Barriers to Trade and Integration in Asia and RCEP Countries

The Australian Centre for Financial Studies (ACFS) in June 2015 launched a project on financial integration in the Asia-Pacific. This note summarises one component, a paper for ACFS on *Barriers to Trade and Integration in Asia and RCEP Countries*. The Regional Comprehensive Economic Partnership (RCEP) trade negotiations started in 2012 and are now intended to reach "a swift conclusion". The main research for the ACFS paper was completed in mid-2016 and some improvements included in June 2017.

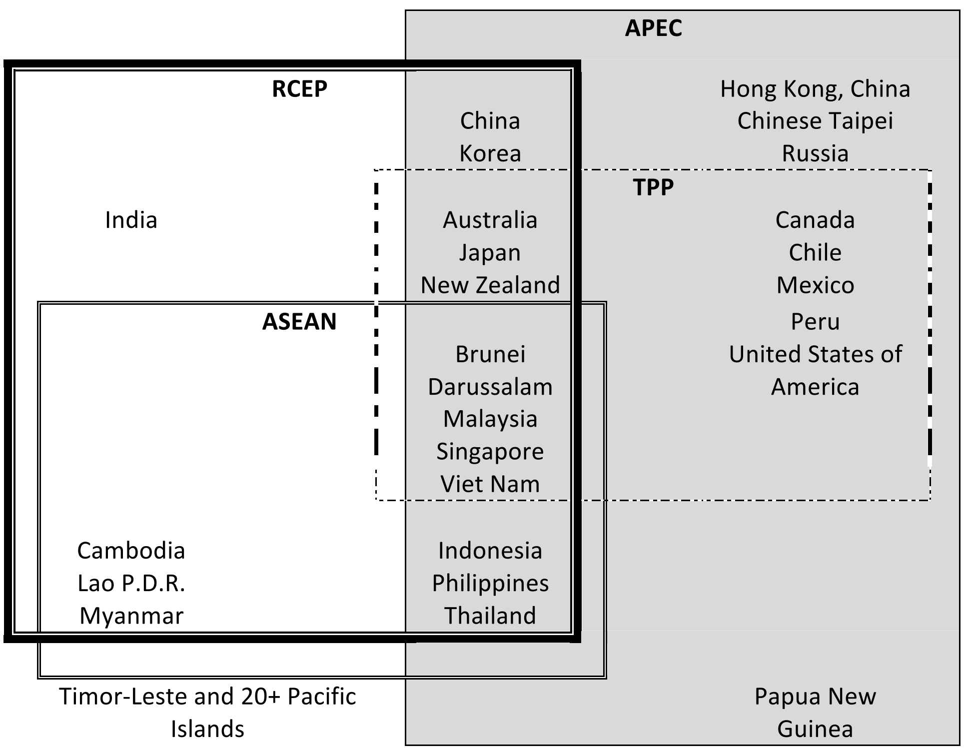
The paper seeks to inform those interested in advancing the RCEP negotiations on two topics: barriers to trade in financial services; and institutional arrangements promoting financial integration.

The premise is that some RCEP countries' barriers to trade in financial services are unnecessarily high, impeding financial integration. RCEP negotiations are an opportunity to adopt and advance ideas that hold the best potential to lower barriers to trade in financial services and promote financial integration.

Background information

The RCEP negotiations involve 16 countries, essentially all 10 ASEAN members and the "Plus Six" of Australia, China, India, Japan, Korea and New Zealand. The 12-country Trans Pacific Partnership (TPP) negotiations had involved 7 of the RCEP countries.

