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Liberalisation of International Trade in Financial Services in Southeast Asia: Indonesia, Malaysia, Philippines and Thailand

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July 2002

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Liberalisation of International Trade in Financial Services in Southeast Asia: Indonesia, Malaysia, Philippines and Thailand

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ABSTRACT

Liberalisation of International Trade in Financial Services in Southeast Asia: Indonesia, Malaysia, Philippines and Thailand

Ramkishen S Rajan and Rahul Sen

This paper outlines the analytical rationale in favour of liberalisation of trade in services with particular reference to the key infrastrucutural sub-sectors of financial services and discusses the empirical evidence thereof. The paper goes on to offer an overview of the state of deregulation and the schedule of liberalisation of the two service sub-sectors in four middle-income Southeast Asian countries, viz. Indonesia, Malaysia, Thailand and the Philippines. An attempt is also made to synthesize the individual country experiences and extract common themes from them.

Key words: Banking, Financial Services, GATS, Insurance, Liberalisation

1. Introduction

Rapid advancements in Information and Communications Technologies (ICT) and regulatory reforms have worked in tandem to increase the scope and importance of service transactions in the global economy. To be sure, service activities have constituted a large and growing share of production, employment, investment and trade, which in turn has led to profound structural changes in many countries, especially in middle and upper income developing ones (World Bank, 2001b)[1]. Trade in services has conventionally been classified on the basis of the location of the service providers according to the following four-fold typology: (a) Mode 1: *cross-border supply* which are services supplied from one country to another (e.g. international telephony); (b) Mode 2: *consumption abroad* which refers to firms or consumers making use of a service across national frontiers (e.g. tourism and health services/medical patients); (c) Mode 3: *commercial presence* which occurs when a foreign company establishes a subsidiary or branch abroad to provide services in another country (e.g. foreign banks or telecommunication firms setting up operations in a foreign country); and (d) Mode 4: *presence of natural persons* which involves individuals travelling from their own country to supply services in another country (e.g. consultants, design or software engineers, or the temporary transfer abroad of employees of a multinational). In the first kind of transaction production and consumption are "separated" or "splintered", while the other modes require the mobility of factors of production, consumers or both (Bhagwati, 1984 and Sampson and Snape, 1985). Mode 3 appears to be where the most multilateral negotiation activity has taken place thus far. Table 1, while somewhat dated, offers some

[1] As classified by the World Bank according to income, these cover Newly Industrialising Economies (NIEs) in East Asia, Oil producing countries in the Gulf region plus Israel.

indication of the global scale of each of the four modes of international service transactions.

Noticeably, the proportion of services in overall international trade appears to be smaller than its corresponding share in aggregate output and employment. On the basis of this, services have conventionally been considered "less tradable" than manufactured or even agricultural products. This is, however, no longer a valid conclusion for an increasing number of services. Part of the reason for the seeming low share of services in international trade may be due to definitional and data problems. As noted, trade in services often requires the simultaneous movement of factors of production (labour and capital in the form of FDI). In other words, a number of important modes of supply of services are not considered in the conventional trade statistics. In addition, some services such as transportation, insurance, and finance are vital in facilitating the production process and bringing manufactured and agricultural goods to the market. Other types of services are directly embodied in goods but may not explicitly be taken into account (e.g. design, software, repair work and other technical expertise). All in all, therefore, available statistics severely downplay the actual magnitude of international trade in services as many transactions go unrecorded[2].

Despite the vague statistical description of services, it is noteworthy that international trade in services has outpaced that of merchandise trade over the last decade (Figure 1). By 1999, commercial services trade accounted for nearly a quarter of world trade and an estimated half of global FDI stocks to all regions save Sub-Saharan Africa (World Bank, 2001a). Echoing the view of many informed observers,

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[2] In recent years, a number of the multilateral institutions have taken significant steps to improve the quality of cross-border services transactions. See, for instance, the UN-ESCAP's website on this issue: http://esa.un.org/unsd/tradeserv/ as well as that of the World Bank: http://www1.worldbank.org/wbiep/trade/services_data.htm .

Primo Braga (1996) has declared that the "internationalisation of services is viewed as being at the core of economic globalisation" (p.34); while the World Bank (2001a) has proclaimed that "(i)n virtually every country, the performance of the service sectors can make the difference between rapid and sluggish growth" (p.69).

It is in recognition of its rising importance that a multilateral framework for liberalising trade and investments in the service sector was conceptualised in the form of the General Agreement on Trade in Services (GATS) initiated under the aegis of the WTO[3]. Among the gamut of services, financial services have undergone the most active international negotiations with the aim of dismantling cross-border trade restrictions. The financial services agreement (FSA) has been the latest among the WTO agreements on financial services to come in force (in March 1999). The FSA includes commitments by 102 WTO members to reform their respective financial services market and provide increased market access through privatisation and deregulation.

The remainder of this paper is organised as follows. The next section briefly outlines the theoretical and empirical rationale in favour of liberalisation of trade in services in general and financial services in particular. Section 3 offers an overview of the present state of financial services liberalisation in four middle-income Southeast Asian countries (Indonesia, Malaysia, the Philippines and Thailand) and their market access commitments under the GATS (Table 2). The final section concludes with a brief discussion of future prospects for financial services liberalisation in these countries[4].

