all corporate and natural persons in China, be them foreigners or Chinese citizens, and be it receipt under the current account or capital account, must be sold to the state-run Bank of China, the only bank authorized to deal in foreign exchange in the country. An example of extremely unbalanced rights and obligations, foreign exchange demands from individuals and enterprises would be only satisfied by the Bank of China according to state plans.64 All foreign borrowings and foreign investments must be conducted on planning basis. The rigid rules on foreign exchange and capital account administration were gradually relaxed in the coming decades. Eventually, China accepted the obligations of Article VIII of the IMF’s Articles of Agreement on December 1, 1996, giving a full liberalization to its current account transactions.65 Under the new Regulation on Foreign Exchange Administration enacted in 1996 and amended in 1997, “the State imposed no restrictions on international payments and transfers under current account.”66 Individuals are no longer required to surrender their foreign exchange to the State,67 while enterprises are allowed to keep a larger proportion (up to 50 percent) of their foreign exchange revenues.68 For current account transactions, a few substantial relaxation measures were implemented in recent years. For one example, a QFII (qualified foreign institutional investor) system was put into place under which QFIIs are allowed to invest in the A shares of China’s listed companies which had long been reserved only for Chinese investors.69 By the end of 2004, 24 QFIIs were approved by the Chinese authorities to buy shares in China’s stock exchanges. However, the QFIIs are subject to several restrictions, including professional experience (e.g. minimum 5 years experience in the

64 Provisional Regulations for Foreign Exchange Control of the People’s Republic of China, issued by the State Council of China on 18 December, 1980, Article 4.
67 Article 18 of the Chinese Forex Regulations of 1996 stipulates: “Foreign exchange belonging to individuals may be kept in their possession or may also be deposited in the banks or sold to the authorized foreign exchange banks. Individuals’ foreign exchange savings deposits shall be governed by the principles of voluntary depositing, free withdrawing, interest-bearing deposit and keeping confidential for the depositors (by banks).”
68 IMF’s 2004 Article IV Consultation with China (n 64) p. 39.
69 ibid.
industry for fund managers), assets requirements, ownership limitation of QFII in a Chinese company, etc.\textsuperscript{70}

One of the most prominent features of the QFII is the strict control of both inflow and outflow of capital. Each QFII’s approved investment quota cannot exceed US$ 800 million. Close-end fund management companies must leave the principal investment in China for at least three years before it is allowed to repatriate. Other QFIIs can remit their principal investment out of China only after the money stays in China for at least one year. Further, close-end QFIIs shall only remit capital in instalments of 20 percent of the total each time, and at intervals of at least one month. For other QFIIs, in addition to the 20 percent limitation, the interval between two instalments should be three months or more. As one commentator observes, “[r]estrictive as it is, this provision effectively forces investors to stay in the market, irrespective of their market judgment. The rationale is … to limit the detrimental effect of international ‘hot money’ which was alleged to cause the 1997 Asian Financial Crisis.”\textsuperscript{71}

III. PROMOTING FINANCIAL SERVICES TRADE IN EAST ASIA

The Benefits of Financial Services Trade Liberalization: Not Much Related to the Risks of Capital Account Liberalization

Since prudence in opening capital account is a wise policy, one might then wish to probe whether financial services liberalization should be subject to similarly stringent control. Based on the understandings that capital account liberalization and financial services liberalization are essentially two different things, that the magnitude of benefits from liberalization of financial services trade is significant, and that the risks associated with this liberalization are relatively smaller and manageable, bolder liberalization measures on financial services trade are desirable from perspectives of both economic growth and financial stability.

As a WTO special study notes, “[f]rom an economic perspective, trade in financial services is no different from trade in other goods or services.”\textsuperscript{72} The gains from financial services trade liberalization are also determined by the same factors as in goods or other services trade, including mainly “specialization on the basis of comparative advantage, dissemination of know-how and new technologies, and realization of economies of scale and scope.”\textsuperscript{73} Furthermore, “liberalization improves financial intermediation, enhancing efficient sectoral, inter-temporal and international resource allocation.”\textsuperscript{74} For consumers, increased competition from both domestic and international sources can force service suppliers in the markets to provide financial services of better quality with lower prices.\textsuperscript{75}

\textsuperscript{71} ibid 25.
\textsuperscript{72} M Kono et al “Opening Markets in Financial Services and the Role of the GATS” (Special Studies No. 1 WTO September 1997) 17.
\textsuperscript{73} ibid.
\textsuperscript{74} ibid.
\textsuperscript{75} ibid 17-18.
The concern, however, is whether the liberalization in financial services trade can bring about financial instability and even crises as that inappropriate capital account liberalization has done. The nature of services liberalization as well as empirical studies suggests the opposite: openness of financial services markets is not likely the causes of financial crises; on the contrary, it can provide incentive for better macroeconomic policies, improve the management of private financial institutions, and enhance regulatory capacity.

