EMERGING ECONOMIES TRANSITION

# Development Centre Seminars

# Asia and Europe

## SERVICES LIBERALISATION

Preface by
Jorge Braga de Macedo and Tadao Chino

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ASIAN DEVELOPMENT BANK
DEVELOPMENT CENTRE OF THE ORGANISATION
FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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## OECD Development Centre

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# Foreword

This publication was undertaken in the context of the International Forum on Asian Perspectives, jointly organised by the Asian Development Bank and the OECD Development Centre. It forms part of the Centre's research programme on The Integration of Developing Countries into the World Trading System, and the Centre's External Co–operation activities. The Forum held its eighth meeting in Paris on 24 and 25 June 2002. Contributions to the meeting are included in this volume.

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# Preface

In 1985, the member states of the European Community took a major step forward to liberalising the service industry by launching their highly ambitious "EC 92" programme. The principal motivation behind this initiative was simple and straightforward: it was judged that introducing a competitive single market in the European service industry would stimulate investment and innovation and would lead to substantial improvements in efficiency and product quality. As a result, economic growth would receive a substantial boost and consumer welfare would be enhanced.

This European initiative was instrumental in putting services on the agenda of a new round of multilateral trade negotiations when the GATT Contracting Parties convened their Ministerial Council meeting in Punta del Este in 1986. Eight years later, the successful conclusion of the Uruguay Round led to the creation of the General Agreement on Trade in Services (GATS) which provides a multilateral framework for a progressive liberalisation of trade in services. Since then, the liberalisation of services has continued, albeit at varying speeds, at the unilateral, regional and multilateral levels. Most notably, it has become an essential component of the regional trade agreements that have been flourishing in many parts of the world. Asia is no exception to this trend.

It was against this background that the Asian Development Bank and the OECD Development Centre chose "Asia & Europe: Services Liberalisation" as the topic of their eighth International Forum on Asian Perspectives, which was held in Paris in 2002. The Forum provided senior government officials, academic experts and representatives from the business community and civil society from both Asian and OECD member countries with the opportunity to exchange their views on the two regions' recent experiences of liberalisation and regulatory reform. As the importance of services in Asia's economy has increased significantly over the past two decades, the Forum sought in particular to draw pertinent policy lessons for the region. In order to assist in this endeavour, two analytical papers were prepared for the Forum. These papers are presented in Part Two of this volume following a summary, in Part One, of the speeches and presentations delivered by invited panellists.

While the economic argument behind services liberalisation is simple and straightforward, carrying it out is not: the process is typically faced with high political hurdles. In the case of Europe, for example, until very recently service industries such as telecommunications, electricity, postal and transport services were generally dominated by state monopolies which were administered directly by the ministry responsible for the particular sector. More often than not, employees of the state-owned companies enjoyed civil-servant status. Under the banner of universal service obligations, broad social or equity considerations played a major role in the formulation of pricing policy. These similar obstacles aside, the unique characteristics of the services provided in the different member states and the divergences in the individual sectors' market structures have resulted in liberalisation proceeding in very distinct ways in almost every service industry. As a result, the extent to which the service industries have been liberalised in each European country has varied considerably, despite the fact that technological and economic forces driving globalisation have led to a major turnaround in the policy approach to what were once vertically integrated service industries.

The European experience highlights the virtue of taking an integrated and well-sequenced approach that combines institution building, domestic regulation and external liberalisation. At the same time, for the aforementioned reasons, Europe has also adopted a gradualist approach to liberalising services. As was pointed out in the course of the Forum, this gradualist approach carries the risk that momentum may be lost. In Asia, since the 1997-98 financial crisis, there has been growing recognition that the orderly development of modern service industries is a prerequisite for the region's sustainable development. Further liberalisation in a progressive manner has been called for with a view to achieving the objectives of the GATS, as stipulated in the Doha Ministerial Declaration. Indeed, as exemplified by the recent opening up of China's insurance market, the increased liberalisation of services will boost foreign direct investment into the region and provide an excellent opportunity for closer inter-firm co-operation between Asia and Europe. Enhancing, through policy dialogue, the understanding of the economic and social impact of services liberalisation is therefore of common interest to both regions.

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February 2003

# Introduction and Overview

*Kiichiro Fukasaku and John Simpson*

The service sector has become the most important provider of output and jobs for industrial countries: it accounts for 60-70 per cent of gross domestic product (GDP) and over 70 per cent of total employment in many OECD countries[1]. In addition, this sector has become the most important source of new employment for these economies. In the developing region of Asia, too, the service sector has grown rapidly over the past decade. Despite the temporary setback caused by the 1997-98 financial crisis, the real annual growth rate of GDP in services was close to 7 per cent during the 1990s (Jha, 2002). From the policy perspective, rather than being one of the results of development, the adequate provision of services is now recognised as one of the preconditions for it. For instance, inadequate infrastructure services, such as poor telecommunication and transport networks or a weak financial system, are perceived as a critical bottleneck for development. Distribution, trade finance, insurance, marketing and other business services are complementary to the healthy growth of industrial activity.

The aim of the 2002 International Forum on Asian Perspectives was to discuss both European and Asian experiences of services liberalisation and draw some policy lessons on what Asia might have to gain from more competition in services. The Forum brought together policy makers, academic experts and representatives from business communities and civil society from the two regions. This volume has two parts. Part One recapitulates the key points made by panellists invited to the public conference held on the second day in the Pierre Mendès Conference Centre of the French Ministry of Economy, Finance and Industry. Part Two presents two chapters, one of which is based on the analytical report that was prepared on behalf of the Asian Development Bank (ADB) and the Development Centre to assist general discussions at the meeting. This report assesses the outcomes of the liberalisation of services in Europe with a focus on several specific sectors and reviews the current state of services liberalisation in Asia. Part Two also includes one more chapter that presents the ADB's on-going work in this area. The rest of this chapter sets out the contexts in which services liberalisation has become one of the key policy challenges in both Asia and Europe and then summarises some of main policy discussions arising from the Forum.

## Dynamic Growth of Service Activities in Asia

The last two decades — with the exception of 1997-98 — have witnessed the dynamic growth of service activities in the developing region of Asia. The increasing importance of the service sector has given rise to significant structural changes in many countries, especially the newly industrialised economies (NIEs) where, since the 1990s, it has been a key driver of overall economic growth. In Korea, Singapore and Chinese Taipei, the service sector now accounts for between 50 and 70 per cent of GDP; in Indonesia, Malaysia, the Philippines and Thailand, the figure is between 40 and 55 per cent. Service activities have also increased their economic weight elsewhere in the region over the past ten years.

Founded on advancements in information and communications technologies (ICT) and their dissemination, the growth of service activities has been spurred on by regulatory reforms and trade liberalisation (in goods). The demand stimulus initially provided by buoyancy in the important United States market for ICT-related goods and services has been reinforced by burgeoning domestic and intra-regional demand.

Although service exports and imports have grown at significant rates, tripling over the 1990s (a slightly higher rate than that for merchandise exports and imports), the relative importance of services to international trade is still much lower than the sector's contribution to national income. This is in part because, by their very nature, balance of payments statistics tend to underestimate the true significance of services, since much of their contribution is embedded in the value of merchandise and therefore subsumed into that category. Nonetheless, it also reflects the generally weaker internationalisation of services. For instance, providing services directly to consumers and end-users in foreign countries *via* foreign direct investment is often the preferred mode of supply in services trade. This can be impeded by often numerous and pervasive domestic barriers such as restrictive rules and legal systems within the boundaries of national economies. Unlike goods trade, then, trade in services typically requires the simultaneous liberalisation of both external and internal barriers to trade. As the contributors to this volume make clear, Asia still has considerable room for further reform efforts.

## Shifting Comparative Advantages of Asian Developing Economies

Reliable data from which to derive a sound appraisal of the comparative strengths and weaknesses of these economies' service sectors is sparse. Indeed, the significant growth in trade in services and the advent of services trade negotiations have exposed this deficiency and brought out the need for both more precise, disaggregated and timely data on trade in services and the development of methods of sectoral and cross-country comparison that are as accurate and pertinent as possible. These would make a valuable contribution to our understanding of the service economy and the provision of more finely tuned sectoral policy advice.

Preliminary evidence on Asian developing economies suggests that all the economies but Hong Kong, China in the sample still have a comparative advantage in merchandise exports, although the analysis of revealed comparative advantage has shown a slightly declining tendency over the past decade, with the exception of Indonesia, the Philippines and the People's Republic of China[2]. In other words, the region as a whole specialises primarily in manufactured goods and resource-based products. Indeed, a large portion of manufactured goods exported from the region has become increasingly ICT-related, getting away from simple assembly operations based on imported parts and components. Hence, it would be expected *ex ante,* given the maturity of the manufacturing sector, that a transition to service-oriented exports would have started to take place in the more advanced economies of Asia.

The analysis of revealed comparative advantage also indicates that India and Thailand have improved the relative strength of service exports during 1990-2000. In India the "other business" sub-sector has driven up the aggregate share of service exports in relative terms, while in Thailand tourism has played a similar role. In Hong Kong, China and Singapore the *entrepôt* nature of their trading activities may partially explain the relative importance of service exports, notably in transport, finance and insurance and other business services. In Korea, backward and forward linkages between manufactured goods exporters and those who export services in transportation and cargo handling, along with Korea's high shipbuilding capabilities, partially explain the relative importance of exports of transport services in the economy.

