

CAPITAL MARKETS LIBERALIZATION: A POWERFUL CATALYST FOR GROWTH OF DEVELOPING ECONOMIES

Executive Summary

In November 2001, the members of the World Trade Organization launched a new, ambitious round of international trade negotiations. Named the “Doha Round” after the city in Qatar in which its initial ministerial conference was held, the trade Round has also come to be known as the “Development Round” because one of its main objectives is to encourage growth among developing countries by reducing barriers to commerce in developing and developed countries alike.

This paper documents how and why the liberalization of trade in financial services – and in capital markets-related services in particular – is central to advancing the goals of economic growth that are central to the Development Round. In addition, there are a number of misperceptions about possible adverse effects of capital markets liberalization which this paper seeks to address and put to rest. In summary:

- ◆ Economists have established empirically that the development and expansion of the financial sector plays a key role in advancing economic growth in both developed and developing countries. In turn, the more open a financial sector is to competition – whether from inside or outside the country – the greater are the benefits to that economy. For example, in 2001, the World Bank estimated that by 2015 the developing world would gain over \$300 billion in annual output, or an additional 2 percent of GDP, from financial sector liberalization [World Bank, *Global Economic Prospects and the Developing Countries* (2001)].
- ◆ The financial sector typically begins with commercial banking and a system of payments and then, over time, expands to include capital markets, generally starting with short-term government debt markets and basic equity markets. The capital markets provide diversified vehicles for saving and investment, additional sources of capital, and increasingly sophisticated instruments (such as derivatives) for managing risk.
- ◆ In particular, as capital markets “deepen” – *i.e.*, as more, and more varied, securities are issued and more participants trade – they bring important benefits to developing countries:
 - Deeper capital markets lead to faster economic growth by increasing the supply and reducing the cost of capital, thereby increasing its availability for investment in the creation and expansion of businesses, and by improving the allocation of capital to its most productive uses through rigorous monitoring by larger numbers of investors.
 - Deeper capital markets promote financial stability, both at the “micro” level of individual financial institutions, and at the “macro” level of entire financial systems and economies.
 - Deeper capital markets strengthen local financial institutions by offering them a wider menu of readily traded assets (*i.e.*, securities) in which to invest and thereby both enhancing the liquidity of their assets and improving portfolio diversification.

- Deeper markets also strengthen the financial system itself. For example, the World Bank has found that more liquid local bond markets enhance the effectiveness of domestic monetary policy, reduce economies' exposure to foreign currency-denominated debt, and contribute to the overall soundness of domestic financial systems. In addition, leading regulatory authorities in both the developed and developing worlds concur that recent financial crises demonstrate that a wider range of nonbank financial institutions, including viable debt and equity markets, can minimize the danger of overburdening the banking system.
- ◆ Empirical evidence suggests that liberalization of trade in capital markets-related services can sharply accelerate the financial deepening process:
 - Liberalization increases access for local businesses to funds in the global marketplace.
 - The entry of global securities firms, whether through a commercial presence or operating cross-border, provides consumers of capital markets-related services with a broader choice of suppliers and types of services.
 - Global securities firms can also enhance innovation in developing country capital markets, by introducing critical market tools, such as repurchase agreements, interest rate swaps, bond futures, mortgage and remittance securitization products, and other new financing techniques that can both mitigate, and more accurately price and allocate, risk.
 - By thus enhancing the variety, quality, and efficiency of capital markets-related services, liberalization in turn enhances the competitiveness of the domestic businesses that use these services.

Finally, there are a number of misperceptions about possible adverse effects of capital markets liberalization that may be unnecessarily hindering valuable liberalization efforts. This paper explains why they lack a factual basis. In summary:

- Empirical studies indicate that liberalization should narrow – not enlarge – income disparities within and possibly even across countries.
- Liberalization does not mean the absence of regulation; on the contrary, liberalization requires sound regulation that promotes stability and safety but does not impede the innovation that lies at the heart of any well-functioning market economy. In addition, any liberalization of trade in capital markets-related services will leave in place the so-called “prudential carve-out” already enshrined in the General Agreement on Trade in Services (“GATS”), which allows Members to take appropriate measures to protect investors or to ensure the integrity and stability of their financial systems.
- Fears that liberalization would displace existing businesses generally have not been realized.