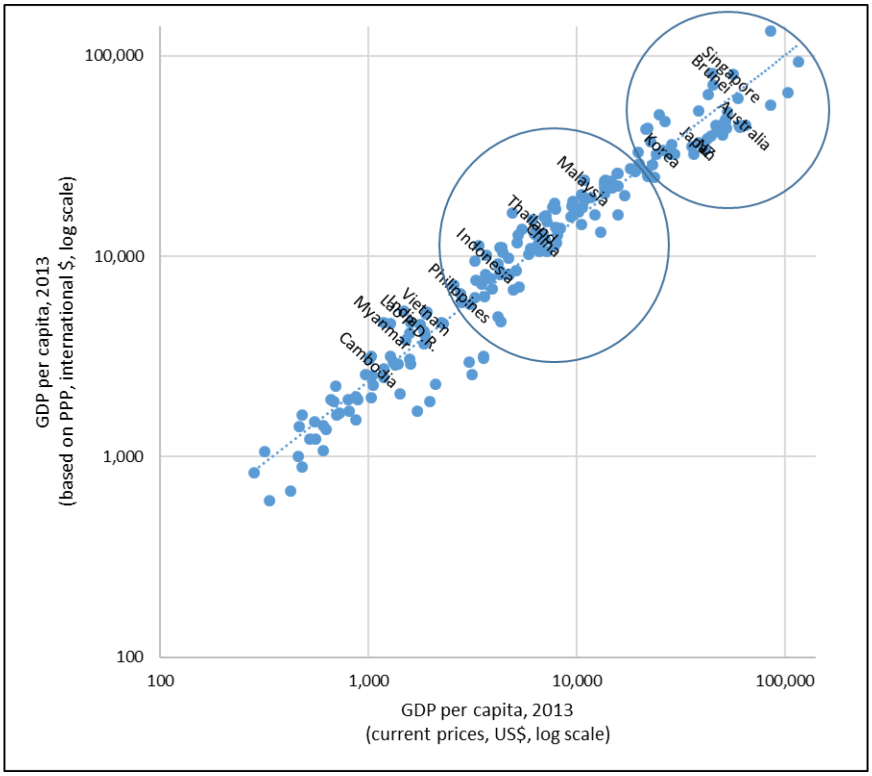
Figure 1: The principal economic partnerships in the Asia-Pacific.



Source: the author, adding to a diagram by Ken Kawasaki.

The 16 countries span a wide income range, arguably falling into three per capita income groupings, low, medium and high. Both ASEAN and the Plus Six are represented in each of the three groupings.

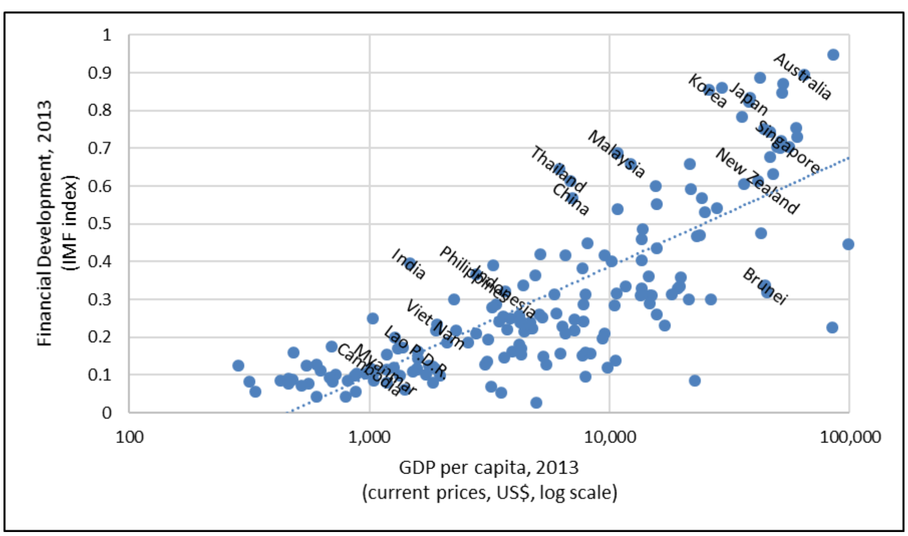
Figure 2: GDP per capita in 2013 for 189 countries, including all 16 RCEP countries.



Source: IMF World Economic Outlook Database, April 2016.

Compared to the averages for all countries, several RCEP countries show higher than average levels of financial development. The main exception is the oil economy of Brunei Darussalam.

Figure 3: GDP per capita and financial development for 180 countries, including all 16 RCEP countries.



Source: IMF World Economic Outlook Database, April 2016, and Svirydzenka 2016.

Issues in barriers to trade in financial services

Modes of supply

Trade negotiations are focused on reducing barriers to trade in services under four Modes of Supply:

- Mode 1: Cross-border supply
- Mode 2: Consumption abroad
- Mode 3: Commercial presence
- Mode 4: Presence of natural persons

For financial services, barriers to trade through Modes 3 & 4 are often the greatest concern to business.

Data

Some RCEP countries are significant globally as exporters or importers of financial services. But balance of payments and other data is weak in quality and coverage, both for RCEP countries and in the rest of the world.

One complication is that balance of payments/trade data can only see some of the flows: Mode 1 (cross-border supply) and Mode 2 (consumption abroad) are export/import flows, but sales resulting from Mode 3 (commercial presence) and Mode 4 (presence of natural persons) are not exports/imports: instead cross-border investment flows are recorded in the financial account of the balance of payments and the earnings of foreign affiliates are recorded in the income account of the balance of payments. Surveys of operations of foreign affiliates are rare.

Better data for all Modes of Supply would help inform negotiators and others considering barriers to trade in financial services.

