GROWTH PROSPECTS IN FINANCIAL SERVICES

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Mr. Chairman, my fellow panelists, distinguished delegates, dear friends,

Pleasantries

It gives me immense pleasure to be here today for the inaugural Asia-Middle East Dialogue (AMED). The endeavour of the Government of Singapore in the organisation of this conference is extremely praiseworthy. I am greatly honoured for being invited here to be a part of this eminent panel and I would like to extend my heartfelt thanks to the organisers for this opportunity. Since time is short and we have a lot of ground to cover during the parallel sessions, let me directly get into the topic, *i.e.*, the growth prospects in financial services. What I am going to do here today is to start with an overview of the global services trade in general and financial services, in particular. I would then provide the state, strengths and weakness of financial services trade in Asia and the Middle East. I would wrap up my presentation with a perspective on how Asia and the Middle East can benefit from each other by increasing their linkages in terms of trade in financial services.

Despite accounting for the bulk of global income, cross-border trade in services remain low

As most of you are aware, in the post World War II period, in almost all parts of the world a process has taken place which we economists call 'tertiarisation' of the economy. What is means in simple terms is that the share of services activities in the overall economic activities has increased tremendously in almost all parts of the world over the last 30 years or so. While services accounted for about half of the world income in the early 1970s, today it accounts for close to 70 per cent of the world income. However, by their very nature and unlike

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most goods, majority of the services need to be produced and consumed (*i.e.*, used) simultaneously and at the same place. For example, if one wants to enjoy the immaculate hospitality of the Singaporean hotels, as we are doing since yesterday, one needs to come here. There is no way you could order and get all these sitting in Mumbai or Abu Dhabi. This can act as a constraint on the growth of international trade in services. That is why, despite accounting for close to 70 per cent of the world income, even today, services trade account for only around 20 per cent of the world trade in goods and services.

Recent innovations have enhanced the scope for cross-border services trade

Innovations and technical progresses over the last decade have, however, made cross-border trade in certain types of services possible in ways which were unthinkable earlier. For example, sitting in Karachi, through video conference, it is possible to consult a doctor situated in Hong Kong, Manila, Colombo or any other place of the world for that matter. Through business process outsourcing, companies in the US or Europe are increasingly sourcing their back office operations from places such as Bangalore, Sanghai or Manila. Moreover, with increased possibilities of digitalisation, lots of goods are getting converted into services and getting traded over the internet. Examples of these include music, computer software, books and magazines. Notwithstanding all these, the bottom line, however, remains. Inherently, services are less amenable to international trade as compared to goods.

Financial services are more amenable to international trade… but challenges remain

The good news, however, is that unlike most other types of services, provision and use of almost all types of financial services can be unbundled. That is, sitting in Singapore, one can open, at least in principle, a bank account in Beijing, buy an insurance policy from New Delhi, and sell a security in Dubai. Keeping in view the systemic concerns, most countries, however, adopt a sequenced approach towards allowing cross-border flows of financial services. Notwithstanding such a cautious approach, most countries in Asia and the Middle East and also in the rest-of-the-world allow foreign financial service providers such as banks, insurance companies or stock broking agencies to come and open shops in their countries and thereby cater to the financial services needs of the residents of those countries. The World Trade Organisation (WTO) considers such provision of services as international trade in financial services. Technically this is known as provision of financial services through physical presence (or Mode 3) and worldwide this is the dominant form of trade in financial services. Operationally, therefore, management of capital account involves a distinction not only between residents and non-residents or between inflows and outflows but also between individuals, corporates and financial intermediaries. If such financial intermediaries are controlled by foreign entities, they perhaps lead to grater volatility in capital flows, as they are often influenced by considerations other than domestic economy and have less appreciation for local conditions (Reddy,2004)[1] .

Recent innovations and technical progresses are facilitating trade in financial services

Technical progress and financial innovations over the last fifteen years or so has substantially widened the scope of cross-border trade in financial services. First, earlier the lack of information was a major constraint for the spread of trade in financial services. Today with the popularisation of the internet, financial and other information are available at any part of the world on real time basis literally at the click of a mouse and for negligible cost. Second, recent years have seen rapid innovations in financial products. Validating an age-old economic proposition known as the Says Law, it appears

[1] Remarks on capital account liberalisation and capital controls by Dr. Y.V. Reddy, Governor, Reserve Bank of India at the Central Bank Governors' Symposium convened by the Bank of England in London, June 25, 2004.

that such supplies are creating their own demand. Three, progress in risk management techniques has made detachment and transference of various types of risks easier. These are facilitating all types of productive activities while boosting trade in financial services. Four, the innovations have drastically reduced transaction costs and time required to undertake a cross-border trade in financial services.