## Maximising the Benefits of Services Liberalisation

Traditional regulatory instruments that stifle competition by restricting market entry and fixing prices or quantities have resulted in serious efficiency losses and disincentives to innovation. The economic costs of protecting inefficient service industries are thus of great concern for end-users and consumers in both OECD member and non-member countries, because services are not only essential inputs into all kinds of industrial activity but also important items for household consumption. At the same time, the ever-rising cost of maintaining the universal provision of so-called "public services", such as postal, transport, education and health-care services, has added to the fiscal burden of national and sub-national governments. Two important developments have led to a major shift in national regulatory policies, with an increasing emphasis on liberalisation and competition in the service sector. First, technological changes have brought down entry costs and created both a demand for and supply of new services, thereby opening the way for re-assessing traditional policy instruments for regulating what were formerly regarded as "natural" monopolies, such as energy and telecommunication services. Second, globalisation of production and distribution across national borders and a surge in foreign direct investment have increased the degree of international competition in many service industries, including financial services. Internationalisation of services is expected to continue apace during the coming decade, as liberalisation of services is part of the built-in agenda of post-Uruguay Round multilateral trade negotiations under the aegis of the WTO[3].

## What Can Be Learned from Europe

Given these external developments, it is important for countries, developed and developing alike, to establish an enabling domestic environment in which external liberalisation and internal regulatory reform are pursued coherently. Europe provides an important example of the impact of liberalisation of services and regulatory reform, which can be used not only to show the benefits of services liberalisation, but also to pinpoint some of the policy failures that can pervert outcomes. Measuring the gains from liberalising services has become the subject of academic research for the past several years. A succinct survey of existing empirical studies, both economy-wide and sectoral, appears in a recent OECD publication (OECD, 2002, pp. 37-44).

The available empirical evidence on liberalising service markets in Europe points to the conclusion that rather than resulting from changes of ownership *per se*, the significant economic benefits from services liberalisation tend to result mostly from the promotion of contestable market conditions. These benefits, typically accompanied by increased trade in both goods and services and higher inward investment in the service sector, fall under three broad headings: *i)* the stimulation of innovation and efficiency; *ii)* the increased range and variety of services available to end-users, generally at lower cost; and *iii)* the possibility of targeting regulatory interventions on core underlying market failures[4].

The European experience of services liberalisation also points to complexities of regulatory reform in several service industries with network characteristics. First, where physical access to infrastructure networks is needed (electricity, railways), internal and external liberalisation (from the intra-European point of view) need to be conducted simultaneously. Second, despite the overall positive effects of liberalisation, the gains from services liberalisation in Europe appear to be somewhat unevenly distributed across sectors and countries. Third, there remain important differences among European countries over such fundamental issues as the extent of universal service obligations (i.e. the access of the poor to essential services), the question of ownership (public or private) and the general approach to *ex ante* regulation. Fourth, it is empirically difficult to isolate the impact of liberalisation *per se* from other causes (e.g. the impact of technological innovation). It is safe to state, however, that unilateral initiatives undertaken by liberalising countries have contributed a great deal to the positive outcomes, but cross-border exchanges even within Europe remain relatively weak, as exemplified by the case of electricity.

The central question for Asian countries is therefore not whether to liberalise the service sector but how best to do so. Before turning to this question, it is necessary first to examine the current degree of liberalisation obtaining in the region.

## Services Liberalisation in Asia: the Current State

Chane-Kune *et al.* in Part Two of this volume discuss recent developments in the telecommunications, financial and energy service sectors in three ASEAN countries (Indonesia, Malaysia and Thailand), Korea and China, with particular emphasis on

their respective liberalisation schedules under the General Agreement on Trade in Services (GATS). The WTO service negotiations to date, as exemplified in basic telecommunications, would suggest that many Asian countries appear reluctant to open the service sector to international competition. Although this situation may have changed markedly in some countries after the 1997-98 financial crisis, the liberalisation of services remains politically and socially sensitive for various reasons, notably infant-industry protection, the costs of adjustment and national security considerations. Yet insufficient competition in the service sector may negatively impact on the expansion of Asian exports and the attractiveness of Asian economies to private foreign investors.

In financial services, there appears to be a clear policy preference for promoting foreign equity investment over facilitating foreign companies' market access. Important steps by all these countries' governments, especially in Korea and Thailand, towards *de facto* relaxation of limits on foreign equity reflect their desire to encourage foreign direct investment in the financial sector while protecting incumbents and avoiding a repetition of the turmoil and instability that followed premature and ill-sequenced liberalisation in the early 1990s (Kim, 2003 in this volume). In line with this approach, many Asian economies have bound their multilateral liberalisation commitments at less than the *status quo*. There appears to be relatively greater willingness to undertake more liberal commitments in the banking sector than the insurance sector.

In recognition that ensuring the stable and low-cost supply of energy is paramount to sustaining growth in the many Asian economies that continue to be net importers of oil from outside the region, some noteworthy steps towards introducing market competition and privatisation have been undertaken by the five Asian countries studied in the report. Nonetheless, there remains considerable scope for further liberalisation. For instance, the distribution and transmission of the energy products that constitute energy services remain largely state-controlled.

While there is a common move toward greater openness in telecommunications, the range in degrees of commitment to greater liberalisation is extremely large. Korea has liberalised almost all telecommunications sub-sectors and China, like Malaysia, has committed to liberalising all but two (telex and telegraphic communications in the former and electronic data interchange and online information in the latter). At the other extreme, Indonesia and Thailand have made very few commitments to liberalise — although in Indonesia this is understandable because the telecommunications company is one of the few state-owned enterprises running at a profit.

Commitments to liberalisation aside, regulatory functions generally are still performed by the sector Ministry rather than an independent regulator, thereby opening up the risk of industry and/or bureaucratic capture. There is indeed a clear preference for "managed competition", the economic rationale for which is difficult to justify. Against this background, the popularity of mobile phones is not surprising — there are fewer well-entrenched vested interests in the sub-sector and greater technological ease of entry. Accordingly, liberalisation of this market segment has been easier and more pervasive.

## Sustaining Momentum for Services Liberalisation

Large as the prospective benefits from further services liberalisation clearly are, there is, as Krirk-Krai Jirapaet highlights in Part One, a lack of awareness of them, both within domestic policy circles and among the wider public. Furthermore, services liberalisation frequently encounters strong domestic resistance for a variety of reasons, most notably the desire of incumbents to preserve their positions, concerns over the inevitable short-term adjustment costs and potential impact on national security and economic sovereignty, as well as fears of losing national cultural identity and heritage. Such concerns are hardly unique to Asia, being voiced with increasing strength in some quarters of OECD countries as well. Proponents of services liberalisation therefore face the challenge of clearly spelling out the overall benefits of greater openness and both anticipating and addressing legitimate public concerns.

It is important to recognise that ill conceived and flawed liberalisation would do more harm than good. Given the important linkages that services have with the rest of the economy, it is necessary, as both Moon Soo Chung and Milan Cvikl stress, to ensure the integrity and sustainability of the regulatory reform associated with liberalisation. Otherwise, severe instability is likely to result not only in the services sector itself but in the rest of the economy as well. This requires devising a set of incentives compatible with a functioning market mechanism in an open environment and, crucially, implementing them in an appropriately sequenced manner.

## The Potential and Limitation of a Regional Approach

As a number of participants in the Forum stressed, the adoption of an integrated and well-sequenced approach that combines institution building, domestic regulation and external liberalisation still carries the risk of becoming so gradual that momentum is lost. For this reason, a regional approach may be attractive and indeed promising for sectors with network characteristics, such as electricity, postal services and transport. Faced with the market imperfection of the network element, liberalisation requires national and supra-national *ex ante* or *ex post* regulatory intervention. This may best be undertaken through concerted regional action. Regional agreements also offer greater scope for making speedier headway on regulatory co-operation in areas such as services-related standards and the recognition of licences and professional or educational qualifications. In practice, however, as Stuart Sweetman notes for European postal services, the extent to which the market has been opened in each country has varied considerably.

Both ASEAN and APEC have played an important role in expanding the scope of services liberalisation and enhancing technical co-operation in individual service sectors. For example, the member states of ASEAN established in 1995 the ASEAN Framework Agreement on Services, with initial negotiations focused on telecommunications, financial services, professional business services, tourism and

transport. In energy services, ASEAN has also very actively attempted to ensure the security and sustainability of energy supplies as well as the efficient use of natural energy resources and the development of trans-ASEAN energy networks.

These advances notwithstanding, the success of liberalisation efforts at the regional level has not been substantial. Reflecting the generally cautious attitude of countries in the region towards services trade and investment liberalisation, and the greater reluctance to commit to a higher level of regulatory transparency and bring to bear regional peer pressure, Asian developing countries have tended to schedule liberalisation commitments at levels below the regulatory *status quo*, whether in regional agreements or in the GATS. The most notable exception has been in temporary entry of business people and the establishment of modalities for facilitating the recognition of diplomas and professional qualifications, which have been done or are being contemplated within the non-binding confines of APEC. More generally, in the key areas of basic telecommunications and financial services, the GATS has in fact achieved a higher level of *bound* liberalisation than that on offer in Asian regional trade agreements (Sauvé, 2002).

European participants in the Forum did not fail to stress that progress in liberalising the European service sector has been uneven and in general quite slow. This has occurred despite positive institutional circumstances, in particular the crucial role played by the European Commission and the European Court of Justice. They have injected dynamism into the liberalisation process over recent decades, repeatedly when deemed necessary. They have pushed the adoption of a common programme, backed by extensive regulatory harmonisation and/or mutual recognition as well as a considerable degree of political will. The European experience suggests that even with considerable efforts, a regionally centred process in Asia will be drawn-out and cannot be expected to generate immediate benefits for all parties. For some sectors, the political economy of multilateral bargaining, with its attendant gains in critical mass, may help to overcome the resistance to liberalisation arising in the narrower or asymmetrical confines of a regional compact. There remains too a need to create effective mechanisms through which national and regional initiatives for services liberalisation might be sustained beyond GATS commitments.