Table 1: RCEP countries in the Top 15 as exporters or importers of insurance services and financial services, global rank and value of exports and imports, US$ billion.

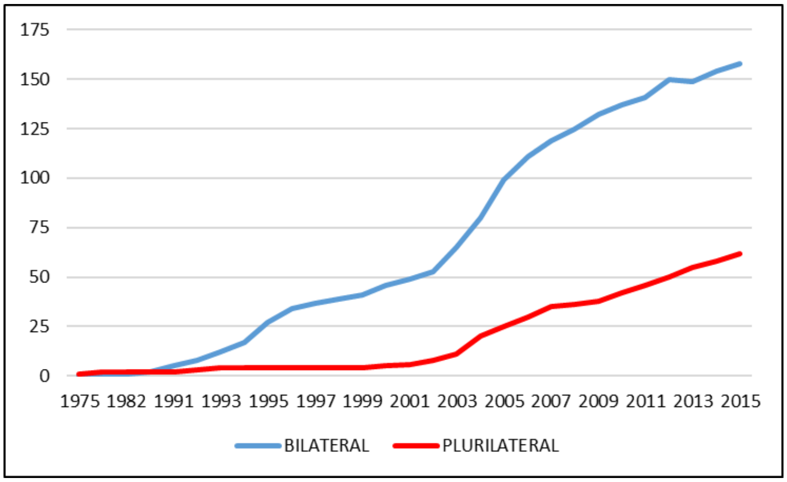
EXPORTS, RANK IN TOP 15 AND VALUE (IN US$ BILLION)					IMPORTS, RANK IN TOP 15 AND VALUE (IN US$ BILLION)				
	Insurance services		Financial services			Insurance services		Financial services	
	2012	2013	2012	2013		2012	2013	2012	2013
China	6th 3.3	7th 4.0			**China**	2nd 20.6	2nd 22.1		14th 3.7
Singapore	8th 3.3	8th 3.8	4th 16.5	4th 18.4	**Singapore**	7th 4.6	7th 4.6	12th 3.1	13th 3.8
India	11th 2.3	12th 2.1	9th 5.4	10th 6.4	**India**			7th 5.3	7th 5.9
Japan			10th 4.6	13th 4.6	**Japan**	4th 7.4	5th 6.8	11th 3.2	15th 3.6
Korea			14th 3.2		**Thailand**	11th 3.1	12th 3.0		
					Malaysia		13th 2.8		

Source: UN Comtrade and UN Service Trade, Insurance services (EBOPS 2002 code 253) 2013 and 2014 and Financial services (EBOPS 2002 code 260) 2013 and 2014.

Complexity

Many fear that a "noodle bowl" of trade agreements has been developing in the Asia-Pacific region. The number of bilateral and plurilateral agreements has been rising and a further profusion is locked in.

Figure 10: The number of bilateral and plurilateral trade agreements involving the 47 countries monitored by Asia Regional Integration Centre, including all 16 RCEP countries.



Source: Asian Development Bank (ADB) Asia Regional Integration Centre (ARIC) Database on Free Trade Agreements, Table 3.

Table 6: FTAs by status.

YEAR	UNDER NEGOTIATION		SIGNED BUT NOT YET IN EFFECT	SIGNED AND IN EFFECT	TOTAL	*OF WHICH*		PROPOSED
	Framework agreement signed	Negotiations launched				*Bilateral*	*Plurilateral*	
1975	0	0	1	0	1	*0*	*1*	0
2000	0	6	10	35	51	*46*	*5*	3
2015	5	65	10	140	220	*158*	*62*	67

Source: Asian Development Bank (ADB) Asia Regional Integration Centre (ARIC) Database on Free Trade Agreements Tables 1 and 3.

One distinct gain from a RCEP would come if it did not add to the "noodle bowl" but reduced it by providing some shared multi-country financial services agreements.

Measures of barriers to trade in financial services

The paper draws together some preliminary estimates of the extent of countries' barriers to trade in financial services from three sources, as available in mid-2016.

The World Bank (WB) Services Trade Restrictions Index (STRI)

Estimates available for 103 advanced and developing countries, including 12 of the 16 RCEP countries.

The WB STRI for financial services (banking and insurance) focuses on Mode 1 (cross-border supply) and Mode 3 (commercial presence); excludes Mode 2 (consumption abroad); and finds data unavailable for Mode 4 (presence of natural persons).

The OECD Services Trade Restrictiveness Index (STRI)

Estimates are available for 42 countries (34 OECD members and 8 developing countries), including 7 RCEP countries.