Liberalization in financial services trade will not directly contribute to financial crises. As noted previously, in the four modes of financial services trade, only Mode 1 (cross-border supply) requires a limited degree of capital movement. In the contemporary age, the most important form of financial services supply is Mode 3 (commercial presence), under which a foreign bank or other financial institution establishes branch, subsidiary or joint venture in the territory of the host country and supplies financial services. This is essentially a form of foreign direct investment (FDI) which generates only long-term capital flow that is directly related to the establishment and operation of the commercial presence. Capital control measures can still be put into place to limit foreign exchange exposure of both domestic and foreign funded financial institutions by the host state. In other words, financial services liberalization, if not accompanied by capital account liberalization, will not generate short-term capital flows which were the major contributor to financial crises.

Commercial presence of foreign financial institutions can enhance the performance of their domestic counterparts through the mechanisms of competition and technology transfer. Financial services were monopolized by a limited number of suppliers in most countries before liberalization. With the entry of foreign suppliers, domestic firms have to reduce cost, improve management, and become more efficient in order to survive. Foreign financial institutions, by bringing superior technical expertise into the domestic market, can tremendously improve the soundness of the local financial system. In China’s experience, by the first quarter of 2005, foreign banks had established 214 operating entities (in the form of branches, subsidiaries, and joint ventures) and 244 representative offices. Foreign financial institutions offer over 100 financial services products in China, tripling the number of services provided by Chinese commercial banks before liberalization. Although foreign funded banks have a significant presence in China, their non-performing loan (NPL) ratio is merely 1.2%, much lower than Chinese commercial banks’ average NPL ratio which is currently 12.4%. As the China Banking Regulatory Commission (CBRC), China’s regulator of financial institutions, admits,

[China’s experience] shows that the presence of foreign banks has not only brought into China advanced and modern banking operation and management expertise, but

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76 Text to n 18.
also motivated the local banks to improve their service quality and sharpen their
competitive edge through reforms and cooperation with their foreign counterparts.\textsuperscript{80}

Not only the domestic financial industry benefits from the institution-building and
market development effects of commercial presence of foreign suppliers (of course with
only limited commitments to capital account liberalization), the regulatory and policy
implementation capacity of the host state can also be improved. Broad-based
liberalization in the financial sector put pressure on the regulators to introduce adequate
prudential regulation and supervision of financial institutions, and on the monetary
authorities to replace administrative controls with market-based, indirect policy
instruments.\textsuperscript{81} The regulators can also benefit from interacting with more sophisticated
foreign financial firms and regulators.

\textit{Market Openness and the Building-up of Comparative Advantage: the Balance
between Protection and Liberalization}

But does liberalization means that the host state shall surrender the control of its
financial industry submissively to foreigners? It is understandable that some
governments wish to establish a “domestic industry”, having strong presence of domestic
financial services suppliers, through certain protection. Governments have also the
concern that foreign financial firms will end up dominating the domestic market after
liberalization and eventually damaging the social and public interests of the host country.
The most commonly used form of protection by the host country is treating the
domestic financial sector as an infant industry which is granted subsidies or better market
access policies. Does this practice violate the principle of free trade and further prevent
the country from harvesting the benefits of financial services liberalization? With regard
to these concerns, the following points are worth discussing.