Limitations of data on financial services trade

Before presenting the big pictures on global trade in financial services, I would like to caution you that data on international trade in services in general and financial services in particular are not very robust. While there are various initiatives to rectify the lacuna, the problem still persists. In fact, there is no consistent international data series available on trade in financial services. I would, therefore, talk about 'other' commercial services, of which financial services is a major part.[2]

Global trade in financial services is increasing fast

Despite being much lower than trade in goods, in the recent years, international trade in services is generally growing at a faster rate. For example, on an annual average basis, during 2000-03, world trade in goods grew by 5 per cent while in trade services grew by 7 per cent. Other commercial services, of which financial services is a major part, grew even faster, at the rate of 9 per cent per year. All of us are aware that financial services are important inputs to almost all types of production, distribution and marketing activities. Therefore, access of the entrepreneurs and other commercial entities to financial products are crucial for economic growth of the country. Moreover, as I indicated just now, the markets for financial services are growing fast and thereby countries with buoyant financial services industry can transform this sector into important source of economic growth and development.

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[2] All data on cross-border services trade reported in this paper are sourced from the releases of the WTO.

Liberalisation of financial services good for both providers and users … but need for prudential measures and safety nets

However, there is a need for caution for the countries while liberalising their financial markets to cross-border flows. Markets for financial services are notorious for their imperfections. Even the highly sophisticated financial markets in the West often do not function properly. And, the fall out of financial markets instability can be potentially destabilising for the economy. Standing here in Singapore, I do not need to elaborate on the ravages of financial crises. The requirement, therefore, is to set up adequate prudential framework while liberalising cross-border trade in financial services. These help us prevent financial crises. Moreover, in the eventuality of a financial crisis, for the resolution of the crisis at the lowest cost, safety nets and well-laid out arrangements for close inter-institutional and inter-governmental cooperation are also needed. In view of the emerging global picture, let me now turn attention to the shape of financial services industry in Asia and the Middle East.

Asia is a major global player in both exports and imports of financial services

A quick look at the trends show that Asia as a whole account for a considerable proportion of global cross-border trade in other commercial services. During 1990-1997, Asia's share in the global exports and imports of other commercial services increased sharply from 17 per cent to 25 per cent and from 21 to 29 per cent, respectively. However, the crisis that occurred during this period seriously disrupted such trade. After almost continuous declines during the post-1997 crisis period, these shares have increased again since 2003. In 2004, exports and imports of other commercial services by Asia at around US $ 200 billion each accounted for around 20 per cent of the global exports and 22 per cent of the imports.

Asian securities

The biggest advantage of the financial services industry *markets offer wide range of products … these markets are deep, liquid and sophisticated in terms of technical and risk-management practices*

in Asia is the diversity of the products offered by them. Apart from the standard products, there has been strong growth in the derivative segments of these markets. These products allow both hedgers and risk-takers to meet their varied risk appetite. It is important to note that the large range of financial products is available not only in the established regional and international financial centres such as Hong Kong, Singapore or Tokyo, but also in most other Asian countries as well. Near complete automation of securities transactions, advanced risk management framework, structured clearing and settlement systems with well-defined counter-parties and generally liquid securities markets with diversified investor bases are other major advantages of the securities markets in Asia.

Asian banks have become stronger over the last decade

The banking industry in Asia is also well developed. Over the past decade, in most of the Asian countries there has been considerable restructuring of the banking sector. The capitalisation levels of the banks have been improved, provisioning for non-performing loans has been strengthened, risk management practices have been restructured in line with international practices, competitive pressures have been increased, exposures to single/group borrowers have been reduced and, in general, interference of the government with the financial services industry has got reduced. Despite certain lingering concerns, some of which I would mention in a few seconds, improvement in the structure of banking in countries such as China, India, Japan and most of the east Asian emerging market economies are particularly noticeable.

Weaknesses of the Asian financial services industry include underdeveloped

Notwithstanding these positive features, there are certain limitations of the financial services industry in some of the Asian countries. While it is well known that the development of domestic bond market is critical in the financial sector development process, a common *bond markets, large non-performing loans of banks*

weakness is relatively low level of development of bond markets in the region. In some of the Asian economies the levels of market capitalisation are low and government deficits are high, which hamper the development of corporate securities markets. Moreover, in some of the Asian countries large portfolio of non-performing loans of the banks is a constraining factor. While many of these weaknesses are structural and can be addressed only over a longer-time period, most Asian countries have liberalised their financial services industry, which have improved the health of the industry and also increased productivity and efficiency.

Potential for financial services trade is underachieved in Asia … the future is, however, bright

I think that in view of the fact that we have three of the four largest economies of the world (under purchasing power parity principle) in this region, namely, China, Japan and India, our shares in cross-border financial services trade, though substantial, are considerably lower than what it should be. We have highly sophisticated financial services centres here in Singapore and also in Hong Kong and Japan. Countries such as China, Korea and Malaysia are also making strong efforts to set up international financial service centres of their own. So, I think that we are ideally poised to take a big leap in substantially increasing our global market shares in financial services in the coming years.