The OECD STRI for financial services (banking and insurance) includes a broader set of barriers, requiring weighting. For instance, the STRI for banking covers restrictions on foreign entry, i.e. Mode 3, weighted 43%, and on movement of people, i.e. Mode 4, weighted 8%, and other discriminatory measures (14%), barriers to competition (23%) and regulatory transparency (13%).

The Economic Research Institute for ASEAN and East Asia (ERIA) Coverage Index and the ERIA Hoekman Index

Some estimates of the coverage and ambition of ASEAN+n trade agreements are available for 13 RCEP countries:

- The ERIA Coverage Index measures the coverage of service sectors by an FTA's member countries and can thus be used to compare the coverage of different trade agreements, drawing attention to similarities and differences amongst the ASEAN+1 FTAs; and
- The ERIA Hoekman Index measures the depth of a country's commitment for all 4 Modes of Supply in a particular sector in selected trade agreements, which can be compared relative to its commitments under WTO GATS.

Of these, the two most revealing are the World Bank STRI and the OECD STRI. They have different qualities and criteria: the WB STRI involves a narrower focus but covers more countries; the OECD STRI has a broader focus but fewer countries (and, especially, fewer developing countries). Both inevitably reflect (sometimes differing) subjective assessments and regulatory interpretations of the compilers.

What drives the extent of barriers to trade in financial service? General levels of STRIs decline modestly as GDP per capita or financial development rise. Many RCEP countries have been successful in economic and financial development and might therefore be expected to have lower-than-average barriers to trade in financial services: some do, but some have above-average STRIs.

Barriers to trade in financial services and the "prudential carve-out"

The paper looks in more detail at the components of the so-called "prudential carve-out" that allow deviations away from WTO/GATS rules. Though there is dispute over its scope, in practice and in the paper the prudential carve-out is broadly interpreted as allowing policies that protect the exchange rate, consumers and financial stability/systemic risk, with the qualification that they do not do this "unnecessarily".

Exchange rate regimes

The typology of exchange rate regimes is well established: the International Monetary Fund (IMF) has been classifying countries' exchange rate regimes annually since 1950, see IMF 2015 (the IMF Annual Report on Exchange Arrangements and Exchange Restrictions, AREAER).

The IMF AREAER now allocates exchange rates to one of 10 regimes: No separate legal tender; Currency board; Conventional peg; Stabilisation arrangement; Crawling peg; Crawl-like arrangement; Pegged exchange rate within horizontal bands; Other managed arrangement; Floating and Full floating. In the paper, we exclude the countries with no legal tender, and split those Full floating into Non-Euro and Euro, as the Euro adoptees have a virtually barrier-less single market for capital, goods and services.

Thus, the range runs from 'hard fix' to 'free floating', which are the exchange rate extremes of the Mundell-Fleming 'trilemma', and with most countries (including most still-developing RCEP countries) in the middle between these extremes (as Grenville 2000 expects).

Consumer protection regimes

The typology for consumer protection regimes is less well-developed: the most established has been classifying countries by whether deposit insurance is explicit or not, which is an ambiguous criterion. A database of the main deposit insurance scheme in 181 countries in 2003 has been expanded to 190 countries and updated to end-2013 (Demirgüç-Kunt et al, 2005 and 2014). However, the more recent paper usefully also provides a Safety Net Index gauging the extent to which depositors will be made whole in event of loss.

Financial stability/systemic risk regimes

The typology of financial stability/systemic risk regimes, by contrast, is still in its infancy. Cerutti et al (2015) has sought to classify regimes simply by counting the number of macroprudential instruments deployed in a country. In addition, a market-sensitive measure of systemic risk posed by countries' financial systems (SRISK) is available from Stern Business School's Volatility Laboratory.

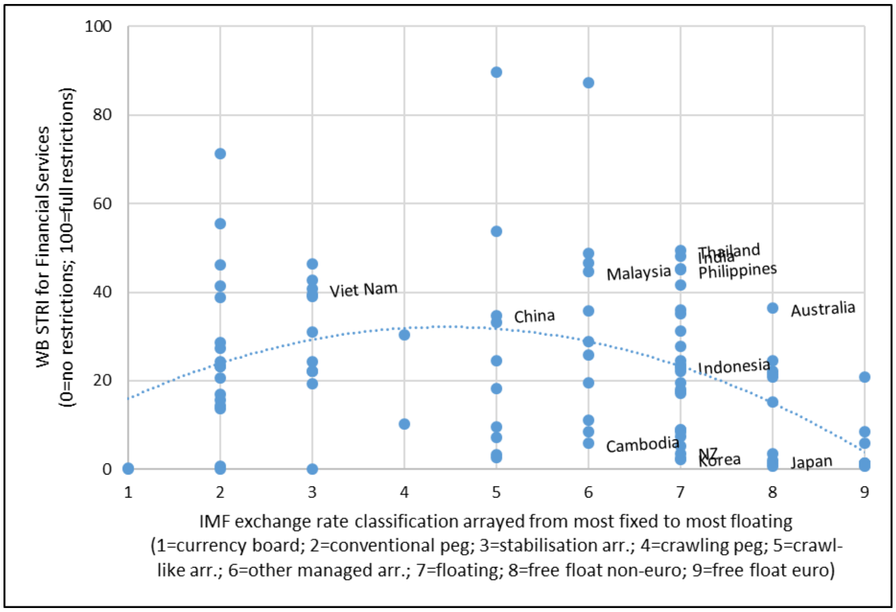
Barriers to trade under a broad interpretation of the prudential carve-out