Finally, as Fabrice Lorillon stresses in the context of China’s recent opening of its insurance market, the further liberalisation of services in Asia will provide a great business opportunity for European firms. The orderly development of modern service industries has also attracted increased attention from Asian governments. In China, for example, as Miaomiao Shi points out, the non-state firms will be given more market access in the service industries where state-owned enterprises play a dominant role. Promoting mutual understanding, through policy dialogues, of the economic and social impact of services liberalisation is of common interest for both Asia and Europe.

# Notes

1. See Chane-Kune *et al.* (2003) in this volume (Part Two) for further discussion.

2. The sample economies are: People's Republic of China; Hong Kong, China; India; Indonesia; Korea; Malaysia; the Philippines; Singapore; Chinese Taipei and Thailand. See Jha (2003) for further discussion on merchandise and service trade statistics in Asia.

3. See WTO (2001), Section IV.

4. See Chane-Kune *et al.* (2003) in this volume for detailed discussions.

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# Part One

# Views from the Forum

# Keynote Address

*John Lintjer*

This annual International Forum on Asian Perspectives tries primarily to promote co-operation between the ADB and the OECD to help the further development of the Asia-Pacific region. To this end, the Forum promotes exchanges of ideas and experiences among high-level policy makers, economists and representatives of the business and financial communities, particularly from Europe and Asia. Since its establishment in 1995, the Forum has provided an excellent opportunity to examine the critical issues and emerging development trends in Asia and the Pacific. It has contributed significantly to OECD members' understanding of the challenges in the region. This understanding, I believe, has facilitated investment in Asia and the Pacific and assistance to the region's developing nations.

Sustainable economic growth is a pressing development task in the Asia-Pacific region in light of the volatility of the economic environment over the last few years. We at the Asian Development Bank believe that the service sector, the main subject of the Forum this year, will be one of the key elements determining the region's economic development path in the medium to long term.

The region over the past five years has felt disturbances from external shocks; the Asian crisis brought the severest slowdown the region has faced in decades. Volatility in financial markets during the crisis filtered through a wide array of sectors in each of the economies across developing Asia, including both manufacturing and other service sectors. The premature, i.e. ill sequenced, liberalisation of the financial sector was one of the factors that triggered the crisis. Because the institutional and regulatory environment was fortified to only a limited extent prior to and during financial sector liberalisation, deregulation in a weak and ineffective regulatory and supervisory environment led to a severe adjustment of the financial sector, which then caused a decline in overall economic performance.

As growth broadens across the manufacturing and service sectors, a natural process as economies move to higher stages of development, the same mistakes should not be made with deregulating and liberalising other service sectors. Many of the

perceived gains from service sector liberalisation arise from the introduction of competition and market access. Domestic regulatory policies and institutions have to be strengthened first, however, before liberalising the trade and investment regime. If this occurs, the volatility we experienced during the Asian crisis may be avoided or at least reduced, given the important linkages that services have with the rest of the economy.

Service activities have grown fast in developing Asia over the past two decades. Services constitute a significant share of both domestic production and external trade in most major economies in the region. Demand as well as supply factors have contributed to the emergence of the sector. Advancements and dissemination of information and communications technologies (ICT), in tandem with regulatory reforms, trade liberalisation and rising real incomes in the region, have contributed to the proliferation of service transactions, following trends in the global economy but at a faster rate. Global exports of services expanded by 3.5 times during 1980-96, while in developing Asia they rose seven-fold.

This has given rise to significant structural changes in many countries, especially the Newly Industrialised Economies (NIEs). Prior to the 1990s, manufacturing was their key driver of growth, but in the last decade the service sector has contributed significantly. On average over the last decade, services accounted for 40 to 70 per cent of GDP growth in Korea, Singapore, and Taipei, China. In India, Indonesia, Malaysia, Thailand and the Philippines, their average contribution has been much lower, on the order of 25 to 40 per cent.

These numbers suggest that in Southeast Asia and South Asia more room exists for creating an enabling environment for the service sector. This could best be done by first creating an appropriate regulatory and institutional environment, followed by trade liberalisation. Trade liberalisation via lower barriers to entry and market access in service sectors will guide resources towards their optimal usage, to sectors with a comparative advantage, and hence result in large efficiency gains. These policy measures will also stimulate large benefits through lower costs of intermediate goods to producers and lower prices for consumers. All these factors should help in the medium to long term to achieve sustainable favourable growth prospects and a return to the high trend growth rates of the last two decades.

Service sector deregulation and liberalisation promise significant economic gains in developing Asia. As with the opening of trade in goods, however, services liberalisation could involve fairly painful adjustment costs, which need to be anticipated and appropriately managed. Deregulation in a weak or ineffective regulatory and supervisory environment could cause severe instability in the services sector as well as in the overall macroeconomy, given the important linkages that services have with the rest of the real economy. Such instability would result in volatile economic conditions, which obviously should be avoided to steer clear of the resulting large social and economic costs, such as those incurred during the Asian crisis. It therefore becomes crucial to put in place a sound and enabling environment for the service sector in order to achieve a sustainable and stable development path for the medium to long term.

# Deregulation and Liberalisation in Services: Experience and Perspectives from Thailand

*Krirk-Krai Jirapaet*

This paper focuses attention on Thailand's experience in liberalising certain key services sectors, namely finance (banking) and distribution (retailing). It emphasises the positive and negative impacts of liberalisation and the lessons learned. The last section reflects on future trends in reform and liberalisation and on ways to move the negotiation process forward.

## General Economic Outlook and Trade Policy in Thailand

Situated in the heart of a natural "hub" of Southeast Asia, Thailand prides itself on being a "country of the free" as translated literally from its own language. Siam, as it was called from its nation building over 700 years ago until late 19$^{th}$ century, has traded freely with Asia and Europe since ancient times. The Portuguese, the Dutch and the British became early trade partners, mainly in timber, tin, rice and a few other oriental products such as herbs and spices. Thailand remains essentially an agrarian society, whose development efforts since the 1950s — after eight National Economic Development Plans and some changes in FDI policies — transformed it into one of the emerging Asian tigers until the Asian financial crisis struck in 1997. Four decades of economic development amidst successive changes of government and turmoil in the region saw significant progress. A decade prior to the financial crisis, there were abundant signs of development and optimism for the future of this medium-sized country. Highlights of the economy include the following:

— An export-led economy, Thailand relies heavily on four major markets — the United States, Japan, the European Union and the rest of Asia.

— Economic growth was sustained at 8 to 9 per cent per year on average, due to high annual export growth of 15 to 18 per cent.

— Despite chronic trade deficits from 1955 to 1995 due to continuously rising imports of capital goods and raw materials, the balance of payments presented no problem, given steady inflows of capital.

— Traditionally, Thailand has a high savings rate of about 35 per cent of GDP.

— External debts were high at about 60 per cent of GDP but remained well within debt-service capacity because of rising export earnings, capital inflows and productive use of the debts incurred.

— Current account deficits peaked in 1995-96 at 8 per cent of GDP, bordering the danger zone.

***Success Factors***

Thailand's success comes from a range of domestic and international factors:

— prudent and conservative macroeconomic policy;

— diversification of export products;

— agricultural development;

— a new generation of business people and entrepreneurs;

— integration into the world economy;

— fairly liberal economic and trade policies;

— the international economic environment and multilateral trade liberalisation; and

— FDI policies.

In the last five decades, foreign investment policy passed through several changes in emphasis and orientation towards greater liberalisation. Economic and trade liberalisation measures had a number of origins. The need to obtain grant aid and technical co-operation from the West had prominence in the 1950s-1970s. Later, Thailand needed to attract FDI for modernisation and development plans. Western pressure also came to play a role, as trading partners attempted to pry open the Thai market and believed that their economic philosophy and policies were also "proper and desirable" for Thailand.

***Economic Weaknesses***

As in many developing countries, the Thai economy is beset with many problems. More details will appear later, but some particular problems merit mention here.

— *A weak technology base.* Compared with some Asian tigers, Thai technology is at least 20 years behind.

— *Low levels of R&D expenditure.* Less than 3 per cent of total budgets in government and the private sector go to R&D and human resource development.

— *A poor and fragile regulatory, supervisory and enforcement framework*. Usually, supervision is lax and enforcement lenient, giving rise to a lack of transparency, discriminatory treatment, etc.

— *Shrinking international competitiveness*. The Switzerland-based IMD ranked Thailand in the low 30s even at the top of its economic boom; that ranking has since fallen further.

## Development of Services Trade in Thailand

Thailand's traditional comparative advantage lay in the agricultural and manufacturing sectors, and the role and importance of trade in services were limited and rather insignificant. Yet in recent years a new trend has emerged. Before the crisis, the combined share of five key service sectors was roughly 48 per cent of GDP[1]. The service sector grew by 9 per cent in 1995 and 5.3 per cent in 1996 then shrank dramatically after the crisis, by 1.2 per cent in 1997 and 10 per cent in 1998[2]. Thailand ranked 28th in the world in service exports in 2000, which was commendable considering that only a handful of non-OECD countries rank among the top 30 world service exporters[3]. Most Thai service export revenue comes from tourism (54 per cent, 11.4 per cent of total exports), followed by a myriad of small business services (5.1 per cent of total exports), transport (3.8 per cent), telecommunications (0.3 per cent), construction (0.13 per cent) and insurance (0.1 per cent). Until 2001, Thailand registered services trade surpluses due mainly to the fast-growing tourism industry. During the Uruguay Round, it was not a *demandeur* for trade in services. Nevertheless, it undertook commitments in ten[4] of the twelve service sectors defined by the GATS.

### *Lack of Credible Statistics on Trade in Services*

Despite these statistics, the precise role of services in the Thai economy remains a matter of anybody's guess, notwithstanding a general feeling that the sector has growing importance. The cloudy picture emerges from:

— *Definitional and classification problems*. Services trade and activities are not recorded in accordance with the GATS definitions of sectors and sub-sectors (Table 1). The balance of payments and other relevant statistics capture only a few service activities such as tourism and transport.