In sum, liberalization of capital markets-related services can generate benefits for all participants in economies, and enhance macroeconomic growth and stability, while preserving the authority of local regulators to safeguard investors and the financial system. The Development Round offers a unique opportunity for countries to make commitments that will help them achieve the benefits of capital markets liberalization.

I. Background: The Respective Roles of Banks and Capital Markets

Banks are the most familiar type of financial intermediary, taking deposits from savers and lending them to borrowers in the private and public sectors. Well-regulated banks provide (i) a generally safe venue for individuals and businesses to store (and earn a return on) their wealth (especially where the deposits are government-insured); (ii) a mechanism for payment for transactions (this is the principal function of “demand” or checking accounts); and (iii) a source for borrowed funds.¹

Capital markets also “intermediate” between savers and the users of capital, typically by bringing together buyers and sellers of tradable claims, or “securities,” which generally fall into two broad categories: debt and equity. The capital markets also make available other tradable instruments, including derivatives, such as options, forwards, futures, and swaps on securities, currencies, and commodities.

Liberalizing trade in the financial services that underlie capital markets promotes the development of those markets. These services include:

- *trading*, that is, buying and selling debt and equity securities, currencies, and commodities, and entering into derivative transactions;
- *underwriting* stocks, bonds, and other securities, raising capital for issuers, and placing financial instruments with investors;
- *asset management*, including investment advice and financial planning for institutional and individual investors; and
- *advising* on all types and on all aspects of financial transactions, including mergers and acquisitions, corporate restructurings, and privatizations.

A. Capital Markets Follow Banking as Financial Sectors Develop

Banking originated to provide safe havens for savers and to provide customized loans with relatively short maturities to borrowers, funded by short-term deposits (many payable on demand). Banks are traditionally reluctant to make loans with significantly longer maturities

¹ Two other types of financial intermediaries are insurance companies, which accept premiums and promise to pay claims covering losses identified by contract, and pension funds, which accept contributions from individuals and return them, all at once, or, more typically, over an extended period in the form of an annuity beginning when the individuals retire.

than their deposit liabilities, especially if the interest rates on the loans and deposits are fixed, which increases the bank's exposure to substantial losses if interest rates unexpectedly and markedly change.

As economies grow in size, and businesses grow in scale and complexity, a need for longer-term or even permanent sources of capital develops that traditional bank lending cannot adequately address. In addition, as investors amass greater wealth, they begin to seek investment opportunities that provide higher returns (even at higher risk) than those available from traditional consumer banking products. The capital markets can provide higher yielding investments in the form of debt and equity instruments in almost infinite variety. Thus, capital markets afford more choice to both savers and users of capital.

B. Banks and Capital Markets Are Complementary and Synergistic

Though banks historically have preceded capital markets, the two types of institutions and systems of finance are complementary and intertwined, even though they also compete. Indeed, the existence and robust development of the capital markets is essential not only for the sound operation of banks, but for the sound operation of other types of financial institutions as well.

For example, as capital markets develop, banks seek to diversify their asset portfolios by investing in securities to complement the less liquid loans that constitute their natural portfolio. Being tradable, securities can be much more easily sold if banks experience a large demand by depositors seeking earlier-than-expected return of their deposits. Other financial institutions – such as insurers and pension funds – also could not effectively operate without the ability to purchase securities, which enables them to match their assets to their funding obligations to their customers and plan participants.

As another illustration of the benefits of capital markets to banks, consider the financial innovations in recent decades that have transformed many previously illiquid loans into tradable securities, a process that has come to be known as “securitization.” This innovative and increasingly important technique encourages banks to originate more loans at lower rates, with a resulting increase in the overall supply of lower-cost capital. As discussed below, securitization holds great promise for developing countries.