It is submitted that the theory should be pragmatically modified to adopt the
comparative advantages gradually acquired in a particular industry under certain period of
government protection. Theoretically, free trade is premised on the economic insight of
comparative advantage, which teaches that maximum gains can be achieved by all trading
nations if each of the nations specializes in the production and export of goods and
services that it can produces relatively more efficient than other countries.\textsuperscript{82} But where
did a country’s comparative advantage come from? The orthodoxy belief of comparative
advantage however does not offer an answer to this. The development experiences of
many countries demonstrate that governments can help establish a domestic industry by
according protection to it at the initial stage. After all, no country was born to have a
strong financial services sector. Once liberalization is started, governments have also
provided various form of protection to domestic firms to help them adjust to foreign
competition, e.g. making liberalization only phased in overtime. However, the most
important thing from the policy perspective is that government protection, as it always
incurs significant distortions and long-term costs, should be used appropriately and
wisely terminated after a limited period of time, whenever it is discovered that the
industry has achieved a certain degree of competitive edge or that it is hopeless to

\textsuperscript{80} ’China’s Banking Sector Marches a New Step’, press release of the China Banking Regulatory
\textsuperscript{81} Kono (n 72-73) 17.
\textsuperscript{82} See e.g., J R. McCulloch The Works of David Reicardo (Lawbook Exchange New Jersey 2000) 75-76.
establish such an industry in this country at all. In this regard, Singapore’s development to an international financial centre is an excellent example.

Home to more than 500 local and foreign financial institutions and some 150 fund management companies, Singapore is the fourth largest foreign exchange trading place in the world, and a growing Asia-Pacific centre for wealth management. However, as its founder Lee Kuan Yew wrote in his memoirs, when Singapore became a country in 1965, it, as a small island with almost no nature resources, “faced tremendous odds with an improbable chance of survival.” Lee mocked that “[a]nyone who predicted in 1965 when we separated from Malaysia that Singapore would become a financial centre would have been thought mad.” However, in about two decades, Singapore was developed into one of world’s leading financial centres. As the country’s Prime Minister Lee Hsien Loong remarks, Singapore’s comparative advantage lies in its “political and economic stability, the rule of law, efficient infrastructure and a highly-skilled professional workforce.” Obviously, all the aforesaid attributes were acquired through delicately designed, government-sponsored programmes, and under certain form of government protection.

However, the Singapore story has presented another experience: appropriate liberalization measures should be timely launched by a government which is sensitive to the cost/benefit analysis regarding the protection. Singapore’s domestic banking sector was protected for about 30 years before the government decided to make a change in the 1990s. The country’s leadership felt that the force of globalization was irresistible so that the protection afforded to domestic firms should be gradually phased out. Lee Kuan Yew noted, “I cautioned [domestic bankers] that, sooner or later, because of bilateral agreements with the United States or possible [WTO] agreements, Singapore would have to open up its banking industry and remove protection for local banks.” He wrote, “[f]or over three decades, I had supported [the Monetary Authority of Singapore (‘MAS’)] on restricting the access of foreign banks to the local market. Now I believe the time had come for the tough international players to force our Big Four [banks] to upgrade their services or lose market share.” Despite the strong desire of local banks for continuing protection, the MAS initiated a five-year programme to liberalise commercial banking in Singapore, allowing qualifying foreign full banks to open more branches and ATMs.

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85 ibid 89 (emphasis added).
87 The Monetary Authority of Singapore (‘MAS’) had adopted policies to protect Singapore banks, especially retail banking, with the objective to help them “grow and assume a larger share of the domestic market.” See Kenneth Tan Wee Kheng, Development in Singapore Law between 1996 and 2000 (Sweet & Maxwell Asia Singapore 2001) 103.
88 Lee Kuan Yew (n 84) 99.
89 ibid 100.
More licenses on restricted banks were also issued. The authority also lifted limits on foreign equity ownership of local banks.\footnote{90 ibid 101. See also Kenneth Tan Wee Kheng (n 87) 103.}

\textbf{A Survey of Banking Services Liberalization in Selected East Asian Countries}

\textbf{Indonesia}

Liberalization of the financial sector was started in the late 1980s. Foreign banks were allowed to establish joint ventures with minimum Indonesian equity of 15 percent or through acquisition in the capital market of a maximum equity share of 49 percent of existing listed local banks. These joint ventures were granted national treatment but were still subject restrictions relating to the numbers and locations of branches. After the 1997-98 Asian Financial Crisis which hit Indonesia badly, reforms in Indonesia have focused on restructuring of the financial sector, assisted by the IMF. As a result, Indonesia had made more and improved commitments under the WTO and IMF, including (1) enhanced foreign participation, (2) elimination of the economic needs test, (3) removal of restrictions on foreign ownership, and (4) removal of restrictions on branching.\footnote{91 B Chane-Kune \textit{et al} ‘Liberalization and Competition in Services Sectors: Experiences from Europe and Asia’ in \textit{Asia and Europe: Services Liberalization} (OECD and ADB: Paris and Manila)79, 155.} Foreign banks now can operate in Indonesia as licensed branches if they meet the requirements of being among the 200 largest world banks and have an operating fund of at least Rp 3 trillion. Relaxation of the foreign ownership restriction is reflected in the new requirement that foreign investors can own up to 99\% of the paid-up capital in listed or unlisted national banks (including joint ventures).\footnote{92 WTO \textit{Trade Policy Review Indonesia – Report by the Secretariat}, 28 May 2003, WTO Doc. WT/TPR/S/117.}