— *Paucity of data*. Thailand, like many other countries (and not uniquely developing ones), is blindfolded by inaccurate and incomplete data. Trade policy makers face a hazardous risk of making decisions that may not be in the best interests of the country.

— *Lack of co-ordination*. No single agency keeps track of new developments, let alone planning. Line agencies are responsible for regulatory, not trade-related matters. The existing laws are obsolete and need speedy updating.

Table 1. **Major Thai Service Exports Classified by Modes of Delivery**

| Mode of Supply (GATS) | Sectors and Sub-sectors |
| --- | --- |
| Mode 1 (cross border supply) | • Telecommunications |
| Mode 2 (consumption abroad) | • Health including long stay and hospital services |
| | • Education (primary education particularly international schools, short courses and tertiary education attracting mostly students from neighbouring countries) |
| | • Tourism |
| | • Recreation and sport |
| Mode 3 (commercial presence) | • Construction |
| | • Restaurants |
| Mode 4 (movement of natural persons) | • Health-related professional (semi-skilled labour in non-mainstream health services) |

### *Regulatory Framework*

*Sui generis* laws[5] regulate a number of services, but they do not address services in a comprehensive way. Other laws and regulations have non-commercial aspects and implications for universal services such as education and telecommunications. For services such as professional services — e.g. legal, engineering and architectural services — related laws and regulations concentrate on standards and ethics. Other commercial aspects, particularly market access, are left to the Foreign Business Act, B.E. 2542 (1999). With its core aims of attracting foreign capital, enhancing standards and skills and fostering competition, the act reduced the number of restricted business sectors from 63 to 43. It contains two major components governing foreign participation in the Thai economy:

— Three categories of commercial activities (mainly services) are strictly reserved to Thai juridical persons unless with the approval of both the Alien Business Board and the Director-General of the Department of Commercial Registration (Ministry of Commerce). The act allows foreign investors to hold over 50 per cent of firms in a number of different businesses, including accounting, legal, engineering and architectural services, tourism and hotel businesses, retailing and wholesaling, transport and banking services.

— Criteria used to distinguish a foreign company from a national company include ownership and control by foreigners or the level of their equity participation and their role in legally directing business decision making.

Thailand has no specific regulations for joint ventures or other forms of business establishments with licenses issued overseas. Those activities are subject to the general provisions of the act.

### *Policy on Trade in Services*

In the past, liberalisation policy for services moved cautiously and in response to the Uruguay Round package. Further actions were rooted more in the economic and financial crisis than in genuine recognition of the value and virtue of a freer services regime. Paradoxically, this caution contradicted to a certain extent both the desire and the long-standing policy to attract FDI. Currently, however, a number of important considerations legitimise continued liberalisation:

— the need to liberalise services gradually and progressively under the GATS;

— the indispensable role of services in social and economic development;

— Thailand's strength in some sectors and their regional export potential, particularly in ASEAN; and

— the need to compete with China and other developing countries as an investment destination.

## Financial Liberalisation and the 1997 Crisis

### *Some Concepts of Deregulation and Liberalisation*

Ideas about financial liberalisation and its degree have evolved and shifted over time in the developing world. Generally, strong governmental involvement and regulation to nurture the private sector have been considered necessary to ensure financial and economic stability. In the 1970s, a liberal school of thought revolutionised this idea, seeing government assistance and intervention as creating distortion and inefficiency that resulted in disintermediation in the financial sector. McKinnon and Shaw were among the first to point out the failure of excessive government control and proposed financial liberalisation based on market mechanisms and the belief that deregulation and liberalisation would best avoid government failure. Ever since the 1930s, in fact, these ideas and concepts have been widely applied with, more recently, their expansion to cover the external sector. They have become mainstream thinking. The liberal school stresses the importance of this sector to economic development while viewing government intervention as obstructive of investment and economic growth. It argues for the elimination of distortions in the financial system by abandoning control and allowing market forces to allocate financial resources. It also supports the so-called "big bang approach" i.e. rapid deregulation and liberalisation. It has become well accepted by many developing countries, with support from international institutions like the World Bank and the IMF.

Nevertheless, there are opposing views, from non-mainstream New-Keynesian, post-Keynesian and Neo-Structuralist economists. Their arguments are just as valid and interesting, particularly the notion that liberalisation is not that easy and may not

always yield positive results. The liberalisation of the financial sector is more complex than conventionally thought. It may have different impacts on the economy and produce various consequences.

### *Thailand's Financial Liberalisation*

Encouraged by its economic achievements since 1985, alerted by the Uruguay Round negotiations and constantly pressed by trading partners and international institutions, Thailand attempted financial liberalisation in the early 1990s. It introduced three kinds of reform aimed at raising competition in the system, namely interest rate liberalisation, relaxation of financial controls and liberalisation of capital transfers. Fixed-deposit interest rates were freed first, followed by saving and loan interest rates. Commercial banks' asset-management and other regulations were also relaxed, as was the definition of liquidity-asset ratios. Financial institutions could now expand their activities relatively freely. To free capital flows and transfers, Thailand signed onto IMF Article 8 and further liberalised foreign exchange to facilitate private-sector trading of foreign exchange without permission, save for outward foreign direct investment and portfolio investment. The liberalisation includes transfers and remittances of profits and dividends of foreign companies. The Bangkok International Banking Facility (BIBF) was established to facilitate capital flows.

Deregulation and liberalisation in 1992 created an important phenomenon. Thai private-sector debt soared, from $11 billion in 1990 to $109 billion in 1996. Non-performing loans (NPLs) in the banking system ballooned to an alarming level. When export earnings faced an unprecedented slow-down to zero growth in 1996, the current account deteriorated. The writing had appeared on the wall. Speculation against the baht began in 1997 and led to successive waves of attacks and defences that culminated in the depletion of international reserves and near bankruptcy. The floating of the currency became inevitable.

The general public, business people (particularly those hard hit by the crisis), and politicians put the blame on liberalisation. They found it all too easy to blame the WTO, which was in their minds synonymous with "total" liberalisation. Understanding of the WTO was minimal outside trade policy circles. This not only placed the purpose and process of liberalisation in jeopardy, but also tarnished the image of the WTO. It and the multilateral trading system are not without flaws, but was the crisis WTO-generated?

### *Causes of the Financial Crisis in Thailand*

The financial crisis in Thailand was not the first nor will it be the last. Crises induced by deregulation and liberalisation have occurred in many countries since World War II. The last crisis in some European countries was only ten years ago. Unfortunately, Thailand did not learn from Chile, Malaysia, Korea and Japan; otherwise the situation would not have been so grave[6]. None of the earlier crises arose from just

one or two isolated factors. That in Thailand also had multiple origins. Moreover, one point is clear: deregulation and liberalisation in Thailand were voluntary and independent of the Uruguay Round, although the Uruguay Round process did influence decisions on them to a degree. Experts in the field[7] have pointed to a number of domestic and external conditions that contributed to the crisis.

*Weaknesses in the Financial Sector*

— A poor prudential supervisory regime, notably for loan classification and supervision practices, was too lax and lenient. Incalculable "connected lending" existed, due to cronyism in business and political circles and frequent "evergreening", i.e. bolstering stressed loans with new loans so payments on the old loans could be made.

— With excessive government ownership of or involvement in banks, they became quasi-fiscal agents of government, providing an oblique mechanism for channelling government assistance to ailing industries.

— The government guaranteed the security of the system too far. Banks were always bailed out of trouble.

— An overwhelming portion of foreign loans had short-term maturities and/or was denominated in foreign currency.

— Banks were over-exposed to the property sector, which accounted for 25 to 40 per cent of total bank loans.

— Bank supervisors lacked the mandate to counter strong political pressures for supervisory forbearance.

— Poor public disclosure and transparency rules.

*Defects in External Financing*

— Abundant and unregulated global liquidity conditions inundated Asian developing countries.

— The BIBF — established to promote Bangkok as a regional financial centre and intended to raise and lend funds abroad (out-out transactions) — became merely a conduit through which Thai banks and firms borrowed abroad (out-in transactions).

*External Sector Problems*

— The pegging of the Thai currency against a basket of currencies denominated in US dollars had unfortunate consequences, compounded by a failure to have timely unpegging.

— Competitiveness declined in terms of real effective exchange rates, which became overvalued by about 7 per cent relative to the long-term average as the baht appreciated against the US dollar.

— A rising current account deficit reached 8 per cent of GDP in 1996. Over the 1990s, Thailand had a cumulative current account deficit of 36 per cent of its 1996 GDP.

— Merchandise export earnings slowed.

— Thailand faced competition from China as the result of a shift of comparative advantage from Southeast Asia to China;

— Amidst intense export competition some key industries over-expanded.

***Some Lessons Learned from the Crisis***

— Efforts to promote financial and capital account liberalisation without strengthening the prudential supervisory framework could lead to economic disaster.

— Hence, reforms of the financial sector and of that framework are important. Reform must have an urgent place on the national agenda even if the country's macroeconomic performance is sound and looks healthy.

— There is a flaw in the international financial architecture. For the crucial tasks of reducing moral hazard and increasing the orderliness and flexibility of private debt rescheduling, developing countries must be convinced to implement strong international prudential, transparency and disclosure standards.

— It is all too easy to point to a scapegoat, the GATT/WTO, and a sacrificial lamb, liberalisation. The general public little understands the functioning of the WTO, despite its importance as a rules-based system. Politicians tend towards "free-trade bashing" for short-term political gain rather than long-term benefit.

— Lessons from both the Thai crisis and the Asian financial crisis in general suggest that more countries in the developing world should move quickly toward stronger prudential/supervisory standards and an international banking standard. Liberalisation leading to disaster at the expense of such quality liberalisation is pointless.