Even more conventional forms of securities – such as equity shares – can help promote the growth of local banking sectors. The need for longer-term and permanent capital generates investment that leads to commercial activity which, in turn, generally requires shorter-term borrowing. Thus, larger stock markets in emerging markets tend to be associated with larger banking sectors.²

² According to one study, based on a sample of 17 major emerging markets, there is a positive relationship between the ratio of bank deposits to GDP and the ratio of stock market capitalization to GDP [Singh, *et al.*, 2001].

In addition, it is often important for issuers of securities to have bank loans or lines of credit, which assures investors that the issuers have the cash necessary to pay the interest on debt securities, even if the issuer's business suffers a decline in its cash flow. For example, investors and often regulators demand that many issuers of commercial paper – short-term issues of unsecured debt by private corporations – have backup bank credit facilities.

In short, capital markets and depository institutions are mutually reinforcing, so that a strengthened banking sector and a robust capital market tend to support each other. Consequently, it should not be surprising to find that businesses grow faster as *both* capital markets and banks develop [Demirguc-Kunt and Maksimovic, 1998],³ or that stock market development actually tends to increase the use of bank finance in developing countries [Demirguc-Kunt and Maksimovic, 1996].

II. Financial Sector Deepening Stimulates Growth, Enhances Stability, and Strengthens Important Finance-Related Infrastructures

Empirical evidence strongly suggests that it is the liquidity and thus the depth of markets rather than their size that is the key to economic growth [Levine and Zervos, 1998]. This conclusion is evident from the scholarly studies that examine both the microeconomic and macroeconomic benefits of financial deepening.

A. Financial Sector Deepening and Faster Growth

Economic theorists have long pointed to a connection between financial development and economic (“real sector”) growth. For example, Schumpeter [1911] emphasized the importance of banks in funding entrepreneurs and established businesses, spurring technological innovation and hence economic growth. British economist J.R. Hicks later noted that the liquidity of capital markets in 18th century England helped ignite the innovation that was associated with the industrial revolution, by allowing inherently “illiquid” long-term investments, such as machinery, which was far too expensive to be paid for by internally generated funds, to be financed from outside sources [Hicks, 1969, pp. 143-145].

During the past two decades, data have become available for both developed and developing countries that have allowed scholars to test these and other propositions relating to the causes of economic growth. Studies focused specifically on the financial sector have confirmed what Schumpeter, Hicks, and other theorists before had claimed: that financial development helps spur growth for businesses, industries, and entire economies by increasing the supply and reducing the cost of capital for investment in growth-generating plant, equipment, personnel, and other factors of production.

For example, two studies have found that *individual businesses* in countries with greater financial development are better able to obtain more outside financing and thus grow faster than businesses in countries where finance is less mature. In the first study, Demirguc-Kunt and

³ This finding is based on a 26-country cross-sectional analysis using data for manufacturing firms over the 1980-91 period.

Maksimovic [1998] analyzed a sample of 30 developing and developed countries covering the period 1980-91, and found that active stock markets, along with an effective legal system, facilitate business growth. In the second study, Love [2003] considered a sample of over 5000 businesses in 36 countries during 1988-98 and found that financial development (measured by a combination of equity market valuations and credit available relative to total output) eases businesses' "financing constraints" and makes them more willing to invest. Moreover, she estimated that the beneficial impact of financial development is twice as large for businesses in countries with low levels of financial development than in countries where financial development is "average." This is especially important for small businesses that face even greater financing constraints in less financially developed economies.

Similarly, a recent report by the McKinsey Global Institute [2005, pp. 47-48] notes that deeper financial sectors (measured by total assets in financial institutions and securities issued, relative to total output) are associated with a wider variety of financial institutions and instruments, thus providing users of capital "with more choice and access." Thus, for example, the growth of pension funds in Chile has provided a powerful source of demand for securities, which in turn gives Chilean companies easier access to the equities market for funding.