\textbf{Korea}

Korea responded to the Asian Financial Crisis with a series of wide-ranging, market-based reforms aimed primarily at the financial, corporate, and public sectors. The post-Crisis reform programmes have made Korea a more open, competitive, and market-driven economy. The overall objective of the reform programmes, taken in the wake of the Crisis, was to ensure that the financial sector operate on a purely commercial basis rather than subject to industrial policy or other non-commercial considerations. Under the financial restructuring plan, since 1997, some 650 financial institutions had been liquidated, 160 had been merged, and 70 had been newly established. On the regulatory front, Korea has accelerated liberalization and deregulation of the financial sector since the Crisis, with a view to bringing the institutional and regulatory framework of the financial system into line with that of OECD countries.\footnote{93 WTO \textit{Trade Policy Review Republic of Korea – Report by the Secretariat}, 18 August 2004, WTO Doc. WT/TPR/S/137 (hereinafter TPR-Korea 2004).}

In 1998, foreign banks were allowed to establish subsidiaries, with only permission from one regulatory body, the Financial Supervisory Commission (FSC). Under its 1999 Schedule of Commitment, wholly or majority foreign-owned subsidiaries of foreign financial institutions are permitted to operate banking, securities, securities investment trust and advisory business. FSC requires report of foreign equity participation between 4\% and 10\%, and the FSC’s approval is needed if foreign
ownership is to surpass levels of 10%, 25%, and 33%. No longer in place is also requirement that a foreign bank rank among the world’s top 500 in asset size in order to open a branch in Korea, as well as the requirement that securities investment trust operate representative offices for at least one year before authorization to establish branches. Since 1998, foreign financial institutions have been permitted to conduct non-hostile mergers and acquisitions. State-ownership limitations for non-residents were finally terminated in 1998. As early as 1992, Korea also eliminated the long established “economic needs test” which was a prior condition for the establishment of foreign bank branches, securities firms, insurance companies and investment trust companies. As the Korea Government notes, now almost all entry barriers against foreign banks have been removed. As of June 2004, the Korea market served as a host place for 38 foreign banks, with 65 branches. Average foreign ownership of banks has increased from under 10% at end 1998 to 30% at end-September 2003.

Malaysia

Malaysia has significant horizontal restrictions on market access pertaining to commercial presence, such as that commercial presence is generally confined to the form of joint ventures in which foreign equity is limited to 15% by a single or grouped foreign interests or to an aggregate foreign interest of 30%. In principle, all applications to provide financial services require the approval of the Bank of Negara Malaysia (BNM). Financial firms involved in insurance, fund management, and securities brokerage services may have 51 percent foreign ownership and at least 30 percent Buniputras (indigenous Malay) equity. Foreign ownership of 100 percent may exist in asset management companies if the companies manage only foreign investors’ fund; otherwise the foreign ownership cap is 70 percent. Malaysia has also signed the Fifth Protocol of the GATS, as a result of which further commitments were made to the effect that 50% foreign ownership in existing joint-venture insurance companies was allowed, that six new licenses for life reinsurance business were issued, that the establishment of majority or wholly foreign-owned fund management companies was legalized, and that new entry into offshore investment banking services was allowed.

In the banking services, as of June 2001, there were 27 commercial banks (of which 24 are foreign owned), 12 finance companies, and 10 merchant banks in Malaysia. Banks must be licensed to operate in this country. It is worth noting that, since 1997, no new banking licenses have been granted to either foreign or local investors.

The Bank Negara Malaysia (BNM) assumes the supervisory and regulatory responsibility over banks. For foreign banks to operate in Malaysia, local incorporation is required. However, a local subsidiary can be a wholly (100%) foreign owned bank. The activities of foreign banks are limited: they can grant loans only in partnership with domestic banks, and they may not establish new branches, including off-site ATMs.