**Distribution Services**

In the Thai economy, wholesale and retail trade accounts for about 16.5 per cent of GDP and ranks second only to manufacturing. The entire sector employs around 15 per cent of the workforce. This sector contains two broad categories, namely "traditional" and "modern" trade. The first includes mainly family-run groceries (corner

stores or “mom-and-pop” shops) with small areas for both trading and living. Often, these shops employ neither modern technology nor management techniques. The second group, on the other hand, includes supermarkets, department stores, hypermarkets, discount stores and convenience stores. They usually run efficient and orderly business operations with modern technologies, such as supply-monitoring systems, warehouse management and modern administrative systems.

Sensitivity exists because the traditional retail shops often form an integral part of the social community. These grass-roots businesses have a considerable share of the country’s employment and serve as an important source of supplementary income for many households. In contrast, the modern retailers form a still more formidable business force. Together, they command a turnover of about $22 billion with a growth rate of between 10 and 15 per cent a year. In a new trend that augurs even faster growth in the near future, the big department stores and hypermarkets (discount stores) are adding catering and entertainment facilities.

Well-known European discount stores and convenience stores of various franchises made their debut in Thailand in the late 1980s. They registered as Thai business entities with foreigners holding less than 49 per cent of the equity. Following the economic crisis, the economy badly needed funds and employment. That led the government to allow these businesses to have foreign majority ownership on the condition that they invest a minimum of 100 million baht (approximately 2.5 million euros). The optimistic authorities focused on only the bright side of liberalisation — that it could lead to beneficial effects on growth, productivity, efficiency, jobs, and consumer choice. This opening of retail services could provide an interesting example of the myth of foreign investment. It occurred quite independently of the GATS, because Thailand has no commitment under retail services.

***Consequences***

The consequences of the liberalisation of retail services are:

— At the end of 2001, almost all of the 97 major discount stores were foreign-owned.

— Franchised chain convenience stores are locally owned.

— Intense competition occurs among the various chains through price-cutting, area coverage and branch expansion in both big cities and provincial towns.

— The discount stores hold 23 per cent of all retail sales, while the 300 000 traditional stores have 46 per cent. The rest is split among the department stores, supermarkets, convenience stores and speciality stores.

— The market share of foreign-owned chain stores is rising at the expense of traditional stores. In major cities and urban areas where the big names have a strong presence, the traditional stores were driven to near extinction. This has led to acute political outcries against liberalisation.

— The spread and market penetration of the modern retailers has effectively foreclosed the emergence of new traditional stores.

— The big discount stores, with their vast spaces and facilities, have drawn customers to an extent that traffic congestion within their vicinities has become critical.

***The Negative and Positive Impacts***

On the negative side, we see:

— The gradual disappearance of traditional stores in Bangkok and provincial towns, particularly in areas covered by franchised convenience stores and discount stores.

— Foreign retailers, through the major discount stores, can gradually build up monopolistic power in Thai retailing.

— With ever fewer corner stores as their outlets, Thai suppliers gradually found themselves in weaker bargaining positions *vis-à-vis* discount stores. This may result in price and quality erosion and even turn suppliers towards producing only house brands for the discount stores.

— Sentiment against liberalisation has grown, along with strong opposition to the domination of foreigners in retail business.

The positive elements cannot be ignored, however:

— The inflow of investment for each chain is sizeable.

— The development of modern trade with new management styles, know-how and technology could provide a good training ground for Thai entrepreneurs.

— Employment creation in these businesses grows with their expansion.

— Consumer choices and welfare increase as a result of competition.

— Government collects greater revenues, due to the good accounting systems of the modern stores.

— The discount stores can serve as exporters of Thai products through their branches overseas.

***Remedial Actions by the Authorities***

In response to complaints by small traditional retailers and in order to curb the negative impacts, the Thai authorities have engineered a number of strategies and measures. The main missions are to ensure the survival of traditional retailers through development of managerial techniques, increased competitiveness, gradual expansion and fair trade practices. Three main strategies involve management capacity building, improvement of marketing techniques and a proper regulatory framework. The following measures have been implemented:

— *Community Retail Shops* (CRS). Policy supports the establishment of community retail shops in remote areas both to service the communities and to prepare a new generation for greater competition in this sector. Seed funds were provided for the initial stage and additional funds for the development stage.

— *Training of CRS managers*. Training courses provided knowledge on planning, management, procurement, inventory management, finance and accounting, promotion and related laws. They also incorporated competition awareness to stimulate adjustment and development.

— *Consultation service for retailers*. A Retail Clinic was established in 2001 at the Internal Trade Department to provide such consultancy services.

— *Connectivity of small retailers*. The aim here is to build networks of small retailers and wholesalers for joint purchase and transport, to improve their bargaining positions and reduce costs. This may lead to new chain store incorporations or franchising.

— A *model modernised retail shop* was established to demonstrate optimal space management, display of products, interior decoration, lighting, etc.

— *Funding for small retail shops* comes through the Government Savings Bank and the SMEs Finance Corporation.

— *Compilation of a database and the use of IT* have been promoted for small retail and wholesale businesses.

— *Regulatory improvement* will include the appropriate and timely application and enforcement of existing laws (the Urban Planning Law, the Competition Law, the Price of Goods and Services Law and the Local Administration Law, among others) to ensure fair trade practice, consumer protection and healthy competition.

***Lessons Learned from the Liberalisation of Distribution Services***

— *Liberalisation of wholesale and retail trade has opened another aspect of "quality of life" to Thai consumers*. Consumers stand to benefit in price and choice from competition among the foreign-owned chain stores.

— *In the longer run, it remains to be seen whether abuse of market domination or collusive power will occur to the detriment of free and fair competition.* There are currently at least eight major complaints of malpractice by these stores at the expense of suppliers. The regulatory and supervisory regime must be strengthened to pre-empt and prevent exploitation and abuse of monopolistic and monopsonistic behaviours and their side effects.

— *Liberalisation of this sector has both costs and benefits*. It is difficult to measure whether costs outweigh benefits or vice versa. Clearly, liberalisation was not introduced as a result of systematic planning, nor was it accompanied by cautious measures to prevent or minimise adverse effects on the related players. One thing men learn from history is that they never learned from history!

— *The lesson learned by traditional retailers is perhaps the most costly*. The failure to heed the influence and effect of globalisation, to adjust to the changing competitive, social and economic environments, will definitely lead to the obituary of their businesses. Resuscitation comes too late to bring about resurrection.

— *Government interventions are unwelcome in most economic activities.* Even when needed, they are almost always a little late. Yet in certain situations and countries, government has a role in nurturing a weak and fragmented sector, as the players are usually unorganised and incapable of systemic improvements in their favour. Such governmental interventions must be proper, appropriate and timely.

## Future Options and Prospects

Thailand's aspiration to reach a higher plane of development prompted voluntary and hasty reform and liberalisation in some crucial service sectors, which led to near disaster. Although the economy has rebounded, the outlook has improved and external vulnerability has declined, public sentiment and confidence remain dubious. Discontent with the recovery and liberalisation is high, making political bashing of freer trade more frequent and intense and further liberalisation more difficult. Yet the options do not seem to permit backtracking.

The commitment to liberalisation exists. The country has in fact never wavered from pursuing openness and liberalisation even in times of crisis. National Economic and Social Development Plans since the early 1980s set their sights on strengthening services trade through deregulation and liberalisation, which actually did happen in some sectors. When the IMF rescue package was needed, Thailand committed to drastic reforms in the financial system and macroeconomic policy. Economic Ministers in charge of crisis solving pledged continued efforts at trade and investment liberalisation. "During difficult times there should be no backtracking of commitments on trade and investment liberalisation", said Dr. Supachai in his speech at Columbia University in early 1998.

Deregulation in the state enterprises started in 1998, aiming at reform to increase competitiveness, raise efficiency in the provision of services to the people and enlist private participation. Privatisation of state enterprises has moved gradually since then. Private power generation plants were encouraged. The national flag carrier became listed on the stock market. In the past ten years, 40 state enterprises were privatised and their number fell from more than 100 to 59. Present policy clearly supports continued privatisation along with free trade internationally. In 2001, Internet Thailand and the Petroleum Authority became corporations, and 18 state-owned enterprises will be privatised soon. Important sectors heading towards privatisation and the stock exchange in 2003 include telecommunications, railway and public transport, the Airport Authority, the Port Authority, power generation and water supply.

Deregulation and privatisation will lead to further liberalisation. The financial sector, particularly banks and finance companies, are the most liberalised. Before the 1997 crisis, 29 commercial banks operated in Thailand, of which 15 were locally incorporated (13 private and 2 state-owned) and 14 were branches of foreign banks. There were 91 financial companies. To date, four commercial banks and numerous securities and mutual fund management companies are majority foreign owned. For the first time, foreign banks, with a total of 21 branches, now operate branch networks that compete directly with Thai banks. The Bank of Tokyo-Mitsubishi, Citibank, Sakura Bank and HSBC are the most active institutions in terms of growth rates and market shares. Global banks tend to concentrate on the largest corporate customers, who need their sophisticated services (foreign exchange, risk management, derivatives trading, cross-border mergers and acquisitions, etc.). Seeing this, local banks have become less fearful that the global banks will run them out of the business of lending to individuals and small and medium-sized enterprises. Whether greater foreign ownership through outright purchases or joint ventures contributes to financially sound banks and a more efficient and stable banking sector remains to be seen.

The current Thai GATS commitment on securities businesses allows foreigners to hold up to 49 per cent of the paid-up capital in securities companies undertaking brokerage, dealing, investment advisory and asset management business. Under the Foreign Business Act, however, securities brokerage is no longer a regulated business and therefore no restriction on foreign ownership applies. Other types of securities businesses must still seek approval from the Director General of the Commercial Registration Department in the Ministry of Commerce. The Foreign Business Act improved on an archaic decree. It is much more transparent, with specific, time-bound procedures and less discretionary power for the bureaucrats. The law mandates its own review, but backtracking is not thinkable.