Financial deepening promotes growth of individual businesses in other ways as well. For example, financial deepening provides incentives for businesses to manage their operations in an efficient and growth-enhancing fashion. Properly managed banks are expert in judging the credit-worthiness of borrowers and monitoring their performance thereafter. Capital markets perform the same function, with the most liquid markets providing ongoing monitoring of businesses' performance and requiring, by virtue of their public nature, enhanced disclosure of performance by the businesses issuing debt or equity securities. Markets can be powerful forces for enforcing discipline, by assessing risk and punishing or rewarding performance, as the case may be.

Capital markets also enable entrepreneurs to take greater risks. With greater access to debt and equity as a means of exit from their investments or as a source of continuing finance, entrepreneurs can be more willing to take the risks inherent in founding new and, innovative ventures, expanding operations, entering new markets and developing new product and service offerings.

Other research has confirmed that there is a link between financial sector development and *industry performance*. Rajan and Zingales [1998] conducted a statistical analysis of multiple manufacturing industries in 41 countries during the 1980s and found that industries requiring more outside financing – whether from depository institutions or capital markets – grew more rapidly in countries with more developed financial sectors.

Empirical research also supports the proposition that if financial sector deepening promotes not only the growth of businesses and industries, but also the growth of *entire economies* as well. King and Levine [1993] studied 77 countries over the period 1960-89, and, after controlling for various factors, found a strong positive relationship between measures of the depth of the banking sector in different countries (bank deposits relative to total output) and different measures of their productivity growth. The authors suggest that this relationship is

causal in nature, since the level of financial development is a good predictor of subsequent capital formation and growth. Levine and Zervous [1998] found similar, strong relationships between measures of stock market development and economic growth in a 42-country sample for the period 1976-83. Like King and Levine, this study also suggests a causal relationship, since measures of both bank credit and stock market liquidity help predict future rates of growth of capital, productivity, and total output.⁴

Financial development not only enhances the overall levels of investment in an economy, it also helps economies grow by *allocating those investments more efficiently* than otherwise would be the case. One study using industry-level data for 65 countries over the period 1963-95 found that countries with higher levels of financial development both increase investment more in growing industries and decrease it more in declining industries than in countries with lesser degrees of financial development. [Wurlger, 2000].

B. Financial Deepening that Includes the Capital Markets Leads to Greater Financial Stability

Financial deepening that includes the capital markets promotes and strengthens financial stability. This benefit, which is sometimes overlooked, was dramatically illustrated by the financial crises suffered by economies in Asia and Russia in the late 1990s, and subsequently by Argentina. In these countries, banks – rather than the capital markets – played the central role in financing the needs of the economy, and they also were both a main source and transmission mechanism of the financial and economic breakdowns that occurred. As Malaysian financial regulatory authorities have observed:

So far, banks have played an important role in financing the needs of the country's rapidly growing economy. But the experience of the recent crisis points to a real danger of over-burdening the banking system with the task of financing production in the economy. A more diversified financial system – one in which the capital market plays a much bigger role than it does currently – can minimise this danger and would result in a more efficient and robust mechanism for mobilising and allocating financial resources in the economy [Capital Market Masterplan, Chapter 2, Trends and Challenges, p. 30].

Similarly, Alan Greenspan, the Chairman of the U.S. Federal Reserve Board, said during the Asian crisis:

Recent adverse banking experiences have emphasized the problems that can arise if banks are almost the sole source of intermediation. Their breakdown induces a sharp weakening in economic growth. A wider range of nonbank institutions, *including viable debt and equity markets*, are important safeguards of economic activity when banking fails. [Greenspan, 1998, emphasis added].

⁴ Several earlier studies also find that stock market liquidity – a measure of capital markets development – facilitates long-run growth [Levine, 1991; Holmstrom and Tirole, 1993; and Bencivenga *et al.*, 1995].

Thus, it is important for financial systems to be *diversified*, rather than to rely too heavily on only one form of intermediation. If banks get into financial trouble, capital markets offer an alternative vehicle for raising funds and saving wealth. The reverse is true if securities prices fall sharply.

