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Financial services in an increasingly integrated global financial market

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ABSTRACT

This paper discusses aspects of global financial services. As part of financial globalisation, financial institutions have evolved both nationally and internationally. FDI is becoming an important vehicle for multinational banks to enter developing countries. This in turn is changing the composition of trade in financial services. The experience of regional integration in Europe and the emergence of large multinational European banks signal a new era of global competition and consolidation of financial institutions. Home bias in international financial services is much less where financial integration is taking place. With financial globalisation, one should expect more diversification of ownership of multinational banks around the world, particularly when China and India are now able to have strategic investment in some of the key investment banks around the world. Financial globalisation requires stronger and more effective international institutions as a way of monitoring the activities of multinational financial institutions at both the national and international levels.

1. Introduction

In the 21st century, foreign direct investment (FDI) is becoming a more important way of reaching foreign customers than trade in goods and possibly services. As part of this process, the capital mobility and financial deregulation of national economies are providing the opportunity for more foreign financial institutions to enter emerging countries. At the same time, the financial products are expanding in diversity, as financial institutions expand their activities into insurance, funds management, wealth creation etc.

We are also observing that where corporate governance is strong, financial institutions are more willing to invest in those countries as well as directly participate in their financial services industry. It appears that reform of national institutions is an important contributor towards the acceleration of globalisation in financial services.

As financial globalisation is expanding to different parts of the world, financial institutions are taking the opportunity to expand their business into foreign countries. This is changing the nature of international financial services, as the nature of trade in financial services, as defined by Moshirian (1994, 2006) is evolving in such a way that FDI is becoming the major source of generating trade in financial services. Asia's success in trade in goods has provided it with success in financial services too. For instance, the opening of the banking sector in China to foreigners is also opening a new market for multinational banks which can position themselves in China ready for greater activities in future decades. At the same time, learning that is taking place as a result of financial integration in Europe has opened up a new way of considering the positive contribution of financial services to efficiency and stability in other regions in the world once a few or some nations decide to form a regional trading and investment block (see Moshirian, 2007).

The purpose of this paper is to discuss the evolution of global financial services by focusing on trade and FDI in financial services. We will consider home bias and the experience of the European countries in the context of the EU and its implications for other parts of the world. To this end, Section 2 discusses FDI in financial services; Section 3 discusses some issues with the emergence of mega banks in this century, Section 4 links trade in goods and trade and financial services, Section 5 discusses home bias and financial services with a focus on the EU, Section 6 discusses the Doha round of trade negotiations with a focus on financial services and Section 7 concludes.

2. FDI in goods and patterns of investment in financial services

According to the study by Kose et al. (2006), the main source of international investment in developing countries is FDI. In other words, most companies that invest in manufacturing products prefer to go and invest directly in emerging countries. If this trend is going to continue, then it is also possible that banks and other financial institutions will have more incentive to follow the manufacturers and/or follow the same strategy in emerging countries. In other words, while home bias will continue as long as the countries

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are not integrated as part of one regional or global economy, capital and financial services are flowing to emerging countries as long as these countries allow the entrance of foreign companies.

According to Domanski (2005), the value of the Financial Sector FDI, in the form of cross border merger and acquisitions targeting banks in emerging countries, has increased from \$2.5 billion in 1991–1995 to \$67.5 billion for 2001–2005. Latin America has been the largest recipient of this type of FDI (48 percent), followed by Asia (36 percent of total M&As) and then Eastern Europe with 17 percent of total M&A over 1991–2005. We are also seeing the partial privatisation of banks in China where some foreign banks were able to have access to some assets of these banks.

As financial globalisation intensifies, one can see that the way of providing financial services will change. As more FDI is taking place in emerging countries, financial institutions are trying to have entry into these markets and hence have direct access to the host countries' customers. This in turn will lead to an increase in international financial services, mainly offered in the form of FDI entry.

As regional blocks such as ASEAN or APEC intensify the removal of their financial barriers, one could expect larger banks to emerge in these blocks and at the same time, to see strong competition from the US and the EU into these two regional blocks and India. However, one should not underestimate the importance of more efficient financial institutions in Asia, as these countries are trying to expand their economic growth and become more competitive.