Thailand has been active in the formation and acceleration of the ASEAN free trade area (AFTA). The scheme will be fully operational by 2003. The ASEAN services trade negotiations have moved slowly despite two rounds of negotiations since 1998. In the difficult third round some new approaches aiming at acceleration have appeared. Beyond AFTA, the latest interesting development is the initiative to negotiate FTAs with the United States, China, Japan, Australia and New Zealand. It will be fascinating to see how this embryo will take shape as it matures.

### *The Need to Go Forward*

The World Bank's recent *Thailand Economic Monitor Report* concludes that the worst of the economic downturn is behind Thailand. The economy has rebounded in 2002 with several factors on the side of recovery. Thailand has made significant progress since the 1997 crisis in rebuilding its banking sector and modernising its regulatory institutions. It is well positioned to take advantage of the expected global recovery, with sufficient fiscal and monetary stimulus and more openness since the crisis. Yet challenges lie ahead, particularly the deterioration of competitiveness and the weak

knowledge economy. The clear policy option is to move ahead. The question is how to proceed so as to ensure quality liberalisation with optimal scope, speed and depth. For a country like Thailand, with bitter experience and still-fresh wounds, the task is both economically and politically difficult. Some critical success factors need to be tailor-made for the Thai scene:

— A strong political will to move further by capitalising on the economic recovery and global economic prospects.

— *Knowing the national interest and potentials*, particularly in services, based on scientific, reliable and ample data.

— An appropriate regulatory framework and institutional capacity, with transparency and strict enforcement.

— *Increased public awareness, education and involvement*. The general public is not aware of the implications — positive and negative — of liberalisation and what is expected of it. There is a sort of "economic immaturity" and a lack of sophistication. If these problems are corrected, consumers can act as a balancing force.

— *Creation of linkages between trade in services and manufactured goods.* National policies should be developed to enable creation of linkages across important sectors and therefore to forge synergy among them. For example, liberalisation in services should support export interest in goods and *vice versa*. Service sectors that can help support the development of agriculture, manufacturing and other activities should be liberalised to the extent that the benefits of greater efficiency and lower costs can spill over to other areas. These sectors include finance, telecommunications, transport, energy, distribution and logistics, among others.

## Ways to Move the Multilateral Process Forward

Moving the multilateral process forward involves understanding certain facts and fears, then developing strategies to deal with them.

### *Facts*

— Most developing countries' service sectors are underdeveloped if not undeveloped as a result of internal shortcomings. They have not achieved a sense of readiness. Their domestic laws and regulations need amendment so that after market opening local business people and consumers can genuinely reap the benefits of free trade.

— Some countries are anxious about past experiences when they innocently, even carelessly embraced free trade. Sometimes, if not most of the time, such wisdom has a negative correlation with spontaneity.

— Contracting out certain public services to private operators has proven counter-productive in the health and utilities sectors. Hospital services in the United Kingdom and the energy blackout in California offer controversial cases in point. Bearing this in mind, developing countries should seek to ensure that further liberalisation is compatible with the public policy objective of providing universal service at affordable prices.

— International networking among NGOs and other political organisations is omnipresent. They have come up with plausible arguments against liberalisation, some of them valid, some half-truths.

— Frustrations are emerging from the implementation of the Uruguay Round as developing countries' concerns are not fully addressed and their expected benefits have not materialised. They therefore hesitate to provide further market access concessions without prior attention to their special development needs and implementation difficulties.

— GATS focuses only on free movements of capital and labour (human capital). With regard to entry and temporary stay of professionals, many countries made commitments only for limited categories of labour such as intra-corporate transfers and specialists. This needs improvement in the Doha round, especially to balance commitments between mode three (commercial presence) and mode four (movements of persons).

— Services under GATS embrace diverse industries ranging from finance and telecommunications to sport and recreational services. These diffuse and diverse service industries have made it difficult to create consistent rules for all of them, on competition or subsidies, for example.

***Fears***

— Developing countries feel certain about the short-term costs of liberalisation but not totally sure of the long-term benefits.

— They fear being unable to compete, especially when granting national treatment in full or in part is at issue. They fear that their domestic services sectors are not yet fully developed and not sophisticated enough to withstand fully-fledged competition.

— Some countries equate liberalisation with the surrender of economic sovereignty. Concerns over transactions on mode one are imminent. Provision of services through electronic means, such as tele-medicine, e-banking and distance learning, requires new legislation to capture the realities — perhaps a new breed of taxation and quality control measures.

— Liberalisation could become politicised to the point that governments in power could not secure their constituencies.

***Strategies***

— *Observe the core principles of GATS.* The MFN principle is beneficial for competition and thus domestic consumers. The National Treatment principle, however, must be flexible enough to allow domestic industries to grow.

— *Adhere fully to the principle of progressive liberalisation.* Basically, no WTO member has to schedule a commitment with which it is not comfortable. Members maintain discretionary power to open fewer sectors according to their stages of development and there is scope for attaching specific conditions to their concessions.

— *Enshrine the object and purpose of right to regulate.* Recently, moves toward greater transparency have had a tendency to pry into rule-making activities of individual governments. Transparency is good unless it impinges upon legislative power of host countries or obstructs the ability of importing countries to manage flows of services — in terms of quantity for healthy competition and quality for consumer protection.

— Fine-tune the developed countries' expectations and scale up developing countries' ambition and courage to liberalise.

— *Put global interests before national interests.* Think like Diogenes, a Greek cynic, that one is a citizen of the world! Narrow interests are usually short-term and counter-productive. Think, "prosper together" and not "beggar thy neighbour".

— *Take regional liberalisation as a building block that supplements global efforts.* Use it to nurture competitive strength and learn to compete in a smaller group. The ASEAN experience may not yet be an example of success, but it surely is a good experimental effort.

— *Explore new approaches other than the GATT multilateral model in the lead-up to a higher level of liberalisation.* To this end, the APEC three-pillar approach, which includes facilitation, co-operation and liberalisation, could be useful. The AFAS[8] has explored many different approaches to achieve free flows of services by 2020. They include the Common Effective Preferential Tariff (CEPT) approach; immediate liberalisation of selected services sectors; drawing up individual action plans; a multi-track approach; and advances among like-minded countries.

— *Put the absent rules in place.* To facilitate liberalising efforts in the WTO, the GATS, a young Agreement, has provided for follow-up negotiations on specific issues to fill in the missing elements, mostly rules. Subsidiary bodies discuss important, unsettling questions on classification, domestic regulations and rules on safeguards, government procurement and subsidies.

To encourage more participation among developing countries, safety valves should be put in place beforehand. Measures that already exist to deal with import surges in goods trade, such as safeguard measures, should not and ought not to be ruled out for trade in services. Members need a safeguard mechanism comprising reasonable and non-discriminatory trade measures readily usable to limit injuries resulting from liberalisation and allow time for policy readjustment to correct

potentially poor governance. This issue has given rise to seven years of heated debate over its desirability and applicability. Members should not let assumptions that are too theoretical cloud the intrinsic political and economic value of safeguards, which provide a mechanism that can respond to injuries instantaneously.

— *Devise effective capacity-building schemes.* The success of the GATS negotiations will depend critically on the universal participation of all WTO members in the negotiations and the capability of all to implement the outcomes. Yet most countries in the developing world still suffer from misguided policies, malfunctioning trade-policy management and shortages of financial and human resources. They have insufficient knowledge and in-depth understanding to fully and effectively engage themselves in the negotiations. Developed countries must search for ways to strengthen the capacity of developing countries, not only to enable full participation in the negotiations, but also to ensure that development needs and concerns become an integral part of any negotiation outcome. Capacity-building programmes including sharing experiences in the regulatory framework can be conducted through relevant international bodies and forums like UNCTAD, ESCAP, UNDP and APEC.

## Conclusion

The role of services is growing everywhere. By the end of 2000, the sector already represented 50 to 75 per cent of production and employment in most countries, developed and developing alike. Its relevance for building infrastructure, creating institutional frameworks friendly to investment and business and upgrading social welfare has rendered the sector an integral part of national sustainable social and economic development schemes. Moreover, despite concerns and fears, efforts to liberalise have indeed been made, for at least three reasons — first, a genuine conviction of the benefits of liberalisation; second, the need for liberal economic policies to redress negative effects of macroeconomic mismanagement; and third, the quest for greater growth, prosperity and sustained international competitiveness. Yet some countries have got into trouble and have bitter experiences from “immature” or “untimely” liberalisation. They cannot blame liberalisation alone, because many economic difficulties and crises found their origins in inherent systemic weaknesses independent of liberalisation. Yet market opening without readiness can spill over to reinforce such weaknesses. The residual sour taste and anti-liberalisation sentiment could backfire against future liberalisation.

The policy, objectives, process and implementation of market opening must be handled with caution and courage. Liberalisation is a non-linear process. It needs a constant reality check and occasional re-regulation. A number of factors can ensure smooth transition towards free trade and the market economy — appropriate institutional frameworks, regulatory and supervisory regimes and good governance, among other things. Thailand’s experiences can offer some food for thought, not only for developing countries but also for future negotiations. Different countries could well arrive at different conclusions, but on a global view the direction of movement is clearly forward.