Consistent with these views, the World Bank [World Bank, 2005, p. 77] recently concluded that development of local bond markets can enhance the effectiveness of domestic monetary policy, reduce economies' exposure to foreign currency-denominated debt, and contribute to the overall soundness of domestic financial systems.

C. Financial Deepening that Includes the Capital Markets Strengthens Infrastructures Critical to Sound Economic Development

In commenting on the growth of domestic bond markets in developing countries as a sign of financial maturity,⁵ the World Bank pointed to resulting improvements in instrumentalities and processes critical to sound financial and economic performance [World Bank, 2005, pp. 76-78, citations omitted]:

- Bond markets foster the development of critical and highly productive finance-related infrastructures, such as clearing and settlement systems, rating agencies to assist investors in evaluating issuers, and regulatory and legal frameworks.
- Local bond markets offer governments an effective tool for conducting and managing domestic monetary policy, because issuing bonds can reduce the government's need to finance deficits by printing money or raising taxes.
- A liquid bond market also can be used as a tool to reduce inflation, manage shocks, and help guide consumption and investment cycles.

III. Capital Markets Trade Liberalization Will Accelerate and Magnify the Beneficial Effects of Financial Deepening

Liberalized trade in capital markets-related services, whether provided through a commercial presence or provided cross-border, will offer consumers of capital markets-related services with a broader choice of suppliers, and in particular will enhance their access to global capital markets, sophisticated advice and new financial products.⁶ Liberalized regimes will

⁵ The Bank noted that the amount of outstanding local bonds as a share of total output had almost doubled from 1993 to 2002 (from 20 percent to 37 percent).

⁶ Firms that are not already in a market will find that offering their services cross-border, without initially establishing a physical presence, is a way to test the market and to develop a sufficiently broad client base to justify later establishing such a presence. Even once foreign firms establish offices in other markets, it is far more efficient for many of the services and products they offer to be imported from their offices in other countries, including their home offices, than to duplicate the development of these offerings and the associated back-office support in each location where the firms seek to do business.

attract more non-domestic investors to local markets and can help provide discipline to local businesses by facilitating better corporate governance practices [Stulz, 1999]. All these changes will enhance the competitiveness of domestic businesses.

A. Empirical Research Confirms the Beneficial Impact of Capital Markets Liberalization on Economic Growth and Stability

The substantial increases that liberalization of trade in capital markets-related services will bring in available capital and in the available range of financial instruments should further lower the cost of capital for businesses. This result was confirmed in one study of 27 countries, which found the cost of capital to be lower in the countries that had liberalized than in those that had not [Kalirajan, *et al.*, 2000]. This finding accords with the experiences of four countries that opened their markets to financial services companies from other countries as a condition of joining the European Union – Greece, Ireland, Portugal, and Spain. The result was a lower cost of capital in each of the acceding countries [Claessens and Jansen, 2001].

As the costs of capital further decline, investment by individual businesses should continue to rise. That is exactly what one study of financial services liberalization in eleven emerging market countries found. Investment was roughly 80 percent higher by the end of the third year after liberalization [Henry, 2000].

Standard economic models suggest that as investment goes up, so does output. World Bank researchers estimate that GDP growth is up to one percentage point higher in countries that have liberalized their financial sectors than in other countries [Mattoo, *et al.*, 2001].⁷ Similarly, recent empirical evidence suggests that allowing non-domestic investors to purchase equities of domestic companies stimulates annual GDP growth – on average, by as much as one full percentage point [Bekaert, *et al.*, 2004a].

Available evidence also confirms that liberalization enhances stability as well as growth.⁸ For example, economists have demonstrated that openness to non-domestic capital for portfolio investment purposes has led to greater stability and less volatility in equities markets: non-domestic investors provide added liquidity and thus depth to these markets, which makes them less susceptible to wide swings in valuations than if they were closed to such investors. This is a central finding of a study of 28 emerging market economies [Kaminsky and Schmukler, 2002], and is consistent with statistical evidence indicating that equity markets liberalization is

⁷ Other researchers have also found a positive relationship between financial liberalization and economic growth, independent of any positive effect on growth exerted by the removal of capital controls [Bonfiglioli and Mendicino, 2004].