3. The emergence of mega-banks

While national reforms are improving the operation of domestic banks in some parts of the world, regional integration such as the EU has created a new banking system which is far more competitive than before. International events and globalisation are also creating global pressure on banks to become internationally more competitive. As the European banks merged and became larger and more competitive, the US financial institutions were allowed to merge and create strong new financial institutions that could compete better globally. However, with the pressure of financial globalisation and strong competition between the European and American banks, the pressure to succeed in Asia and be part of the growing markets in Asia, is contributing to the emergence of mega-banks which will increase in number over the next few decades.

It is conceivable that we may see a major American bank or European Bank merging with a major Chinese or Japanese bank (or one large US and one large European bank merging). This type of acquisition is going to then put more pressure on other large international banks to follow suit. This may create mega-banks as part of an increasingly integrated financial market in the 21st. In parallel to this process, we are also seeing very large mergers and acquisition in manufacturing products. It appears that as part of globalisation, we are going to see a concentration of financial institutions which will be controlling a large share of global financial services products. As part of this process, ownership structure will also change and hence we will be seeing a wider distribution of ownership amongst some countries whose investors can afford to participate in this process. In this new global environment, multinational banks will be able to circumvent some of the national regulations and almost make national boundaries irrelevant. It is this force of globalisation and the pressure to formally open up national economies and allow regional integration that will determine the way financial institutions will evolve over the next decade or so.

4. Success in trade in goods and advantage in financial services

Trade imbalances between China, mainly with the US has created an opportunity for China to increase her foreign reserve assets. This is allowing China, which does not yet have a comparative advantage in financial services to make strategic investments in financial institutions. This in turn may change the composition of ownership of many companies around the world. In other words, as part of globalistion, as ownership of firms are becoming more diversified, one should revisit the nature of trade in financial services which was discussed by Moshirian (1994). In this new global environment, success in trade in goods may provide enough financial assets for some nations such that they could directly find access to some of the existing leading financial institutions. This new phenomenon could also add a new dimension to the process of financial globalisation, global ownership and the way goods and services are traded.

At the same time, one should not underestimate the effects of partial privatisation of Chinese banks and access by foreign banks to China's markets as well as their partial ownership of some of these banks. Similarly, India is providing a fertile ground for further expansion of foreign financial institutions. All these are putting more pressure for mergers and acquisitions by current large multinational financial institutions, particularly, if they cannot participate in the joint venture opportunities in China or India.

The success of Japan in trade in goods in the past led Japanese banks to become amongst the top major banks in the world. However, the US and the European banks have maintained their comparative advantage in financial services over Japanese banks. In this new global environment, if some of the major banks and other financial institutions are going to be owned (subject to some national restrictions on foreign ownership policy) by countries such as China or India who keep accumulating foreign assets, one could increasingly see global trade and financial factors as the dominant forces determining the global allocation of resources. In this new climate where more multinational banks are going to emerge and at the same time, their ownership is going to be diversified, the role of an international institution such as the BIS will become more important as a way of ensuring some international standards are followed both at the international and national levels.

5. Financial services and home bias

There is no question that over the last few decades, barriers to international investment and finance have declined, particularly since the Uruguay round of negotiations. There have also been some efforts on the part of certain emerging countries to reform their national institutions and laws and ensure that there are better environments for attracting foreign companies, including financial institutions, into their countries. In this process, there have been some successes and yet a majority of developing countries are not attracting as much capital and foreign investment as they would like to. At the same time, sometimes there are national restrictions on foreign financial institutions being able to operate in their countries. This in turn is limiting the flows of financial services internationally. As discussed by Moshirian (2007), the neoclassical theory predicts that in the absence of explicit barriers and removal of national constraints for foreign capital, capital should flow from rich to poor countries where capital productivity is much higher. This will also spread risk amongst countries and in effect, in such a globally integrated economy, the role of countries with respect to the location of investment, is very much diminished. However, in reality, we do not yet have such an integrated global economy that borders between nations could be argued to be irrelevant with respect to the movement of capital and labor. At the same time, the way some multinational companies, including financial institutions, are positioned internationally, they sometimes could