[3] See Hoekman (2000), Hoekman and Mattoo (2000) and Mattoo (2001) for recent discussions on the GATS.

[4] Space limitations preclude a comparison of these countries' GATS commitments with those made under a regional agreement (the ASEAN Framework Agreement on Services or AFAS).

2. Benefits of Liberalisation of Services Trade

2.1 The Theoretical Case

There have been a handful of theoretical studies on the role of services in the production process and international trade (e.g. Markusen, 1989; also see survey by Sapir and Winter, 1994). At the risk of generalising, notwithstanding some theoretical curiosities, the broad conclusion of these studies is that the positive static welfare effects of liberalising trade in goods extends to services as well. Thus, an appropriately timed and sequenced liberalisation of the service sector ought to provide the usual Harberger Triangle welfare gains by reducing, if not entirely eliminating, the wedge between domestic and foreign prices as well as permit the "rationalisation of service activities along the lines of comparative advantage" (Deardorff, 2001). A number of countries, including developing ones, have a comparative advantage and niche export opportunities in certain service activities, particularly professional and business ones (such as computer and office services), tourism, health, construction and transport. Consequently they have a substantial stake in an orderly liberalisation of global service markets.

Beyond the direct effects on output and employment, as noted, the service sector is a key input in merchandise and agricultural production and trade. According to the World Bank (2001a) "(a)s countries reduce tariffs and other barriers to trade, effective rates of protection for manufacturing industries may become negative if they are higher than they would be if services markets were competitive" (p.76). In addition, a relatively new phenomenon in trade in manufactured goods is "intraproduct specialisation", broadly defined as the fragmentation of the process of

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For a discussion of AFAS, see Austria and Avila (2001) and Nikomborirak and Stephenson (2001)

production of a good into its sub-component parts and processes which in turn are distributed across countries on the basis of comparative advantage[5]. As Arndt (2001) notes, the "basic idea is to think of the region rather than the nation as the production base and to spread component production around the region in accordance with comparative advantage." Such production fragmentation depends considerably on the reduction in transactions costs (i.e. insurance, transportation and ICT services) and is therefore facilitated by services liberalisation (Deardorff, 2001). For instance, the liberalisation of the financial service sector ought also to enhance the process of sectoral and intertemporal resource allocation, overall savings, investment and risk sharing. In addition to these direct static gains, as with the trade in goods, there are potential dynamic productivity and growth gains via technology transfer (particularly in cases where services are embodied in FDI) as well as due to the introduction of market competition (i.e. "X-efficiency"). Further welfare gains could accrue to consumers from the availability of broader product variety of specialised producer services as well as enhanced product quality (World Bank, 2001a).

An important caveat should be noted. Unlike trade in merchandise and agricultural goods, it is especially important to ensure that the deregulation of services is handled with care and, in particular, that the domestic regulatory environment is strengthened prior to and during the process of liberalisation. The benefits from services liberalisation are far from automatic. If deregulation and internationalisation takes place prematurely, i.e. in a weak or ineffective regulatory and supervisory environment, there may be severe calamitous consequences on the sector in question as well as disruptions to the overall macroeconomy. As is

[5] Other descriptive terms sometimes used in the literature to describe this phenomenon include "international product fragmentation", "disintegration of production", "Heckscher-Ohlin (HO)-plus-production fragmentation", "slicing the value chain" and "super specialisation" (see Rajan, 2001b).

increasingly recognised, the issue is not one of *whether* to open up and integrate with the global economy in a market-consistent manner, but *when and how* to do so. Nowhere is this more pertinent than for the service sector. This said, what is meant by "effective regulation" will vary based on the sector under consideration[6]. For instance, effective regulation in the case of the telecommunications sector refers to pro-competitive regulation, while in the financial service sector it refers to prudential regulation (Matto et al., 2001). In fact, concerns about loss of monetary and financial controls led to an insertion of an "Agreement of the Annex on Financial Services" which includes a provision to the effect that member countries are free to take measures for prudential reasons to protect the integrity and stability of the financial system. This clause is generally referred to as the "prudential carve-out" clause.

2.2 The Empirical Case

In view of acute data problems, it should not be surprising that there is a dearth of empirical studies on the impact of services liberalisation on growth. For reasons discussed above, one might expect, a priori, that the liberalisation of services trade ought generally to have a relatively more simulative effect on growth than merchandise trade. This is particularly so since services have hitherto remained relatively more protectionist than have manufactured goods which have undergone decades of liberalisation of quantitative, tariff and nontariff barriers worldwide.

Mattoo, Rathindran and Subramaniam (henceforth M-R-S for short) (2001) is a noteworthy econometric study on the impact of liberalisation of the financial sectors on overall economic growth. Given the paucity of studies on this issue as well as the

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[6] Admittedly, it might be difficult to distinguish between regulations that are necessary to minimise possible financial and economic disruptions and those that may have a protectionist goal or effect.

influence that it has apparently had on the World Bank (see World Bank, 2001a), it bears summarising the main elements of the study in some detail[7].