⁸ A lesson to be drawn from the Asian financial crisis is not that liberalization is bad but that countries should be wary of pegging their exchange rates to foreign currencies, which can encourage excessive short-term borrowing in foreign currencies (by lulling borrowers into believing that they face no currency risk when taking funds from foreign lenders). The countries that were most affected by that crisis generally have since abandoned their pegs, cut their foreign currency borrowing, and instead built up large foreign currency reserves. Singapore and, to a lesser extent, Korea have liberalized entry by foreign securities firms into their capital markets. The key point, however, is that the Asian financial crisis does not provide a rationale for developing countries to deny themselves the benefits that capital markets liberalization can bring.

associated with reduced volatility in national consumption growth [Bekaert, *et al.*, 2004b].⁹ Furthermore, the presence of non-domestic financial institutions in a market reduces the volatility in capital flows [Kono and Schuknecht, 2001], and thus reduces the risk of banking crises in particular [Barth, *et al.*, 2004].

B. Entry by Global Securities Firms Promises Services of Particular Significance for Developing Economies

Liberalization will make available a number of financial techniques and resources that should have special positive potential in developing economies. For example, global securities firms can bring their expertise in “securitizing” assets to the developing world, where securitization either has not yet occurred or is in its infancy. Peruvian economist Hernando De Soto has estimated that as much as \$9 *trillion* of real estate assets are held “informally” – without registered titles, an essential precondition both for ownership and for mortgage credit – throughout the developing world [De Soto, 2000]. As ways are found to transform informally held property into formally titled property, mortgage credit should grow, and, as it does, so should the opportunity for securitization. And as more mortgages (and other types of loans) are securitized, the cost of credit should decline. This outcome would be of great importance to parts of the world, such as Latin America, where local banks have been reluctant to extend credit to private borrowers.¹⁰

In addition to securitization of mortgages, the World Bank has suggested that debt instruments backed by remittances from expatriates living abroad and receipts from tourism and exports could provide an important source of finance for many developing countries. Since the first remittance-backed securities (or as they are now known, “diversified payment rights” or DPRs) were issued in Mexico in 1994, a number of other countries – Brazil, El Salvador, Kazakhstan, Peru, and Turkey, for example – also have issued them. From 2000 to 2004, a total of \$10 billion in DPRs were floated, \$4 billion by Brazil alone (which saved 700 basis points in interest costs relative to the cost of issuing government debt). Using their experience in securitization generally, global securities firms are ideally positioned to help this market further expand. Although a number of legal and institutional hurdles remain, the World Bank projects that eventually \$9 billion annually could be raised by developing countries issuing DPRs. These assets not only can afford local residents alternative, high-yielding investment opportunities, but DPRs also could help attract non-domestic capital that would help finance local investment.¹¹

Second, global securities firms can expose their own non-domestic clients to investment opportunities in developing countries and thereby enhance the flow of capital into such countries. The same World Bank report that celebrated the recent growth of capital markets in developing countries also notes that, so far, there has been relatively little non-domestic investment interest

⁹ Though the authors acknowledged that their results are weaker for emerging markets countries, they do not observe an increase in consumption growth volatility when countries liberalize.

¹⁰ During the 1990s, the average level of bank credit to GDP in Latin America was just 28 percent, significantly lower than in developing countries in other parts of the world [IADB, 2004].

¹¹ The source for the data in this paragraph is the World Bank, 2005, pp. 108-109.

in many emerging bond markets – due in significant part to ignorance or misperceptions of the risk associated with these instruments and markets. Global securities firms can give their clients information to overcome these barriers. In the process, global securities firms add to the benefits of domestic bond markets the Bank has outlined, while enabling their clients to better diversify their portfolios.

Third, developing countries can benefit from the knowledge and experience that global securities firms have in assisting government privatization efforts. Though a number of governments throughout the world already have privatized many formerly state-owned enterprises – often by offering their shares to the public through initial public offerings (IPOs) – government ownership (of banks in particular) is still prevalent in many countries. As governments continue privatizing state-owned enterprises and assets, they will want to take advantage of the skills and services offered by global securities firms.

