

Chapter One

Introduction

Financial liberalization has prevailed in several developed and developing countries over the last three decades. Financial liberalization, through giving banks and other financial intermediaries more freedom of action, results in resources being governed by the market mechanism and hence being more efficiently allocated. Three broad types of financial liberalization are discussed in the literatures. One is concerned with lifting the restrictions on the domestic financial sector, which includes the deregulation of the interest rate, the exchange rate, allowing new financial instruments to be introduced, and encouraging mergers among financial institutions, to name but a few. Demirgüç-Kunt and Detragiache (2001) have chosen the deregulation of bank interest rates as the centerpiece of financial liberalization, and find that banking crises are more likely to occur in countries with a liberalized financial sector. Kaminsky and Schmukler (2003) measure the liberalization of the domestic financial system by analyzing the regulations on deposit and lending interest rates, and complementing that information with the regulations on allocation of credit and foreign currency deposits. Moreover, Montes-Negret and Landa (2001) investigate the liberalization process of interest rate in Mexico.

The second broad liberalization refers to the opening up of the domestic market to international participants, that is, allowing the domestic market to be parallel to the international one. Claessens and Glaessner (1998) point out that internationalization has helped build more robust and efficient financial systems by introducing international practices and standards, by allowing more stable sources of funds, and by improving the quality, efficiency, and breadth of financial services. Claessens, Demirgüç-Kunt, and Huizinga (2001) study the effects of foreign bank entry on the efficiency of domestic banks. The experiences of various countries seem to suggest that a foreign bank

presence can facilitate increased competition, improve the allocation of credit, and help increase access to international capital markets. Henry (2000) reports that stock market liberalization identified by official policy decree date has led to faster growth rates of capital accumulation in nine of eleven developing countries. Bekaert and Harvey (2000) show that the liberalizations in emerging equity markets defined by regulatory changes, introduction of depositary receipts and country funds, and structural breaks in equity capital flows leads to a decrease in the cost of capital. Nevertheless, Kawakatsu and Morey (1999) seem to reject the hypothesis that equity market liberalization should improve the efficiency of markets.

The third approach is to construct a financial liberalization index on the basis of the schedules of commitments which have submitted to the World Trade Organization (WTO). The members of the *General Agreement on Tariffs and Trade* (GATT), the predecessor of the WTO,¹ commenced bilateral negotiations on trade in services in 1994 and have started to submit liberalization commitments and schedules since then. Each member, in considering its own domestic situation, has progressively liberalized its trade in services according to these schedules.

There are twelve sectors covered in the services negotiation under the WTO,² we focus particularly on the largest one, the financial services sector. For each activity in financial services, three categories of commitment, *unbound* (no commitment), *bound* (partial commitment), and *none* (full commitment),³ are promised by each country. By employing the schedules of commitments as of mid-1994, Hoekman (1995, 1996) uses values of 0, 0.5, and 1 to enumerate the above three categories of commitments, with a higher

¹ The WTO began life on January 1, 1995, but its trading system is half a century older. Since 1948, the GATT has provided the rules for the system. The last and largest GATT round was the Uruguay Round, which lasted from 1986 to 1994 and led to the WTO's creation. Whereas the GATT dealt mainly with trade in goods, the WTO and its agreements now cover trade in services, in the context of the *General Agreement on Trade in Services* (GATS), and other areas.

² The classification of services established by the Group of Negotiations on Services (GNS) is as follows: (1) business services; (2) communication services; (3) construction and related engineering services; (4) distribution services; (5) educational services; (6) environmental services; (7) financial services; (8) health related and social services; (9) tourism and travel related services; (10) recreational, cultural and sporting services; (11) transport services; and (12) other services.

³ The Chapter Two of this dissertation will further explain these commitments.

number denoting a higher degree of liberalization. Other researches also use this frequency measures method to quantify and assess the impediments to trade and investment in services, which are less transparent and more difficult to quantify.