M-R-S create a set of openness indicators for both the sectors under consideration. In the case of financial services, the index ranges from 1 to 8 with higher values signifying greater liberalisation. The index is a lexicographic representation of these policy variables, viz. *competition*, *foreign ownership* and an *index for capital controls*, with the first element deemed as most important followed by the second. The first two variables indicate the degree of international market competition of the sector[8]. An index for capital controls which was included in recognition of the close nexus between financial sector openness and capital account deregulation (see Bird and Rajan, 2001a). A country's financial sector is thus considered to be "full liberalised" if the index value is 8 (Table 3). M-R-S exclude a proxy for regulation of this sector in their measure of openness is that it "does not have the same competition promoting role that it does in the telecommunication sector" (p.12)[9].

Having developed the indices for services liberalisation, M-R-S run a series of cross-country regressions for a sample 60 countries (37 of which are developing ones) for the period 1990-99. They estimate the following regression specification:

$$G_j = \alpha + \beta X_j + \gamma R_j \quad \text{for } j = 1\ldots\ldots N$$

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[7] This section limits the review to a single recent econometric study. There have been some important computational general equilibrium studies on the issue.

[8] Since no data are available on national policies on competition and foreign ownership, M-R-S infer them from the countries' commitments under the GATS (see section 3). Since some countries (like Brazil) have *de facto* liberal regimes, the authors make appropriate adjustments to the rankings to reflect this.

where G_j is the average annual growth rate of per capita GNP (adjusted for purchasing power parity) between 1990 and 1999 in country j, α is a constant term, X_j is the vector of standard growth controls for country j[10], R_j is a vector of the openness to trade in services for country j, and N represents the number of countries in our sample.

Considering indices for the financial sector, M-R-S find that both indices entered with the right sign (i.e. positive), with the latter being statistically significant at the 5 percent level and the latter at the 10 percent level. Results are consistent if the sample is limited to developing countries. Thus, there is evidence that the greater the degree of financial sector openness, *ceteris paribus*, the greater will be average output growth. The evidence of the growth-inducing effects of financial sector openness, viz. the Schumpetarian thesis of banking sector development facilitating economic growth through technological change and capital accumulation) has also been confirmed by a number of other studies (Beck et al., 1998, King and Levine, 1993 and Levine et al., 1998).

3. Country Experience in Liberalisation of Financial Services

This section offers an overview of recent developments in the financial sectors in the four middle-income Southeast Asian economies with particular emphasis on

[9] M-R-S do go on to note that "the omission may nevertheless be serious because the quality of banking and prudential regulations is of paramount importance in addressing systemic risk" (p.12).

[10] The standard growth controls used by M-R-S include the natural log of per-capita GNP in 1990 (the convergence variable), investment rate (lagged value), schooling ratio (human capital), government consumption to GDP ratio (as a proxy for government size and magnitude of government induced distortions), the inflation rate (as a proxy for macroeconomic imbalances), proxy variables for political and institutional stability, geographical and regional dummies, and an index of tariff and non-tariff barriers.

their respective schedules of liberalisation vis-à-vis GATS and under the FSA. Due to space limitations, the descriptions offered here are necessarily somewhat brief. As will be apparent, the country overviews preclude a systematic comparison of liberalisation strategies and patterns across the countries. As such, following the country overviews, an attempt will be made to synthesize and compare the nature of financial service liberalisation undertaken in each country. The focus will be restricted to the banking and insurance sub-sectors[11].

3.1 Indonesia

Banking: The Ministry of Finance is responsible for the general policy framework governing banks, including the rules and regulations on the conditions of establishment of banks in Indonesia. However, international negotiations with respect to market access are carried out jointly with Bank Indonesia, which is responsible for the daily supervision of banks and prudential control. Thus, while the Ministry of Finance has complete jurisdiction over the licensing (or withdrawal of licenses) of banks, the decision is subject to the letters of recommendation of Bank Indonesia.

As a part of its financial sector liberalisation, the banking sector in Indonesia began a process of deregulation in 1988 wherein foreign banks were allowed to

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[11] Mattoo (1999) notes

> Financial services under the GATS consist of insurance services and banking and other financial services. Insurance services encompass direct insurance (life and non-life), reinsurance and retrocession, insurance intermediation, and auxiliary insurance services (including consultancy, actuarial, risk assessment and claim settlement services). Banking and other financial services are defined under GATS to include acceptance of deposits, lending, financial leasing, payment and money transmission services, guarantees and commitments, trading (in money market instruments, foreign exchange, derivative products, exchange rate and interest rate instruments, transferable securities, and other negotiable instruments and financial assets), participation in issues of securities, money broking, asset management, settlement and clearing services, provision and transfer of financial information (including data processing), and advisory and intermediation services. (pp.9-10).

operate in the form of joint ventures, with minimum Indonesian equity of 15 percent, or via the acquisition of a maximum equity share of 49 percent through an existing listed local bank in the stock market. These joint ventures were granted national treatment in the sense that they could engage in the same commercial operations as locally owned banks. Nonetheless, restrictions continue to be imposed on the number and location of branches, initially set at one per large city, as well as on the presence of natural persons (these limitations were reflected in Indonesia's GATS 1994 and 1995 Schedules). The banking sector in Indonesia witnessed a rapid expansion in the early 1990s; the number of banks approximately doubled while branches tripled. However, in the early 1990s, there were concerns about the soundness and safety of the banking system in Indonesia, with the increasing share of non-performing loans in total lending for state-owned banks. The 1997-98 regional financial crisis hit Indonesia particularly hard, resulting in the virtual decimation of the banking sector (Dobson and Jaquet, 1998). The emphasis has since been on restructuring the sector (Bird and Rajan, 2001b).