## Notes

1. The five major subsectors are trade (wholesale/retail), 16.7 per cent; other services (education, health, recreational and sports, business services, hotels and restaurants, etc.), 10.7 per cent; transport and telecommunications, 7.8 per cent; banking, insurance and real estate, 6.8 per cent; and construction, 6.2 per cent.
2. ADB (2001), Table 12.
3. WTO (2001), Table I:7.
4. Business, communication, construction, distribution, educational, energy, environment, financial, tourism and transport services *less* health and "other" services.
5. Examples are the Tourism Authority of Thailand Act, B.E. 2522 (1979), the National Energy Policy Council Act, B.E. 2535 (1992), the Land Development Act, B.E 2526 (1983), and the Provident Fund Act, B.E. 2530 (1987).
6. See Supanitch and Wora-Uraui (2001).
7. See, for example, Goldstein (1998) and Panitchpakdi (1998).
8. The ASEAN Framework Agreement on Services (AFAS) was established in 1995. Long-term parameters to guide liberalisation of financial services include the objective of a "free flow of services by 2020" as a vision. Seven sectors were chosen as priority areas, namely air transport, maritime transport, construction, finance, tourism, telecommunications and business services. To date, ASEAN Economic Ministers have signed three packages of commitments upon the conclusion of the previous two rounds of liberalisation negotiations. Those commitments are GATS-plus, i.e. packages of improved commitments undertaken under AFAS are deeper or broader than those under GATS. Milestones are to be set by having a new round of negotiations every three years. During the 33rd Asian Economic Ministers' (AEM) Meeting held in Ha Noi, Viet Nam on 15 September 2001, the Ministers agreed to launch the third round of negotiations beginning in 2002 and ending in 2004, covering all sectors and modes of supply.

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# Reform and Liberalisation of Financial Services in Korea

*Moon Soo Chung*

## Introduction

Since the outbreak of the financial crisis in December 1997, Korea has taken important and wide-ranging steps to restructure the financial sector. They include strengthening the regulatory and supervisory system and cleaning up moribund financial institutions and their non-performing loans (NPLs). They have tried to put the weak financial sector back on its feet while swiftly adjusting to the rapidly changing economic environment. They also have earnestly pursued the liberalisation of the financial market. By generating inflows of foreign capital, this has helped stabilise the foreign exchange market and facilitate the restructuring of the financial sector itself. Financial reform also contributed to an early normalisation of the financial system and eased the credit crunch. Overall, the restructuring has brought about many significant changes in the Korean economy. It rebounded strongly from the crisis earlier than expected, and the sovereign credit rating, which had plunged below investment grade, recovered to the pre-crisis level.

Despite this remarkable performance, much remains to do. The financial reform is not yet fully complete and needs further improvements to strengthen it. The government-driven reform successfully quick-fixed the sector and built a public consensus on the need for financial reform, but the private sector has yet to show a more positive attitude towards reform. In order to sustain its initial spirit, the market now must lead the reform, motivating the private sector with profitable incentives and making it systemic. This will contribute to enhancing the competitiveness of the Korean economy as a whole.

## Financial Sector Restructuring

The restructuring has been implemented in two stages (Table 1). The first, under government leadership, focused on closing troubled financial institutions and disposing of financial institutions' NPLs. It proceeded on the basis of several principles set by the Ministry of Finance and Economy (MOFE) and the Financial Supervisory Commission (FSC):

— the capital adequacy standard is the basis for identifying troubled financial institutions;

— if financial institutions fail to satisfy it, they must submit rehabilitation plans;

— an appraisal committee of experts evaluates the rehabilitation plans;

— based on the evaluation, either rehabilitation or resolution is decided. If the rehabilitation plan is approved, support is provided through taking over NPLs and other measures. If the plan is approved conditionally, a forceful self-rescue and implementation plan is required.

— MOFE and FSC formulate policy schemes for facilitating the normalisation of financial institutions;

— nonviable institutions will be closed through purchase and assumption (P&A) or mergers. Public financial support is provided as part of the package to prevent deterioration of the asset quality of surviving financial institutions.

Table 1. **The First and Second Stages of Financial Restructuring**

| | First Stage | Second Stage |
|---|---|---|
| Goal | Recovery from economic crises | Strengthening Korea's competitive power (creation of a mature financial culture, establishment of market order) |
| Focus | Individual institutions or firms (troubled financial institutions, insolvent enterprises) | Market (financial system, market participants' way of thinking) |
| Form | Government-led | Market-led |
| Contents | "Hardware" reform | "Software" reform |

The second stage, still ongoing, aims at cleaning up unrealised NPLs and enhancing the competitiveness of the financial industry as a whole. It implements the "software" part of restructuring, designed to improve the ownership structure and the management system of financial institutions. Accordingly, it requires all market participants to engage actively in the reform process. As opposed to the first stage, where government initiative drove the reform, the role of the government now is limited to creating an institutional environment that facilitates restructuring by market participants, rightly compensated for their efforts.

### *Salient Features of the Reform*

*Strengthening the Supervisory System*. In January 1998, an independent supervisory institution, the Financial Supervisory Commission (FSC), was newly established to consolidate all existing financial supervisory bodies. The government wanted a consolidated agency to enable comprehensive supervision in line with the progress of liberalisation and the rapidly changing circumstances in the financial market. The spread of universal banking and the emergence of various new financial derivative products necessitated a timely and comprehensive regulatory framework.

*Restructuring Financial Institutions*. Before the crisis, 2 101 financial institutions were in operation (Table 2). By March 2002, 620 of them had been closed, merged into others and suspended. Five banks closed through P&A and nine merged with other banks. Among the non-deposit-taking institutions, 28 investment banks, eight security companies, 15 insurance companies, seven investment and trust companies, 122 mutual savings and finance companies, 416 credit unions, and ten leasing companies closed, merged into others or were suspended.

Table 2. **Restructuring of Financial Institutions (as of March 2002)**

| | No. of Institutions (end-1997) (A) | Restructuring | | | | | New Entry | No. of Institutions (March 2002) |
|---|---|---|---|---|---|---|---|---|
| | | Licenses Revoked | Merger | Dissolution | Total (B) | Ratio (%) (B/A) | | |
| Deposit-taking Banks | 33 | 5 | 9 | - | 14 | 42.4 | 1 | 20 |
| Non-deposit-taking Institutions of which: | 2 068 | 118 | 144 | 344 | 606 | 29.3 | 57 | 1 519 |
| Investment Banks | 30 | 18 | 6 | 4 | 28 | 93.3 | 1 | 3 |
| Securities Companies | 36 | 5 | 2 | 1 | 8 | 22.2 | 16 | 44 |
| Insurance Companies | 50 | 7 | 6 | 2 | 15 | 30.0 | 9 | 44 |
| Investment and Trust Companies | 30 | 6 | 1 | - | 7 | 23.3 | 7 | 30 |
| Mutual Saving and Finance Companies | 231 | 71 | 26 | 25 | 122 | 52.8 | 12 | 121 |
| Credit Unions | 1 666 | 2 | 102 | 312 | 416 | 25.0 | 9 | 1 259 |
| Leasing Companies | 25 | 9 | 1 | - | 10 | 40.0 | 3 | 18 |
| Total | 2 101 | 123 | 153 | 344 | 620 | 29.5 | 58 | 1 539 |

*Source:* Financial Supervisory Commission.

*Fiscal Support Scheme*. The government's basic position on fiscal support has held that financial restructuring is to be funded by the financial institutions themselves and that the government would not provide financial support unless financial institutions

undertake self-rescue efforts to reduce costs and get recapitalised, most likely through foreign investment. In cases where financial support was offered, however, the government considered it sufficient to return the troubled institutions to solvency, requiring them to write down the capital of existing shareholders. The government initially planned to spend a total of 64 trillion won (KRW) for deposit payment, recapitalisation of banks and purchase of NPLs. From November 1997 to the end of March 2002, however, the injection of public funds for financial restructuring amounted to KRW 156.2 trillion (Table 3).

Table 3. **Fiscal Support (as of March 2002)**
(trillion won)

| Use/Source | Equity Participation | Capital Contribution | Deposit Payoffs | Assets Purchase | NPL Purchase | Total |
|---|---|---|---|---|---|---|
| Bond Issuance | 42.2 | 15.2 | 20.0 | 4.2 | 20.5 | 102.1 |
| Recovered Fund | 3.9 | 1.2 | 5.95 | 4.35 | 16.7 | 32.1 |
| Public Money | 14.1 | - | 0.05 | 6.3 | 1.5 | 22.0 |
| Total | 60.2 | 16.4 | 26.0 | 14.9 | 38.7 | 156.2 |

*Source:* Financial Supervisory Commission.

The *P*rompt *C*orrective *A*ction (PCA) System applied to almost all financial institutions. It made the assessment of capital adequacy stricter by strengthening asset classification standards to international standards (Table 4), setting provision requirement standards and enforcing accounting principles. Significant efforts went towards improving the evaluation of financial institutions. The CAMEL System (*C*apital adequacy, *A*sset quality, *M*anagement, *E*arnings, *L*iquidity) applied to commercial banks has been strengthened to CAMELS with the addition of *S*ensitivity to market risks.

Table 4. **Classification in the PCA System**

| | First Step | Second Step | Third Step |
|---|---|---|---|
| Deposit-taking Banks (BIS Capital Adequacy Ratio) | less than 8% greater than 6% | less than 6% greater than 2% | less than 2% |
| Investment Banks (BIS Capital Adequacy Ratio) | less than 8% greater than 6% | less than 6% greater than 2% | less than 2% |
| Securities Companies (Net Capital Adequacy Ratio) | less than 150% greater than 120% | less than 120% greater than 100% | less than 100% |
| Insurance Companies (Solvency Margin Ratio) | less than 100% greater than 50% | less than 50% greater than 0% | less than 0% |
| Mutual Savings and Finance Company (BIS Capital Adequacy Ratio) | less than 4% greater than 2% | less than 2% greater than 1% | less than 1% |

*Note:* Government makes a "Management Improvement Recommendation" for the first step, issues a "Management Improvement Order" for the second and takes "Management Improvement Measures" for the third.
*Source:* Financial Supervisory Commission

*Loan Classification Standards and Provision Requirements*. July 1998 saw a major revision of loan classification standards and provision requirements (Table 5). Loans in arrears of three months or more are now classified as substandard (instead of six months or below in the past) and loans in arrears of one to three months as precautionary. Asset quality classification standards strengthened further in 1999 with adoption of the forward-looking criteria (FLC), which focus on expected future performance. Pursuant to the FLC, financial institutions must add up a large sum of provisions. While the imposition of the strengthened criteria reduced their short-term profitability, it has contributed to enhancing the soundness of their financial structures.