94 ibid.
96 TPR-Korea 2004 (n 93).
98 ibid.
99 ibid.
Singapore

Singapore maintains a relatively more open economy in the Southeast Asia region. In recent years, it has been progressively liberalizing the financial sector through two rounds of liberalization (in 1999 and 2001), and foreign entrants have been allowed into the insurance market. In 2003, 117 commercial banks were operating in Singapore. Foreign participation in the banking sector is significant. In the 27 full banks, 22 were branches of foreign incorporated banks. In addition, 31 foreign financial institutions operating as wholesale banks, and 59 other banks were offshore banks.100

In May 1999, the Monetary Authority of Singapore (MAS) announced a five-year agenda to liberalize the domestic banking sector, with a view to moving toward a more open and competitive environment to strengthen local banks and to enhance Singapore’s position as an international financial centre. A significant liberalization item in this programme is the so-called Qualifying Full Bank (QFB) scheme, under which the MAS extend privileges to selected full foreign full-license banks to widen their domestic retail operations privileges, increase the number of restricted bank licenses, and provide greater flexibility to offshore banks to conduct wholesale transactions in Singapore dollars.101 The underlying philosophy is two-fold: first, domestic banks can only be strengthened by good corporate governance and the gradual introduction of competition; second, the high quality of services and systemic stability of the financial sector can be maintained by granting additional market access only to well managed foreign banks with good credit and legal support rating.102

As part of the liberalization programme, the MAS removed the 40% shareholding limit on local banks, which required that the level of foreign participation in a particular local bank could not be higher than 40%. However, the existing safeguards were remained, meaning that Singapore’s national interests must be protected through the board of directors in a bank comprising a majority of Singapore citizens and permanent residents. Hence, foreign investors may not control the bank. The MAS has also put into place a 12 threshold on the acquisition of shares in banks by a single shareholder or shareholders, in addition to the 5% and 20% stake. Moreover, additional market access will only be granted if all the following three conditions are met: (1) the foreign investor must be a “strategic partner” bringing specialized skills, new technologies, or business strategies; (2) foreign entities must be strong and well-managed; and (3) the “Singapore character” of the bank must be retained. In essence, the purpose is to ensure that the control of the bank lie with Singapore citizens or permanent residents.103

In the second round of liberalization which began in 2001, foreign full banks were given more business opportunities in retail banking. But the major focus of this phase is on the improvement of corporate governance.104

Thailand

101 ibid. The MAS issued six QFB licenses to foreign banks over the 1999-2001 period, including Citibank, ABN Amro, Banque Nationale de Paris, and Standard Chartered, among others.
103 TPR-Singapore 2004 (n 100).
104 ibid.
Thailand has implemented comprehensive reform measures in the aftermath of the Asian Financial Crisis, with a view to strengthening the capital base of financial institutions and the supervisory framework based on international standards of risk-based supervision and good corporate governance. These multi-faceted reforms have met with considerable success according to the WTO’s Trade Policy Review Body. One material change implemented in 1997 included measures to relax foreign equity ownership by permitting 100% foreign ownership in locally incorporated banks, finance companies and credit foncier companies for a period of ten years after which the foreign investors will not be allowed to purchase additional shares in the bank until their shareholding declines to below 49%. As a result of this relaxation, foreign equity holding in four Thai commercial banks increased substantially, ranging from 52 to 79%.¹⁰⁵

Despite these liberalization efforts, foreign banks remain subject to certain severe restrictions. In principle, they can operate up to three branches, but in practice, none of them has yet received approval to open more than one branch according to a WTO report.¹⁰⁶ Further, a rather limited number of foreign personnel (up to eight) are allowed per foreign bank office, under a specified set of conditions. The 1997 amendments also require that maximum foreign equity ownership should be limited to 25% of paid-up registered capital, that the combined shareholding of an individual and related persons does not exceed 5% of a bank’s paid-up registered capital, and that at least three fourths of the directors are of Thai nationality. These measures, taken in midst of the Asian Financial Crisis, can be relaxed by the Minister of Finance if it is deemed suitable. Similar measures were taken for finance companies and credit foncier companies.¹⁰⁷