Indonesia improved upon its GATS commitments under the FSA (the fifth Protocol to the GATS) concluded in December 1997 and undertook further supplementary commitments in the context of the IMF programme in January 1998. These new GATS and IMF commitments include: (i) enhancing foreign participation in existing joint venture banks and increase by one the number of branches operated by foreign-owned banks and joint-venture banks in Indonesia's main cities[12]; (ii) eliminating the economic needs test that was hitherto applied to the presence of natural persons and removing limitations on national treatment pertaining to capital requirements of foreign joint ventures; (iii) removing restrictions on foreign

ownership in listed banks by June 1998 and allow foreign investors to increase (up to 100 percent) its ownership of a listed local bank and further; and (iv) revoking restrictions on branching, to allow foreign banks and joint-venture banks to operate nation-wide, with unlimited number of offices and branches.

Insurance: The Ministry of Finance is responsible for the general policy framework, supervision, regulation and licensing of new companies in the insurance sector in Indonesia. All insurance products are to be supplied through a locally incorporated insurance company that may be either Indonesian or foreign owned, except for products not available in the Indonesian market. Foreign commercial presence in Indonesia in the insurance service sector can take place via a joint venture with an Indonesian firm or through participation in the capital of a listed company.

As at mid-1997, there were 103 general insurance companies in Indonesia, including 18 joint ventures with foreign participation, and 58 life insurance companies, including 17 joint ventures. Prior to the FSA, foreign ownership in joint ventures was restricted to 80 percent and to 40 percent in a listed company, and restrictions on intra-corporate movement of personnel and discriminatory capital requirements were in existence. However, under the Fifth Protocol to the GATS, Indonesia committed to the removal of ownership limits on foreign insurance companies and binding of up to 100 percent foreign ownership in domestic companies. Indonesia has also committed to promote greater flexibility in the movement of intra-corporate personnel for insurance companies and to the removal of remaining discriminatory capital requirements.

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[12] According to Indonesia's GATS Schedule, branching is also subject to geographical limitation (limited to eight cities or regions in Indonesia).

3.2 Malaysia[13]

Banking: All applications to provide any financial services including banking require the in-principle approval of the country's central bank, Bank Negara Malaysia (BNM). The operation of banking institutions is overseen by the Banking and Financial Institutions Act 1989, while the Islamic banks are governed by Islamic Banking Act 1983. All foreign banks need to be locally incorporated to operate in Malaysia. Their parent banks are allowed to hold 100 percent interest in their Malaysian subsidiaries except for companies involved in insurance, fund management and securities brokerage. Foreign banks can extend loans only in partnership with domestic banks. Foreign banks are not allowed to establish new branches, including off-site ATMs. Although banking has remained the largest sub-sector, non-bank intermediaries have also been increasing their presence in Malaysia's financial sector.

As of June 2001, there were 27 commercial banks (including 2 Islamic banks), 12 finance companies, and 10 merchant banks licensed in Malaysia[14], nearly half of which were foreign owned and controlled about a quarter of total assets, gross loans, and deposits in the commercial banking sector.

There are significant restrictions on market access pertaining to commercial presence and hence foreign equity holdings in the financial service sector in Malaysia, depending upon the specific activity involved. Thus, financial companies involved in insurance, fund management, and securities brokerage are allowed up to 51 percent foreign equity and at least 30 percent equity from Bumiputras (indigenous Malays). However, for companies involved in finance/banking and venture capital, Bumiputras must locally hold 70 percent of equity with at least 30 percent equity. 100 percent

[13] This section draws on information from WTO (1998a,b and 2001b).

foreign ownership is permitted for those companies involved in asset management provided that the companies manage only foreign investors' funds, else only 70 percent of foreign equity is permitted. Similar restrictions apply to companies that are engaged in offering investment services to the companies other than those within the same group.

Insurance: The insurance industry in Malaysia is regulated by the Insurance Act 1996, and offshore insurance is regulated by the Offshore Insurance Act 1990. As in the case of Banking sector, the BNM is in charge of the overall supervision of the insurance sector. The Labuan Offshore Financial Services Authority supervises offshore insurance activities.