Wherever there are data for STRIs for financial services and the policy regime permitted under the prudential carve-out, we try to observe an association between the two.

As shown by the 100 countries for which we have a measure of barriers to trade in financial services and an exchange rate regime classification, differing exchange rate regimes do seem associated with differences in STRIs (in this instance using the WB STRI).

There is a "frown", being higher STRIs for exchange rate regimes that are neither a hard fix nor freely floating. Furthermore many (but not all) RCEP countries tend to have STRIs above the average for their chosen exchange rate regime.

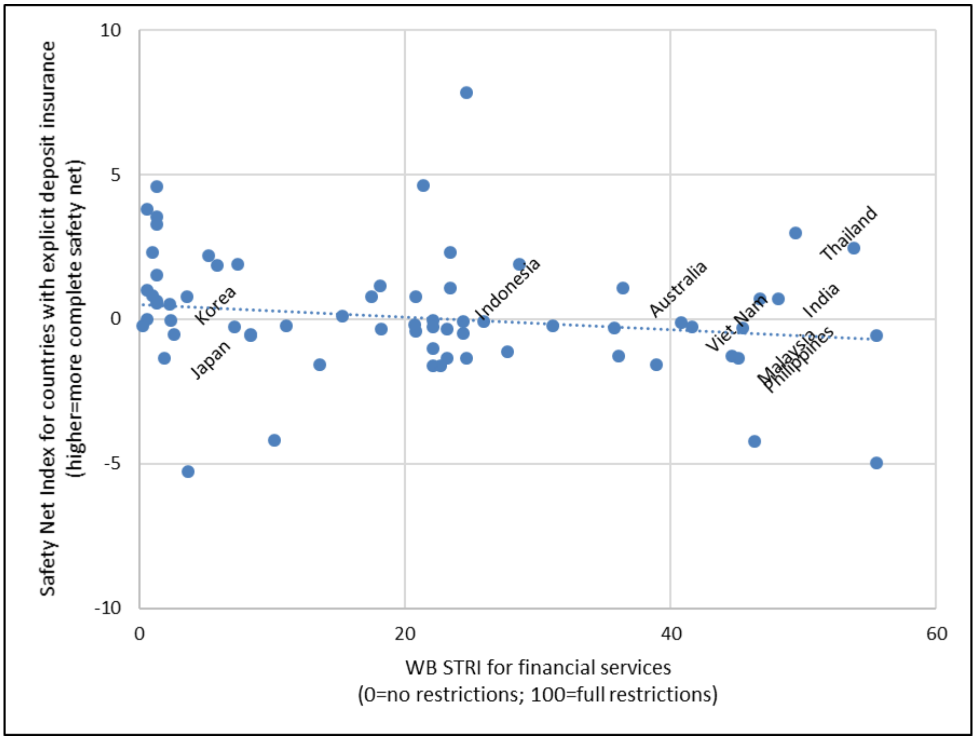
Figure 21: Barriers to trade in financial services and exchange rate regimes, 100 countries including 12 RCEP countries.



Source: IMF AREAER for 2013 and WB STRI for 2013. Notes: The category "Free floating" is split between countries not in the Euro area and countries in the Euro area; and the Figure excludes regimes with no separate legal tender (therefore no exchange rate).

By contrast when considering the 69 countries with data for consumer protection (as measured by the extent of the Safely Net Index), there seem little relationship to the extent of the restrictions on trade in financial services. There is no clear association for RCEP countries either.

Figure 25: Consumer protection (safety net index) and restrictions on trade in financial services for 69 countries, including nine RCEP countries.