Impact of China’s Financial Services Liberalization

Aaditya Mattoo observes that “the fulfillment of China’s accession commitments will lead to one of the most dramatic episodes of services sector liberalization seen in any country”.¹⁰⁸ Economists computed three indicators to measure China’s market access and national treatment commitments, concluding that:¹⁰⁹

Overall for China, the coverage of market access commitments (i.e., the unweighted average account) was 57.4 percent. This coverage is much more extensive than the commitments offered in the Uruguay Round by any other group of countries (including high-income ones). The “average coverage,” a measure of coverage that better reflects the extent of liberalization of services, was 38.1 percent for China – again showing more openness than that of even the high-income countries. China’s share of completely liberal commitments (i.e., no restrictions) of the maximum possible was 23.1 percent, which is much higher than that for any other group of developing countries but somewhat lower than that for high-income countries.

¹⁰⁷ TPR-Thailand 2003 (n 105).
¹⁰⁹ Ibid 119.
China’s commitments on national treatment are deeper and wider than those of all other country groups.

The financial services sector provides a good example of China’s openness in trade in services. China’s financial services sectors were severely restricted to foreign participation. However, according to China’s WTO Schedule of Commitments, upon WTO accession on December 11, 2001, foreign financial institutions were permitted to provide foreign currency services to all enterprises, and full-range local currency services to Chinese enterprises two years after accession. Within five years after accession, foreign financial institutions will be permitted to provide local currency services to Chinese individuals as well. This essentially means that foreign financial institutions will be granted national treatment by 2006, leading to the full liberalization of the banking sector. Foreign non-banking financial institutions were allowed to provide auto financing upon accession. In the securities service sector, foreign investors were permitted to have up to 49% equity stake in joint ventures engaging in investment funds business, and up to 33% equity state in joint venture engaging in securities services including underwriting and trading. In the insurance sector, three years after accession, all the geographic restrictions on foreign insurers were to be lifted altogether and the scope of permitted business activities significantly expanded. Foreign non-life insurer were permitted to establish wholly-owned subsidiaries in two years after accession. Foreign life insurers were required to operate on a joint venture basis, with a maximum equity interest of 50%.110

For financial services, China has also agreed to eliminate the economic needs test or quantitative limits on licenses, establishing instead standards based solely on prudential reasons. Foreign financial institutions, meeting certain asset size requirements as well as prudential standards, will be able to establish branches, subsidiaries, or other presence in China.111

Records show that China has faithfully implemented its commitments on financial services. Some commitments were even put into place ahead of schedule. For instance, in 2004, China lifted geographic restrictions in the banking and insurance sectors one year ahead of schedule. By the end of October 2004, 204 operational institutions, in the form of branches, subsidiaries, and joint ventures, and 223 representative offices, had been established by 62 foreign banks from 19 countries and regions across the world. As for the business scope, staring from 2005, 116 foreign banks were authorized to conduct Renminbi (China’s currency) business.112

China’s broad-based financial services liberalization has profound impact both domestically and internationally. First, China’s generosity in opening up its services sector can put pressure on most of its Asian neighbours who are very reluctant to expose their domestic services to international competition. By acceding to the WTO, “China has promised to give up over the next few years much of the freedom it had to restrict new entry and foreign ownership, to discriminate between trading partners and in favour of its own firms, and, more broadly, to change its mind”.113 Participating in regional economic integration, according the WTO rules, will only lead to more liberalized trade

110 ibid 127.
111 ibid.
112 ibid.
113 ibid 129.
regime. For example, in terms of eliminating discrimination, China, abiding by the MFN and national treatment obligations, has listed surprisingly narrow MFN exemptions and few limitations on national treatment in its Services Schedule. For national treatment, for the most part, China has abandoned the right to offer preferential treatment to domestic enterprises through any measure affecting the supply of services. As regards market access barriers, by promising to use other methods (e.g., the prudential criteria in the case of financial services), China has chosen not to impose limitation on the number of foreign service providers. In huge contrast with China, most other Asian developing countries have tended to schedule liberalization commitments at levels below the regulatory status quo, whether in regional agreements or in the GATS.

Another implication is related to the concern that China’s generosity can mean that not much policymaking discretion and regulatory space is reserved for itself in regulating trade in services. For instance, as asked by Mattoo, “Is it good policy to allow unrestricted entry in all service sectors? Will China’s commitments deprive the government of an important policy instrument?”