The insurance sector in Malaysia comprises life and general insurance, insurance brokers, adjusters, and registered agents. According to the latest available data, out of 63 insurers, 23 were foreign owned. Foreign shares accounted for 72 percent and 36 percent of total life and general premium, respectively. As at December 2000 there were 83 offshore insurance as well as insurance-related companies in Labuan. Entry of foreign insurers into the Malaysian insurance market is currently allowed through investment in existing insurance companies that are subject to an aggregate foreign shareholding limit of 30 percent. For existing joint venture companies in the insurance business, foreign shareholders that were the original owners of the companies are allowed to own up to 51 percent of the total shares. For the insurance sector as a whole, foreign equity ownership of up to 51 percent is permitted with at least 30 percent of Bumiputra held equity. As of October 2000, 7 new licenses for non-life reinsurance business and 1 license for life reinsurance

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[14] In 1995, there were 37 commercial banks, 40 finance companies, and 12 merchant banks licensed in Malaysia. No new banking licenses have been awarded since 1997 other than for offshore banking licenses.

business were issued to foreign reinsurers since 1995. In July 1999, BNM invited applications for 6 licenses for professional life reinsurance business offered under Malaysia's GATS Schedule. Apart from these regulations, the industry itself practises self-regulation through market agreements, rules and codes issued by the four mandatory associations representing general insurers, life insurers, insurance brokers, and loss adjusters.

Malaysia has attempted to liberalise the financial services sector in a graduated and progressive manner under the GATS framework. As part of its membership commitments to the WTO, Malaysia signed and ratified the FSA that encompassed financial services. Malaysia has *not* made any horizontal commitments covering cross-border supply and consumption abroad[15]. Its commitments to permit commercial presence have generally been limited to joint ventures in which the maximum foreign equity permitted is 15 percent by a single or grouped foreign interest or to an aggregate foreign interest of 30 percent. (though holding of more than 30 percent foreign equity may be allowed on a case-by-case basis). National treatment provisions are in place for all land and real estate related transactions with tax incentives and preferences offered to Bumiputras.

3.3 Philippines[16]

Banking: The Philippines central bank, the Bangkok Sentral Ng Pilipinas (BSP), is responsible for controlling and supervising the financial services sector in the country. Although reforms were introduced in the financial sector in the Philippines in the 1980s, restrictions on entry into the banking sector stymied

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[15] Horizontal commitments refer to those commitments which apply to all service sectors in a given mode of service provision.

[16] This section draws on WTO (1999a).

competition. It was only in the 1990s that controls on branching and entry of new banks in the financial system was relaxed. The BSP passed the Republic Act (R.A.) 7721 in 1994 that allowed for the entry and scope of operations of foreign banks in the country. Thus, the number of branches of foreign banks operating in the country grew from 4 to 14 by 1997. These new banks were permitted entry either as a branch or a subsidiary only if they ranked among top 5 banks according to their assets, in their home countries, or were ranked among the top 150 banks in the world (Dobson and Jaquet, 1998). Another 4 foreign banks were allowed to establish subsidiaries and/or purchase up to 60 percent of the voting stock of existing banks. These measures resulted in an expansion of the operating network of the financial system in the country, and by 1999, banking institutions in the Philippines accounted for 41 percent of the total financial institutions operating in the country.

Such liberalisation measures in the early 1990s, coupled with the deregulation of the foreign exchange market in 1992, attracted large amounts of foreign capital inflows, most of which was directed into the real estate sector, creating an asset "bubble" which ultimately adversely affected the economy during the financial crisis in East Asia in 1997-98. As with other regional economies, the pursuance of financial liberalisation by the Philippines without the prior institution of an effective regulatory or supervisory framework was one of the root causes behind its vulnerability to the crisis (Gochoco-Bautista, 1999)

In response to this, the BSP has concentrated significantly on improving upon the regulatory and supervisory framework for banking operations in the country, as well as enhancing their competitiveness through privatisation and modernisation of banking facilities. As part of it, capital adequacy requirements have been raised, rules for non-compliance have been strengthened, and an early intervention mechanism for

possible bank failures has been adopted. Steps are also underway to strengthen the legal and regulatory systems related to corporate governance and restructure financial institutions and bankruptcy laws (Gochoco-Bautista, 1999).

As part of its horizontal commitments under GATS for financial services liberalisation, the Philippines has restricted the participation of foreign investors, which is limited to proportionate share of foreign capital invested. It has, however, committed to maintain a minimum foreign equity participation level of 40 percent. These requirements were maintained even in areas where the Constitution has allowed as much as 100 percent foreign equity participation. In 1994, it raised the foreign ownership limit in banking sector to 60 percent, although foreign participation in Philippine owned banks was restricted to 30 percent. Under the FSA of 1997, the Philippines made commitments to allow up to 51 percent foreign equity ownership for banks.

Insurance: The insurance sector in the Philippines comprises two government owned institutions, the Government Service Insurance System (GSIS) and the Social Securities system (SSS), along with a few other government and private insurance companies. The Insurance commission is the main regulatory agency overseeing the activities in the insurance market. The market is heavily reliant on reinsurance, with almost half of the assets of insurance companies being invested in government securities, stocks and bonds.

Since 1991, banks have been allowed to have an ownership stake of up to 35 percent in an insurance company. Foreign commercial presence in this sector is yet to be significantly established, although the government allowed up to 40 percent foreign ownership in insurance companies in the early 1990s. However, under the

FSA, the Philippines has agreed to increase the limit of foreign ownership in insurance companies to 51 percent from 1999.