International financial community is bullish on the financial services industry in Asia

Interests of the international community in the financial services industry in Asia are tremendous. Asian emerging market economies, most notably China, are among the top recipients of foreign direct investment. More recently, realising the potentials of the stock markets in the region, large cross-border investments are coming to countries such as China, India, Korea, Malaysia and Taiwan. Similarly, realising the potentials of the banking and insurance sectors of the Asian economies, the industrialised countries from the West are putting constant pressures on us for liberalisation of these sectors, especially through binding commitments at the WTO.

Both exports and imports of financial services by the Middle-East remain low

Let me now say a few words about the financial services industry in the Middle East. Despite various strategic advantages, in relative terms, cross-border trade in financial services by the Middle East remains low. Both the exports and imports of financial services by the Middle East stood around US $ 20 billion in 2004. Global shares of the Middle East in financial services during 2004, in terms of both exports and imports, remained below 2 per cent. These shares, I am sure that everyone present here would agree, are very low given the potential of the region. Let me illustrate this point with an example.

Strong potentials for deepening financial services trade in the Middle-East … governments are facilitating the process

In September 2003, the Government of the Emeritus issued bonds (with five year maturity) worth about US $ 400 million without any international rating. The spread offered was less than 50 basis points over the comparable US swap rate – a very reasonable rate even for a highly rated security. These bonds were, however, oversubscribed by one-and-a-half times. This just shows that there exist strong demand for financial services offered by the Middle East and also favourable perception about the region in the international financial community. Governments in the region are taking active steps to increase participation of the region for cross-border trade in financial services. Provisioning of export credit in Egypt through collaboration between the International Finance Corporation and the Citibank and permission to open joint-venture foreign banks in Syria are examples of such moves.

Financial services industry in the Middle East remains less

In a general sense, the developments of the financial services industry of the Middle East are not as advanced as most the larger Asian economies. The securities markets in most of these countries, even when present, *developed than Asia*

do not have large investor base or liquidity. The numbers of products offered by these markets are generally limited. The services offered by the banks or insurance companies are also not extensive in many cases.

Scope for cooperation between Asia and the Middle East in financial services is large

With this brief overview of the state, strengths and weaknesses of the financial services industries in Asia and the Middle East, let us now explore how these two regions can help each other in terms of financial services. In my view, there are two main ways in which Asia and the Middle East can help each other in terms of financial service industry. First, collective pooling of experiences in respect of developing of financial sector can be very helpful, especially in the areas of prudential regulation and supervision, risk management and phased liberalisation of the financial services industry. Second, increased interaction of corporates and investors from the Middle East and Asia for purposes such as raising resources, listing of securities, investing of funds and risk management can indeed be mutually beneficial. Such a cooperative framework would also help the Asian financial service industry in deepening their client and investment base and also to raise the liquidity of these markets and thereby strengthen the efficiency of the price discovery process.

Asia-Middle-East Cooperation in Financial Services and the oil sector

Apart from the general areas of cooperation between Asia and the Middle East in the context of financial services mentioned above, a specific area of cooperation relates to the oil sector. Oil prices, as all of us know, are historically extremely volatile. This volatility is a source of problem for both the oil exporting and importing countries. In the contemporary context, the oil exporting Middle-East is faced with the dilemma of how best to utilise the surpluses emanating from high international oil prices. On the other hand, almost all Asian countries outside the gulf region are net oil importing countries.

Many of these countries are faced with balance of payments problems on account of the current high oil prices. Once again with the aid of financial services industry, both the regions can help each other in the current context. This is a large canvass, so I would limit myself to a few illustrative examples. First, futures market for oil products in Asia can help both the importers and exporters to stabilise their cash-flow situation. It is, however, important to point out that these instruments would not be able to either reduce the volatility in oil prices or lead the oil prices to any particular level. Second, buoyant financial markets of Asia offer various lucrative options to the oil-rich Middle East countries to deploy a part of their substantially increased income on account of high oil prices. Such inflows from the Middle-East can also help some of the Asian countries to weather their bulging oil import bills. Three, currency futures and derivatives markets in Asia can aid the Middle East to hedge the exchange rate risks emanating from high volatility and uncertainties in the G-3 currencies. There are many other avenues for cooperation here. But, as I said, these are just illustrative examples on the possible areas of cooperation.

Synergies between Asia and the Middle-East in terms of financial services are too large to be wasted

To conclude, I must mention that apart from physical proximity, strong cultural ties and shared heritage, there are sound complementarities between the financial services industry in Asia and the Middle-East. Asia can be the doorway to the world for the financial services needs of the Middle-East and also a source of inspiration and expertise for deepening of the domestic financial services industry. The Asian financial services industry, in turn, would be benefited by the closer ties with investors and clients from the Middle-East. These synergies are too large to be wasted. At the same time, due to the inherently sensitive nature of financial services emanating from the sheer size of financial markets, speed of transaction and complexities arising out of rapid pace of financial innovation,, each country will have to evolve a policy that is best suited to its own circumstances. I sincerely hope that this session would stimulate the industry leaders and officials from both the regions to leverage our respective advantage so as to derive mutual benefits.

Thank you.