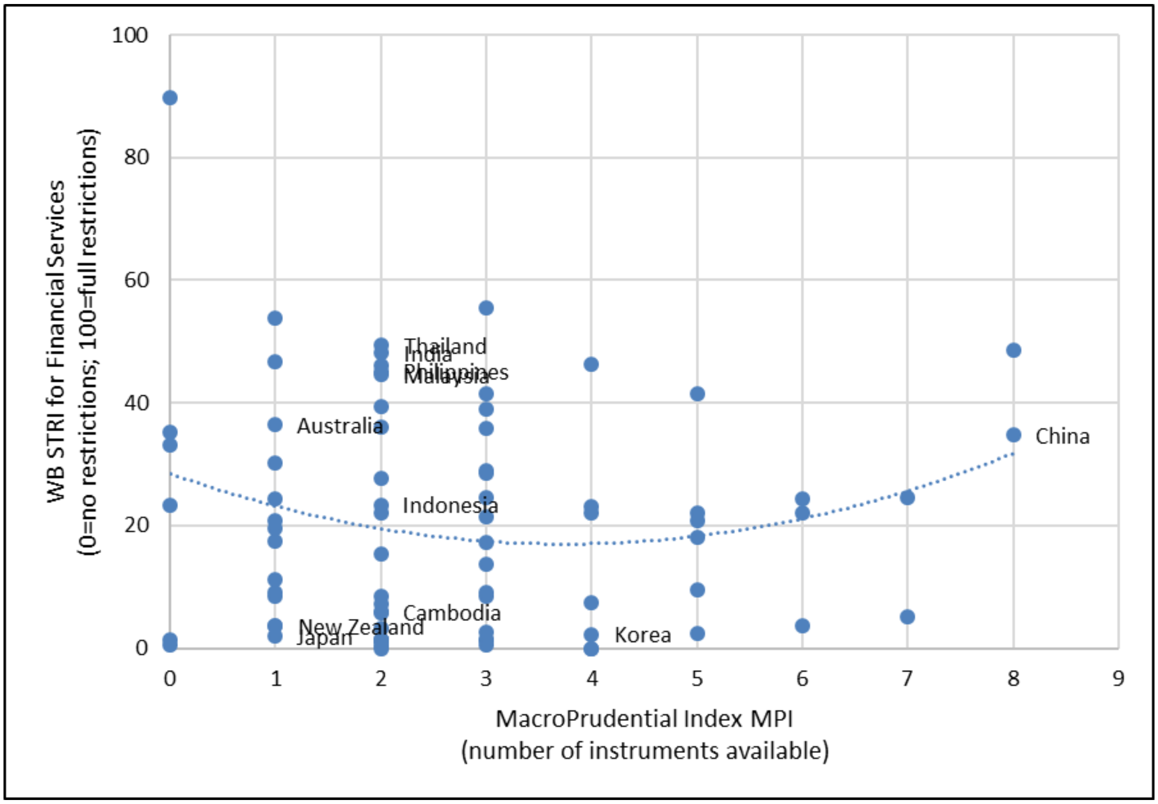


Source: Demirgüç-Kunt et al 2014 and World Bank Services Trade Restrictions Index (STRI).

Judging the systemic risk regime in 78 countries by the number of macroprudential policy instruments available, there may be a minor "smile" in the association with the STRI for financial services. This suggests that a "goldilocks" number of macroprudential instruments (neither too few nor too many) may be associated with lower barriers to trade in financial services. While RCEP countries typically have few macroprudential instruments in place at this early stage of implementing policies for financial stability, this may not throw much light on their choices for barriers to trade in financial services.

In the paper, there is also a chart of July 2016 data for 36 countries that suggests that lower systemic risk as judged by the Stern V-lab estimate of SRISK is associated with higher barriers to trade in financial services (and vice versa). Not too much should be made of this: the SRISK series is relatively experimental, volatile month-to-month and the measure is not widely used. Further investigation seems warranted.

Figure 26: Barriers to trade in financial services and the regimes for macroprudential policy for 78 countries, including 11 RCEP countries.



Source: WB STRI and IMF dataset for Macroprudential Index. Dataset developed in "The Use and Effectiveness of Macroprudential Policies: New Evidence" by Eugenio Cerutti, Stijn Claessens and Luc Laeven. IMF Working Paper, March 2015.

Summary of findings on barriers to trade in financial services

Looking at the choices made by countries on the three typologies against the estimates of barriers to trade in financial services, it seems the association between barriers to trade in financial services and exchange rate regimes is clearer than between STRIs and the consumer protection or financial stability/systemic risk regime.

It seems that the lowest hanging fruit in terms of potential for reduction in barriers to trade amongst RCEP countries are:

- those countries with above-average levels of STRI for any given exchange rate regime; and especially
- those countries transitioning from relatively fixed exchange rates towards more flexible regimes.

The paper suggests that, especially as RCEP countries transition from fixed to floating exchange rates, some cooperation between regulators and policymakers to review what barriers remain necessary would be appropriate.