3.4 Thailand[17]

Banking: The Bank of Thailand (BOT) is responsible for regulation and supervision of the commercial banking sector in Thailand under the Commercial Banking Act of 1962 (last revised in 1992). In the aftermath of the East Asian crisis, the government has been opening up this sector to foreign investment in order to attract foreign capital and expertise, and enhance competition in this sector (Montreevat and Rajan, 2001). Thus, Thailand's banking sector has been undergoing a period of intense consolidation (Rajan, 2001a and Bird and Rajan, 2002). The number of banks was expected to decrease from 15 to 13 at the end of the consolidation process.

With regard to cross-border supply and consumption abroad, there have been no changes in Thailand's market-access commitments in the financial sector save insurance. These remain unbound with the possible exception of financial advisory services and financial data processing.

With regard to commercial presence, no limitations are placed on representative offices of banks. Thus, 21 foreign banks operated fully licensed branches in Thailand in mid-1999, up from 14 in 1995, while 15 foreign bank branches operated as offshore International Banking Facilities (IBFs) in Thailand under specified terms and conditions.

Foreign bank branches are subject to certain operational restrictions. In principle they can operate up to three branches, but in practice, none of the

[17] This section is based on WTO (1998a,b and 1999b).

foreign banks have yet been granted approval to open more than one branch. According to the authorities, there has not been any demand for licenses to open additional branches, notably as four local banks have been put up for sale. A limited number of foreign personnel allowed per foreign bank office are allowed and is governed by a specific set of conditions. Locally incorporated banks in Thailand enjoy a significant advantage over their foreign counterparts, as they are not limited in the number of branches.

Following legislative amendments in 1997, foreign investors are now allowed to hold up to 100 percent of shares in commercial banks, finance, and "credit foncier" companies for a period of ten years, and thereby operate locally incorporated banks[18]. Thereafter, foreign investors will not be obliged to divest their holdings but may not purchase additional shares until the proportion of total foreign shareholding falls to within 49 percent. Foreign banks that purchase a majority share in a local bank are allowed to continue operating that bank under the rules pertaining to locally incorporated banks. The amendments of 1997 also maintain the requirement that maximum foreign equity participation should remain limited to up to a quarter of paid-up registered capital, and that the combined shareholding of an individual and related persons should not exceed 5 percent of a bank's paid-up registered capital, and that at least three fourths of the directors are of Thai nationality. However, the Minister of Finance may relax any of the above conditions for a particular bank if deemed suitable at its discretion. A similar decree was also issued concerning finance companies and credit foncier companies.

Insurance: The Ministry of Commerce in Thailand is the main regulatory body for overseeing the activities of the insurance sector. Thailand approached a three-stage

approach to the liberalisation of the insurance industry from 1997. In the first stage, 25 percent of foreign equity participation in domestic insurance companies was allowed and approval granted for setting up 25 new insurance licenses, out of which 12 were in the life-insurance business, and 13 were engaged in non-life insurance business. As a second stage, foreign equity participation is expected to be allowed up to 49 percent of registered share capital. In the third stage, foreign equity is allowed beyond the 49 percent limit after appropriate legal institutions are in place and have been in effect for five years.

Foreign insurance companies have played a significant role in the Thai insurance market, accounting for nearly half of total direct premia in the life insurance sector (as of mid 2001). Foreign insurance companies are able to sell life insurance policies to Thai residents, reflecting a high degree of liberalisation of this sector. However, there are limitations on national treatment for life insurance services, with life insurance premia being tax deductible up to 10,000 baht only for holders of policies that are issued by locally licensed companies, that may be either domestically or foreign owned. Cross-border supply of non-life insurance services has remained unbound, except for international marine, aviation, and transit, together with all classes of reinsurance in Thailand's insurance service sector. Market access conditions for intermediaries and suppliers of auxiliary services have not changed, viz. a branch of a foreign insurance company cannot conduct the business of insurance brokerage and insurance agent; while foreign commercial presence remains limited to 25 percent of equity.

Apart from the initial commitments made by Thailand in 1993 under the GATS, new commitments on Financial Services agreed to in July 1995 with respect to

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[18] Credit foncier companies are essentially non-banking financial intermediaries dealing in

insurance, banking and other financial services have been made through the Second Protocol to the GATS (the so-called Interim Agreement) and via the WTO's FSA concluded in December 1997 in its Schedule annexed to the Fifth Protocol. This also included the elimination of the MFN exemption of according differential treatment of other members on a reciprocal basis.

3.5 Section Summary

The above experiences of financial services liberalisation in the four middle income economies among the Southeast Asian countries indicates that both Indonesia as well as Thailand have been active in opening up their respective banking and insurance sectors to competitive market forces. This is indicated in their improved market access commitments in the FSA in 1997 (which was concluded during the onset of the financial crisis in both these countries), compared to their initial offers under the GATS schedule in 1994-95. It is evident that the crisis was a major factor in hastening the pace of multilateral financial services liberalisation under GATS in the two countries. Although Malaysia was also adversely affected by the crisis, its current financial services regime in some cases appears more restrictive to foreign competition and commercial presence, compared to the other neighbouring economies.