Fourth, global securities firms could help facilitate the expansion of pension systems in the developing world. As recent reports from the United Nations and the International Monetary Fund have documented, the *entire world* is aging, not just the populations of developed countries [International Monetary Fund, 2004; United Nations, 2004].¹² Further development of capital markets will enhance economic growth, and the pension funds that are created in the process – public and private – will be a growing source of demand for the securities that are issued and traded in capital markets. The asset management experience of global securities firms can help maximize returns earned by developing country pension funds and the employees whom they benefit.

IV. WTO Commitments Will Greatly Enhance Entry into Developing Economies by Global Securities Firms

If liberalization of trade in capital markets-related services can generate all of these benefits, why shouldn't countries liberalize unilaterally? A few have, and they quickly have become homes to much financial activity. For example, Singapore now hosts over 100 non-domestic commercial and investment banks. With its vibrant stock exchange, Singapore has become a "financial hub" for activity throughout Southeast Asia. Indeed, the most active investors in the securities firms of that region after the 1997 crisis have been from Singapore. Among the transition economies of Eastern Europe, Hungary has been in the forefront of integrating its financial sector with global capital markets. Ireland, only two decades ago the poor cousin of Europe, now is the financial gateway for financial firms seeking to do business in Europe, and has one of the highest per capita incomes in Europe [OECD, 2005, p. 85].¹³

¹² Indeed, according to the sources cited above, developing countries will be home to an increasing share of the world's elderly, from roughly 60 percent now to 80 percent by 2050. Developing countries will need to do everything they can to grow in the meantime to generate the savings that will be necessary to provide even minimal levels of financial support for people when they are too old to work.

¹³ As of 2004, Ireland was the home to approximately 450 international financial institutions, including roughly half of the top 50 financial institutions in the world, and more than half of the world's top 20 insurers. Collectively, these institutions employ over 20,000 Irish citizens [Deloitte, 2004]. Ireland also hosts almost 2,000 foreign mutual fund companies, which perform their custody and administration services in the country.

The Development Round offers a unique opportunity for countries to make commitments that will help them achieve the benefits of capital markets liberalization. The chief advantage of multilateral agreements is that, unlike unilateral or even bilateral liberalization, they can immediately generate faster growth for the entire global economy, which in turn benefits all countries that choose to be integrated globally (through cross-border trade and capital flows). In addition, by formally adopting liberalization, multilateral agreements signal to global investors that they can have confidence in the economies of the countries that make commitments under them. *Indeed, the World Bank has estimated that by 2015, the developing world would gain over \$300 billion in annual output, or an additional 2 percent of GDP, from general financial sector liberalization* [World Bank, 2001].¹⁴

V. Correcting Misperceptions About Liberalization of Trade in Capital Markets-Related Services

A number of concerns are often expressed about possible adverse impacts of liberalization of trade in capital markets-related services. This paper closes by explaining why some of those most frequently repeated concerns are misplaced.

A. The Gains From Liberalization and Financial Deepening Will Be Widely Shared

Contrary to what may be conventional wisdom, financial deepening can contribute to poverty reduction. The most recent and thorough study of this issue covers 52 countries over the period 1960-99 and not only confirms this poverty reducing effect, but also provides some interesting and important estimates [Beck, *et al.*, 2004]. In particular, this study estimates that if Brazil had had the same credit-to-GDP ratio (a measure of financial intermediary development) as Korea throughout this 40-year period, the average income of the poor in Brazil would have grown at 1.5 percent annually, instead of at zero. Or contrast data from the same study for Chile and Peru, respectively. In Chile, which has a relatively high ratio of credit-to-GDP, the percentage of the population living on less than \$1/day declined at a remarkable 14 percent annual rate between 1987 and 2000. But in Peru, which by comparison has a poorly developed financial intermediary sector, the number of people living in such extreme poverty increased at an annual rate of 19 percent over this period.¹⁵

The findings by Love [2003] (mentioned above) suggest additional ways in which capital markets liberalization can positively affect distribution of income and access to investment capital. As noted, Love found that financial development enhanced local businesses' ability to raise outside financing twice as much in countries where financial development started from a

¹⁴ World Bank, 2001, p.172. This document suggests that developing countries could gain nearly \$900 billion in annual GDP from liberalizing trade in services generally, 4.5 times the gains from further liberalization of goods markets.