Institutional arrangements promoting financial integration

The paper briefly reviews RCEP countries' access to and participation in the global and regional bodies involved in international cooperation in regulation of banking, insurance, securities and anti-money laundering and counter-terrorism financing (AML/CFT). Unlike prior to the Asian crisis in 1997, RCEP countries today seem well integrated into global and regional arrangements for financial cooperation. There are no obvious gaps for RCEP to fill.

However, there may be some initiatives in regionally-driven regulatory cooperation and integration in financial services that could benefit from potential RCEP impetus. The frameworks tend to be complex, arising from the evolving institutional structures of APEC and ASEAN and from ASEAN trade agreements with other partners and other forms of cooperation. The paper compares two case studies, the Asia Region Funds Passport and the ASEAN frameworks for financial integration, as well as other frameworks promoting financial integration through cooperation between financial regulators.

Asia Region Funds Passport

The ARFP initiative is being developed to open up access in Asia to similar benefits achieved through the Undertakings for Collective Investment in Transferable Securities (UCITS) scheme first adopted in the European Union (EU) in 1985. UCITS enables funds to be freely marketable across the EU provided local individual country marketing requirements are met, distributable to both retail and institutional investors. Funds issued under the UCITS scheme are often available in Asian financial markets in the absence of an Asian scheme with broad coverage for funds passporting.

A Memorandum of Cooperation (MoC) was signed by Australia, Japan, Korea and New Zealand on 28 April 2016, to come into effect at end-June. The initiative is open to any APEC economy that signs, and participating economies have up to 18 months from 30 June 2016 to implement domestic arrangements. Activation of the Passport will occur as soon as any two participating economies implement the arrangements under the MoC.

The ARPF is complemented by two other regional efforts to liberalise cross-border raisings by funds managers:

- ***The ASEAN Collective Investment Scheme (CIS) Framework*** for cross-border offerings of collective investment schemes was launched in August 2014 under the ASEAN Capital Markets Forum (ACMF). Managers in Singapore, Malaysia and Thailand will be able to passport their compliant domestic funds to retail investors in these three countries. Viet Nam and Indonesia have signed on to join. By March 2016 13 funds had been recognised by their home jurisdictions as Qualifying ASEAN CIS, and five had been approved and launched in a host jurisdiction.
- Securities regulators of Hong Kong, China and of Mainland China have agreed a ***Mutual Recognition of Funds (MRF) arrangement***. From July 2015, compliant funds domiciled and managed by a compliant regulated asset manager in one can be distributed in the other to retail investors. The first funds under the MRF were approved in December 2015, with three ("north-bound") Hong Kong funds being approved to be offered to Chinese investors, and four ("south-bound") Chinese funds being approved for distribution in Hong Kong. Recent reports suggest almost 50 mainland funds have been approved to sell in Hong Kong (as Recognised Mainland Funds), of which half may have begun actual sales, and a much smaller number have been approved for mainland distribution but have garnered more inflows.

The ARFP initiative has adopted the "APEC approach", consistent with the APEC Leaders' advocacy of "open regionalism", involving regional collaboration by governments and business and communities to implement agreed objectives. As with the "ASEAN way", no country has been forced to participate. The ARFP is a pilot: it will be open to others.

One RCEP-relevant possibility arising from the ARFP progress to date is that the seven "pilot" ARFP countries (all being RCEP countries) could specifically commit to providing a forum for attracting some of the other nine RCEP countries to join the ARFP. This might involve assistance for those countries with newer and more closed capital markets.

ASEAN frameworks for financial integration

The ASEAN, founded in 1967, has been built on aspirational objectives to integrate and develop, and the financial sector has been recognised as a key sector for development and integration. It is quite different in all respects from the centralised single-market-with-passporting-focused EU. Key milestones have been:

- entry into force of the ASEAN Free Trade Area (AFTA) in 1993;
- signing of the ASEAN Framework Agreement on Services (AFAS) in 1995;
- adoption of the ASEAN Economic Community (AEC) Blueprint in 2007; and
- AEC establishment in 2015 and ambitions set out for the AEC for 2025.

Progress with services integration under AFAS, including financial services, has been comprehensively reviewed in a 2015 ASEAN Services Integration Report, a joint review by the ASEAN Secretariat and the World Bank. It found impediments to financial services trade and integration and recommended significant changes to improve the effectiveness and implementation of agreed policies, including increased regulatory cooperation.

The Joint Review itemised the ASEAN Banking Integration Framework (ABIF) agreed by ASEAN Finance Ministers, which will enable "Qualified ASEAN Banks" (QABs) to have a greater role in promoting intraregional trade and investment, as a matter for progress.