The pace of financial liberalisation in these three economies vis-à-vis its GATS commitments is summarised in Table 4. As with a number of other countries, these countries have bound their multilateral obligations at less than *status qu*o. The binding of commitments below status quo is a reflection of governments' dual objectives of trying to encourage foreign investments into the financial sector while

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immobile properties (Dobson and Jaquet, 1998).

simultaneously avoiding a repeat of the turmoil and instability following the premature and ill-sequenced liberalisation prior to the regional crisis of 1997-98, not to mention providing some degree of protection to the incumbent national suppliers from immediate competition. This said, all the countries, especially Thailand, have continued to take important steps towards the *de facto* relaxation foreign equity limitations. There appears to be a clear policy preference for promoting foreign equity investments (ownership/divestment) over the promotion of market competition (Table 5).

With regard to the insurance sector, entry limitations have been accompanied by restrictions on foreign equity. There appears to be a relatively greater willingness to undertake more liberal commitments in the banking than the insurance sector (Table 6), and there has been a relatively greater willingness on the part of these countries to commit to liberal consumption abroad than to cross-border supply.

4. Concluding Remarks

The paper has outlined the theoretical and empirical rationale for liberalisation of trade in services and has attempted to assess the state of liberalisation and the policy environment of the financial and telecommunications sub-sectors in four Southeast Asian countries, viz. Indonesia, Malaysia, the Philippines and Thailand. While the country experiences indicate a general move towards greater deregulation and privatisation, a close comparison of actual policies with the offers made by these countries under the GATS schedule reveals that many of the multilateral offers made have been at status quo or below it (i.e. "water" in the liberalisation commitments). Similarly, the countries have been very cautious in committing themselves to GATS-plus offers and have made little progress in liberalising service trade in the two sub-

sectors at the regional level (Austria and Avila, 2001 and Nikomborirak and Stephenson, 2001).

In conclusion, it warrants repeating that, as with the case of liberalisation of trade in goods, liberalisation of trade in services could involve fairly painful temporary/short-term adjustment costs that need to be appreciated and appropriately managed. In addition, services liberalisation in particular requires that the institutional and regulatory environment be fortified prior to and during the process of liberalisation. Deregulation in a weak or ineffective regulatory and supervisory environment could cause severe instability in that sector and the overall economy in view of the important linkages that services have to the rest of the economy. This was made clear by the East Asian crisis of 1997-98 which was partly due to the premature, i.e. ill-timed and ill-sequenced, financial liberalisation.

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Table 1
International Transactions in Services by Mode of Supply, 1997

GATS Mode of Supply	Category	Value ($ Billion)	Cumulative Share (percent)
Mode 1	Commercial services (excl. travel)	890	41.0
Mode 2	Travel	430	19.8
Mode 3	Gross output of foreign affiliates	820	37.8
Mode 4	Compensation of employees	30	1.4
Total	--	2,170	100.0

Note: Modes 1,2 and 4 are derived from balance-of-payments data
Source: Karsenty (2000)

Table 2
Major Statistics of the Service Sector

	Average annual growth		Share of Services Sector		Rank as World	Rank as World
Country	**of service sector**		**Value Added (as percent of GDP)**		**exporter of**	**importer of**
	1980-90	**1900-2000**	**1990**	**2000**	**commercial services**	**commercial services**
Indonesia	6.5	4.0	41	36	39 (0.3)	30 (1.0)
Malaysia	4.9	7.2	43	48	26 (0.9)	25 (1.2)
Thailand	7.3	3.7	50	49	28 (1.0)	28 (1.0)
Philippines						

Note: Figures in parentheses indicates percentage share in world exports / imports of commercial services
Source: WTO (2001a), and the World Bank (2001b)

Table 3
Methodology for Constructing Financial Index of Openness[a]

Rank	Market Structure	Foreign Equity Permitted	Capital Controls (Dailami Index)
8	Competitive	≥ 50%	≥ 1.6
7	Competitive	≥ 50%	< 1.6
6	Competitive	< 50%	≥ 1.6
5	Competitive	< 50%	< 1.6
4	Not Competitive	≥ 50%	≥ 1.6
3	Not Competitive	≥ 50%	< 1.6
2	Not Competitive	< 50%	≥ 1.6
1	Not Competitive	< 50%	< 1.6

Note: a) Rankings are assigned on a basis of a lexicographic scheme discussed in detail in source
Source: Mattoo, Rathindran and Subramaniam (2001)

Table 4
Financial Services Liberalisation in Southeast Asia: Actual Policy versus GATS commitments under 1997 Financial Services Agreement (FSA)

	Actual Policy	GATS (FSA)	Remarks
Indonesia	Allows 85 percent ownership in banking, new foreign equity capped at 49 percent.	Committed to 49 percent ownership in banking,	Status Quo
	Allows 80 percent ownership in insurance	Committed to 100 percent owned subsidiaries in the insurance sector.	Status Quo Plus
Malaysia	Allows 30 percent ownership in banking sector	Committed to 51 percent equity in banking.	Status Quo Plus
	Allows 49 percent ownership in insurance	Committed to 51 percent ownership in insurance ; existing investments not grandfathered	Less than Status Quo
Thailand	Allowed 100 percent ownership in banking till 2007, thereafter 49 percent for new equity.	Committed to 100 percent ownership in banking till 2007, thereafter 49 percent for new equity.	Status Quo
	Allowed 25 percent ownership in insurance sector.	Committed to 25 percent ownership in the insurance sector.	Status Quo
Philippines	Allows 60 percent ownership in banking sector	Committed to 51 percent ownership in banking, grand fathering existing rights.	Less than Status Quo
	Allows 40 percent ownership in insurance	Committed to 51 percent ownership in insurance.	Status Quo Plus