¹⁵ The study noted that if Peru had had the same level of financial development as Chile, the number of such extremely poor people would have increased at only 5 percent per year, so in 2000 the share of Peruvians living on less than \$1 would have been about 2 percent rather than the actual 15 percent.

low level than in countries where financial development was average. She also found that the underdevelopment of the financial sector disadvantages small firms more than large firms. These results imply, first, that the deepening of financial sectors in relatively undeveloped economies should narrow funding disadvantages smaller firms have relative to larger firms. Furthermore, from Love's finding that financial development disproportionately benefits comparatively less developed economies, one can infer that liberalization could also narrow income disparities across countries.

B. Sound Regulation Must Accompany Liberalization

Another unfounded concern is that liberalization will result in the weakening of domestic financial regulation. The very opposite is the case.

Capital markets and consumers of capital market-related services require the transparency, predictability, and other characteristics associated with orderly markets that only sound regulation can provide. Indeed, it is in the interest of global securities firms intent on expanding access to their services to ensure that consumers have confidence in the markets in which those firms seek to do business. It is also appropriate, and indeed necessary, that developed countries provide technical assistance to developing countries in regulating their capital markets. Such assistance should be made not only on a bilateral basis but also through such entities as the International Organization of Securities Commissions (IOSCO).

Making commitments to liberalize will not compromise the safety and soundness of local financial systems or the protection of their investors nor deprive financial market regulators of their authority. Indeed, the GATS, the WTO agreement under which trade in financial services commitments are made, expressly reserves to countries making commitments in this sector the right to take prudential measures "for the protection of investors, depositors, policy holders or person to whom a fiduciary duty is owed," or to "ensure the integrity and stability of [their] financial system[s]." In addition, the GATS protects a Member's right, in accordance with GATS Article XII, to impose restrictions on capital transfers.

C. Liberalization Will Not Lead to Significant Displacement of Local Firms

It is frequently assumed that liberalization of capital markets-related trade will lead to significant displacement of local financial firms. But this assumption is contradicted by the reported experiences of the few developing countries that have already liberalized their capital markets. In 2001 scholars Ranjit Ajit Singh, Attila Emam, and Kar Mei Tang surveyed securities regulators from developing countries who are members of the Emerging Markets Committee of IOSCO. They found that "Fears of displacement of domestic firms have not, in general, been realized." [Singh, *et al.*, 2001, p. 181] One reason is that even where local securities firms already are doing business, liberalization may signal the strength of the domestic securities industry to the international investment community. [*Ibid.*] In addition, countries with relatively undeveloped financial sectors typically have few domestic securities firms.

Conclusion

Capital markets liberalization offers participants in the Development Round the opportunity to enhance their own economic growth and stability without imposing significant adjustment costs on domestic businesses. Liberalization yields benefits at all levels of an economy: existing financial institutions are able to diversify their investment portfolios, thereby enhancing their stability; and local businesses gain greater access to capital and to new and more flexible means of financing from both domestic and non-domestic investors. More investment, in turn, leads to the formation of more new local businesses and to the expansion of existing ones – *i.e.*, economic growth, which benefits all citizens by creating jobs, and generating more and better products and services at more competitive prices. Developing country governments will benefit, as capital markets facilitate the issuance and trading of government debt, which both lowers governmental financing costs and reduces the need to finance deficits by monetary means. In short, the array of benefits, and the spectrum of beneficiaries, is compelling. And as individual sectors reach higher levels of investment, growth, and stability, growth and stability for the economy as a whole improves. The time is ripe, therefore, for developing countries to realize these benefits by making commitments to liberalize trade in capital markets-related services.

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