The first purpose of this dissertation is interested to further extend and improve the methodology proposed by Hoekman (1995, 1996) in calculating the financial liberalization indices under the WTO. However, our work makes several improvements on Hoekman (1995, 1996) and others in at least three important ways. First, and perhaps most importantly, we intend to analyze in more detail the information involved within different degrees of liberalization and thus score further on the partial commitments instead of unanimously giving a score of 0.5 to the partial commitments as Hoekman (1995, 1996) and Hoekman and Primo Braga (1997) did. The second improvement of our measure is concerned with covering four modes of supply on trade in services and all the activities listed in the *Annex on Financial Services* in calculating the liberalization index.⁴⁵ Finally, the third revision is to assign weights to four modes of supply.

The second goal of this dissertation is to examine the effect of financial liberalization on economic growth by employing our newly constructed financial liberalization index under the WTO. The effect of liberalization on growth has recently attracted a significant amount of attention. In the literatures, the different spheres of liberalization are threefold, namely, trade, financial, and equity liberalization. For studies using trade liberalization as a proxy for liberalization, Sachs and Warner (1995) find a strong positive impact of postwar trade liberalization on economic performance in developing countries. Greenaway, Morgan, and Wright (1998) suggest that trade liberalization does impact favourably on the growth of GDP per capita but not in a wholly straightforward way, which may be a “J curve” type of adjustment

⁴ The GATS distinguishes the ways in which services are supplied from foreign suppliers into four possible modes, which are listed as cross-border supply (Mode 1), consumption abroad (Mode 2), commercial presence (Mode 3), and the presence of natural persons (Mode 4). The Chapter Two of this dissertation will further explain these modes.

⁵ Detailed contents of *Annex on Financial Services* will describe in the Chapter Two.

at work. Eschenbach, Francois, and Schuknecht (2000) place emphasis on the pro-competitive effects related to the trade in banking services. They find that there is a strong positive pattern linking banking sector competition and liberalization of banking services trade, and between growth and banking sector competition. With regard to financial liberalization, Levine (2001) shows that international financial liberalization, by enhancing stock market liquidity through fewer restrictions on international portfolio flows and by improving the efficiency of domestic banking industries through greater foreign bank presence, accelerates economic growth. Tornell, Westerman, and Martinez (2004) find that both trade and financial liberalization lead to higher GDP growth in developing countries, and that the former has typically been followed by the latter. In addition, Shen and Lee (2006) find that financial liberalization has little effect on the relationship between financial development and economic growth. Finally, for researches using equity liberalization as a proxy for liberalization, Bekaert, Harvey, and Lundblad (2001), who base on the liberalization dates presented in Bekaert and Harvey (2000), find that average real income growth increases 1 percent and 2 percent per annum after equity market liberalization for thirty emerging economies. By employing further alternative measurements of the liberalization variable, Bekaert, Harvey, and Lundblad (2005) show that equity market liberalizations lead to a 1 percent increase in annual real economic growth for ninety-five countries. However, there is only scanty empirical research that uses the WTO liberalization index to study the same issue.

The third objective of this dissertation makes an attempt to investigate whether there are any systematic determinants of a country's level of commitments in financial services which have submitted to the WTO. Within the framework of the theory of endogenous protection, Marvel and Ray (1983, 1987), Trefler (1993), Lee and Swagel (1997), Gawande and Bandyopadhyay (2000), and others have contributed to the literatures on the formation of nations' trade policy, which typically focus on trade in goods. By contrast, relatively few studies are involved with the examination of what determines the implementation of policy of trade in services, especially the financial services.

The remainder of this dissertation is presented in the following four chapters. Chapter Two introduces the history of the WTO commitments, describes how we construct and assess the financial liberalization index, and discusses some patterns of our calculated financial liberalization index. Chapter Three examines the correlation between economic growth and the financial liberalization under the WTO. Chapter Four explores the determinants of our constructed liberalization index of banking services. Finally, Chapter Five summarizes the conclusions that are drawn.