Mattoo (2004) observes that, despite the revolutionary concessions in China’s service commitments, considerable policymaking and regulatory space was left to China. First, China still retains certain discretions with respect to variable treatment in domestic regulations such as licensing, recognition of qualifications, and various other technical regulations. “Such discretion is likely to be constrained, but probably not eliminated, by the assurance that licenses in financial services will be issued solely on the basis of prudent criteria and by the requirement of transparency of licensing criteria and decision process in other areas”. In addition, the freedom to impose explicit quantitative restrictions on the number of providers in legal, medical, and retailing services is preserved in China’s hands. Furthermore, according to GATS, apart from the general MFN obligation, there is no specific rule mandating the non-discriminatory allocation of quotas in services. Hence, “it remains to be seen whether the Chinese regulators can resist the temptation to resort to other, more discretionary methods of allocating quotas”.

IV. CONCLUDING REMARKS

Financial liberalization has two major components: capital flow liberalization and financial services liberalization. The two components are two things which should not be confused from the policy perspective. The mainstream economic literature on financial crises has established that premature capital flow liberalization was the major cause of financial crises. Stiglitz’s warning that “capital account liberalization was the single most important factor leading to the [Asian Financial] crisis” is supported by lessons from various financial crises. Dani Rodrik also wrote, “[I]f the recent evidence teaches us anything, it is that there is a compelling case for maintaining controls or taxes on short-term borrowing.” Thus it is highly advisable that the emerging economies be more

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114 See e.g., GATT, Article XXIV, and GATS, Article V.
115 ibid. (n 108) 129.
116 ibid.
117 ibid 130.
118 ibid.
119 Text to n 37.

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cautious in implementing capital account liberalization reforms which are still necessary in achieving higher efficiency and proper capital resources allocation in the longer run. Although there is no magic bullet to stop financial crises, it is suggestive that countries establish at least a working domestic regulatory framework that can assure the maintenance of independent financial policies. As Jean Bonvin, the former President of OECD Development Centre, and Mitsuo Sato, the former President of Asian Development Bank, advised, “external liberalization is not sustainable in the longer run if it is not accompanied by domestic deregulation and the establishment of transparent governance structures in both the public and private domains and building of regulatory capabilities.” They suggested the reason why financial liberalization was so disorderly in Asia was because “liberalisation is inexpensive, quick and easy to implement; while building the appropriate financial infrastructure is expensive, slow and complex. Thus, many countries have opted for the quick and easy reforms first, undermining the stability of the financial system.”

One important conclusion of this paper is that, in addition to having appropriately sequenced, gradualist reforms on capital account liberalization, a country should keep certain regulatory space for itself and maintain independently the financial policy-making power. In this regard certain Asian countries, such as Malaysia and China, provided good examples.

The paper also surveys the financial services liberalization of selected Asian countries. As trade liberalization in financial services should not be confused with capital account liberalization, so are their respective consequences. The paper argues that financial services liberalization should be promoted as it presents tremendous benefits. Moreover, because, according to the nature of GATS’s modes of services supplies, financial services liberalization does not necessarily involve massive capital flows, it will not contribute to financial crisis which has been proved to be caused by uncontrolled short-term capital flows. As an example, China had advanced broad-based financial liberalization yet it still maintains heavy controls on capital account transactions.

Another important conclusion of this paper is that it is understandable that countries wish to accord protection to its domestic financial sector. The paper suggests that the theory of comparative advantage should be modified pragmatically to accommodate the comparative advantage acquired under an initial period of protection. However, the government that provides protection should be wise enough to know when and where to stop. The development of Singapore’s development to a leading international financial centre is an illustrating example. The country’s comparative advantage, embodied in its political and economic stability, effective legal regime, efficient legal infrastructure, and highly-skilled professional force, is a combination of attributes which were acquired through decades of development. When it was felt that financial globalization was irresistible, Singapore’s government resolutely made decisions to liberalize its financial sectors, introducing more foreign financial institutions into the domestic financial markets to increase competition. The important lesson is, as a WTO study points out, “it should be kept in mind that protection should only buy time to put the proper policy framework in place, not permit policy complacency.”

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122 ibid.
123 K M Finger and L Schuknecht “Trade, Finance and Financial Crises” (Special Studies No. 3 WTO 1999) 55.
References:


_______ India 2002
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_______ Korea 2000
_______ Korea 2004
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_______ Thailand 2003