The ASEAN Banking Integration Framework

ASEAN countries have negotiated an ABIF, endorsed by ASEAN central bank governors in December 2014, to enable banks with QAB status to operate freely in neighbouring countries and receive national treatment equivalent to that of local banks. The ABIF arrangements and the specific qualifying criteria for QABs will be agreed between countries mutually on a bilateral basis. The central banks of Philippines and Malaysia in mid-March 2016 agreed on the guidelines regarding the entry of qualified ASEAN banks between the Philippines and Malaysia, and Malaysia's central bank has said it has signed agreements with its counterparts in Thailand and the Philippines on market access and operational flexibility for lenders.

The AEC 2025 Strategic Action Plans for Financial Integration target the establishment of the first two QABs in 2018-2019 and at least before 2025. The potential for more complexity is obvious:

- There are 45 possible bilateral ABIF QAB agreements within 10 ASEAN alone [(10*9)/2]; and
- If the RCEP negotiations were to see the non-ASEAN "Plus Six" included in the ABIF, the number of possible bilateral ABIF QAB agreements would reach 120 [(16*15)/2].

In addition, important issues relating to bankruptcy and administration, access to lender-of-last-resort facilities, macroprudential policy, depositor preference and deposit insurance, all “lessons from Europe”, still need to be addressed within the ABIF framework, see for example Davis 2015.

As pathways towards financial integration, neither case study stands out. The ASEAN framework seems particularly slow: but even the more focused ARFP initiative still has not seen a dollar of cross-border investment of retail funds after many years of engagement. The chief lessons are the need to build focus and timeliness in the mechanism for dialogue and follow-up.

Lessons for financial services reform from Singapore

The Joint Report suggests that Singapore’s liberalisation of financial services trade and other regulations is a best-practice example for other ASEAN countries. Singapore is by far the most successful at trade in financial services within ASEAN and – on recorded data – amongst all 16 RCEP countries, and its financial services sector is the most integrated in the region. Singapore has focused on financial system stability, opening the market to foreign banks and insurance companies with high prudential standards and actively preparing the domestic financial sector for increased competition.

Other frameworks promoting financial integration through cooperation between financial regulators

The paper briefly reviews other frameworks, including examples of trade agreements that put in place frameworks and processes for regulatory cooperation, transparency and involvement of the private/business sector. Better trade agreements from a financial integration perspective seem to have put in place a committee or working group on financial services, comprised of policy officials and representatives from regulators, to implement financial services commitments and to support cooperation efforts in financial services. The keys are responsibility and accountability, driven by a timetable.

What is important in the RCEP context is to emphasise the development benefits of lowering barriers to counter the mercantilist and instability fears arising from increased foreign market entry. This broader agenda could contemplate commitments for:

- assistance with economic cooperation and technical assistance, to offer a development benefit to still-developing countries; and
- public sector-private sector dialogue, to ensure private sector/business input, which hopefully ensures commerciality in the prioritisation of issues to be negotiated.

The paper notes some examples to draw on.

In negotiating the RCEP, developed countries also need to advance issues likely to appeal to the less developed countries that are involved. Such possibilities include using RCEP as a vehicle for:

- expanding the coverage and effectiveness of the ARFP (as above);
- advancing innovation by improving the regulatory environment for FinTech (an active interest of many);
- promoting reforms that will increase financial inclusion; and
- providing assistance to increase the quality and availability of data on trade in financial services (e.g. through surveys of foreign affiliates) for as many modes of supply as is practical.

Conclusions

After canvassing many options and considerations, the paper's overall conclusion is that the RCEP has greater chance of making a difference if it establishes mechanisms for progressing financial services liberalisation and integration that involve negotiators, regulators and the private sector and encourages countries to opt in to a timetable for effective dialogue on opportunities to lower existing high barriers to trade. Such dialogue requires sustained input by all parties to make region-wide trade facilitation effective and achieve its benefits.

In addition, opportunities should be taken to focus dialogue between regulators and policymakers on financial-services-trade barriers, both those countries with above-average barriers to trade in financial services for any given exchange rate regime, and especially for countries transitioning from more fixed or managed exchange rate regimes to more flexible regimes.

However, negotiators may bear in mind that unilateral reforms to reduce barriers to trade in financial services would be simpler and quicker, only requiring explanation to trading partners.

Memo

If the study were being prepared today, it could draw on updated data and new papers. Updated data includes new, more recent, estimates of the OECD and WB STRIs. Amongst the new papers, one stands out as it has a sub-index for regional integration in money and finance: Hyeon-Seung Huh and Cyn-Young Park 2017 *Asia-Pacific Regional Integration Index: Construction, Interpretation, and Comparison*. ADB Economics Working Paper No. 511 April
https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2982755