Source: Dobson and Jaquet (1998)

Table 5
Market Access Commitments in Banking Services

Member	Limits on Cross Border	Limits on Cross abroad	Legal form	No. of suppliers	Equity	Number of operations (branches)
Indonesia	None	None	New: I, joint venture (G of old B)	New: U	Acquisition of existing: 49% (G)	2 B office
Malaysia	Deposits:U	None		New: U	Existing: 30% (G) DLSO	U for B and ATMs of commercial banks
	Lending ≥ RM25m only with mode 3					
Thailand	U	U	I or B	S: U B: DL	Acquisition of existing: 25% (limits on individual. ownership) DL on ≥25%	Existing banks with a B before 1995: 2 additional Bs (G); new Bs: DL
Philippines	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Notes: Abbreviations used are as follows:
B = branches
S = subsidiaries
h = restrictions in horizontal commitments
I = local restrictions required
None: commitment to impose no restrictions
No text: no restrictions, but reference to some regulations
U: unbound (no commitment)
R: reciprocity condition or MFN exemption
DL: discretionary licensing or economics needs test
(D)LSO: (discretionary) limits on single ownership
G: grandfathering provisions
n.a.: not available

Source: Mattoo (2001)

Table 6
Market Access Commitments in Insurance

Member	Limits on Cross Border	Limits on Consumption Abroad	Limits on commercial presence			
			Legal form	No. of suppliers	Equity	Other
Indonesia	U	DL			100% of listed cos. (G)	
Malaysia	Life: U	I	I	New: U	On incorporation of existing branches and for original owners: 51%; new participation in existing 30% (DLSO)	No branches for foreign 50% (G)
	Non-life: DL					
Thailand	U except for international marine aviation and transit			DL	25%	n.a.
Philippines	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Notes: Abbreviations used are as follows:
B= branches
S= subsidiaries
h = restrictions in horizontal commitments
I = local restrictions required
None: commitment to impose no restrictions
No text: no restrictions, but reference to some regulations
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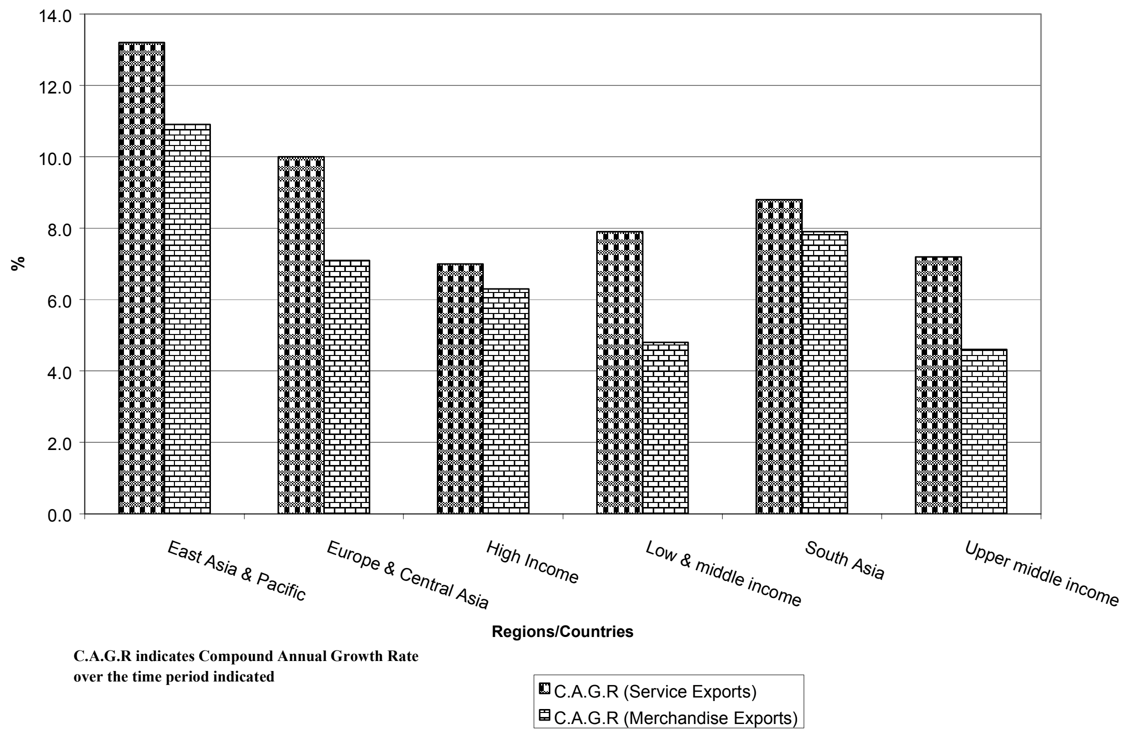
(D)LSO: (discretionary) limits on single ownership
G: grandfathering provisions

Source: Mattoo (2001)



Source: Computed from World Bank (2001b)