Table 5. **Provision Requirements Based on Loan Classification Standards**
(percentages)

| | Old | New | FLC |
|---|---|---|---|
| Normal | 0.5 | 0.5 | 0.5 - 2 |
| Precautionary | 1 | 2 | 2 - 20 |
| Substandard | 20 | 20 | 20 - 50 |
| Doubtful | 75 | 75 | 50 - 100 |
| Loss | 100 | 100 | 100 |

*Source:* Financial Supervisory Commission.

*The Deposit Insurance System*. A partial-protection system was adopted in January 2001. To minimise side effects, its coverage ceiling increased from KRW 20 million to KRW 50 million per person for each financial institution. Introducing limited coverage had three goals: to establish market principles, to enhance confidence in government policy and the sovereign credit rating and to expedite the restructuring process with the help of market forces.

*Provisions for Foreign Exchange Risks*. Regulations were changed to improve management of short-term foreign exchange risks. They required each financial institution to report maturity mismatches in various categories and mandated that provisions be accumulated to maintain at least at 80 per cent the ratio of current assets (90 days to maturity) to current liabilities (90 days to maturity).

*Accounting Practices*. In the past, securities were treated the same as loans in that they were valued at purchase prices. Since November 1998, they are valued at their current market prices.

*Bank Disclosure System*. Unified disclosure standards were introduced, with all financial institutions now subject to the new system. It stipulates regular disclosure twice a year and raises penalties for false or dishonest disclosures. It also includes new disclosure items deemed necessary for judging management conditions. These cover the size of non-performing loans and credits and risk management systems.

## The Liberalisation of Financial Services

Korea's financial services liberalisation began gradually in the late 1980s. With nearly three decades of rapid economic growth coming to an end, the government recognised the essential need to develop a financial market capable of keeping up with the already substantial developments in the real economy. During the early fast-growth period, the government had treated the financial sector as a tool for economic growth rather than as a system for providing efficient financial services. As a result, the financial infrastructure, including the financial supervisory and deposit insurance systems, remained underdeveloped, and systemic weaknesses continued to grow. Inefficient financial institutions, especially commercial banks, could not cultivate their ability to regulate themselves. Easing restrictions on entry of foreign bank branches and life insurance companies was probably among the most important financial liberalisation measures taken in the late 1980s.

Full-scale liberalisation began in 1993, when the government established the "Three-Phase Programme for Financial Self-Regulation and Market Liberalisation", commonly known as the "Blueprint". The programme called for domestic financial deregulation, including interest-rate deregulation and a shift to an indirect monetary policy regime, as well as financial market liberalisation. At the time, Korea's entry into the OECD and the WTO financial services negotiations sped the pace of liberalisation. It picked up speed again following the financial crisis of late 1997. After the crisis erupted, the government saw that reducing financial vulnerabilities would be key to not only ending the crisis swiftly but also preventing future ones. It pursued internal reform and accelerated outward liberalisation simultaneously. Liberalisation occurred across the range of financial services, capital markets and foreign exchange transactions.

### *Financial Services*

The government liberalised all types of commercial presence in all financial service areas. It also abolished all regulations that discriminated against foreign suppliers, except prudential measures. In April 1998, foreign bank subsidiaries joined the already allowed branches with permission to establish freely; FDI was also freed in insurance and insurance-related services such as brokerage and risk assessment. In May, FDI in the securities industry was fully opened for the establishment of subsidiaries, acquisition of existing companies or hostile takeovers. In December, FDI in investment advisory service companies and securities trust companies followed.

Thanks to such measures, foreign direct investment in domestic financial businesses dramatically increased. By March 2001, foreigners had become the largest shareholders in 26 financial institutions, entitling them to participate in management: five banks, eleven security houses, six life insurance companies, three investment and

trust companies and one investment bank. Sixteen of these investors entered the Korean market after the 1997 crisis. Remarkably, most foreign financial institutions that entered the market after the crisis were investment banks and funds that specialise in M&As and portfolio investments. This pattern differs from that in other developing countries, where investment came mostly from commercial banks. Tables 6 and 7 provide more detailed data on FDI in Korean finance.

Table 6. **Foreign Direct Investment in Domestic Financial Markets**
($ million)

| | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 (April) |
|---|---|---|---|---|---|---|
| Finance | 178.3 | 302.5 | 473.2 | 1 830.4 | 1 414.7 | 157.8 |
| Insurance | 16.1 | 7.2 | 73.1 | 331.6 | 440.8 | 118.9 |
| Total | 194.4 | 309.7 | 546.3 | 2 162.0 | 1 855.5 | 276.7 |

*Source:* Ministry of Commerce, Industry and Energy.

Table 7. **Market Shares of Foreign Capital-Based Banks and Domestic Banks, end-2000**
(percentages)

| | Deposits | | | Loans | |
|---|---|---|---|---|---|
| | Savings Deposits | Deposits in Excess of 500 mill. Won | Foreign Currency Deposits | Loans in Won | Loans to Households |
| Foreign-based Banks[a] | 33.5 | 42.2 | 68.5 | 33.4 | 25.9 |
| Domestic Banks | 66.5 | 57.8 | 31.5 | 66.6 | 74.1 |

*Note:* *a)* Korea First Bank, Korea Exchange Bank, Shinhan Bank, Koram Bank, Hana Bank, and 43 Foreign Bank Branches.
*Source:* The Bank of Korea.

### *Capital Markets*

After the outbreak of the crisis, almost all restrictions on capital transactions, including short-term financing, were liberalised following the IMF agreement. The focus lay on increasing Korea's access to foreign capital and technology. Ceilings for foreign equity ownership were eliminated in 1998 (Tables 8 and 9). Moreover, 41 closed business sectors were opened. Hostile M&As by foreigners were also fully liberalised in 1998, and the bond market was opened; foreigners can now invest in local bonds and short-term money market instruments without restriction. The only exception is a limitation on shareholding of some public enterprises at 40 per cent of outstanding shares. The foreign land acquisition procedure switched from an approval to a notification system.

Table 8. **Ceilings on Foreigners' Equity Ownership**
(percentages)

| | 3.1.92 Open | 1.12.94 (1st) | 1.7.95. (2nd) | 1.4.96 (3rd) | 1.10.96. (4th) | 2.5.97 (5th) | 3.11.97 (6th) | 11.12.97 (7th) | 30.12.97 (8th) | 25.5.98 (9th) | 15.11.00 (10th) |
|---|---|---|---|---|---|---|---|---|---|---|---|
| *Total holdings*: | | | | | | | | | | | |
| Private enterprise | 10 | 12 | 15 | 18 | 20 | 23 | 26 | 50 | 55 | 100 | 100 |
| Public enterprise | 8 | 8 | 10 | 12 | 15 | 18 | 21 | 25 | 25 | 30 | 40 |
| *Individual holding:* | | | | | | | | | | | |
| Private Enterprise | 3 | 3 | 3 | 4 | 5 | 6 | 7 | 50 | 50 | 100 | 100 |
| Public Enterprise | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 3 | 3 |

*Source:* Ministry of Commerce, Industry and Energy.

Table 9**. Ceilings on Foreigners' Equity Ownership in the KOSDAQ Market**
(percentages)

| | Sept. 1996 | Dec. 1997 | April 1998 | May 1998 |
|---|---|---|---|---|
| Total ceiling | 10 | 15 | 55 | 100 |
| Individual ceiling | 3 | 5 | 50 | 100 |

*Source:* Ministry of Commerce, Industry and Energy.

### *Foreign Exchange Transactions*

The freeing of foreign exchange transactions consists of three stages, named "immediate", "first", and "second". In the immediate stage, which took place on 1 July 1998, liberalisation aimed mainly at promoting foreign capital inflow. Almost all restrictions on foreign investment in domestic capital markets were liberalised, as were a number of those related to foreign borrowing by Korean residents. For instance, the authorities lifted all restrictions on firms' short-term trade financing, allowing firms to borrow abroad or issue foreign currency-denominated securities for maturities longer than one year. In addition, foreign currency positions held by foreign exchange banks were freed so that the restriction on spot positions was removed and overall positions (spot plus forward), in either direction (oversold or overbought), were expanded to 15 per cent of paid-in-capital. Foreign exchange banks no longer needed to worry about the composition of their foreign exchange positions.

The first stage was launched on 1 April 1999. Its main theme was adoption of a negative-list system that liberalised all foreign exchange transactions except those on the list. For example, it freed all transactions related to firms' business operations while those for non-business purposes remained restricted. Foreigners also could now participate in the market for KRW-denominated deposits with maturities of more than a year. The restriction of forward transactions to match real demand was also liberalised.

Those who wish to do forward transactions need no longer submit to the foreign exchange banks documents identifying business purposes for underlying transactions. Permission for firms' overseas borrowings was also extended to less than one-year maturity, but only for firms considered financially sound. Financial institutions that met certain requirements were allowed to engage in foreign exchange businesses. Entry barriers for the foreign exchange broker market were significantly lowered; Commercial brokerage firms now may compete for profit opportunities.

As an important feature, the first-stage measures established safeguards intended for use in the event of sudden increases in capital inflow or outflow or in extremely unfavourable market conditions. The safeguards include freezing foreign exchange transactions, a permission-based capital transaction system, funnelling foreign currency to the Bank of Korea and activation of the Variable Deposit Requirement (VDR) system that requires a certain percentage of capital flow to be deposited in non-interest bearing accounts.

The second stage of liberalisation began in January 2001. It involves removal of most restrictions remaining on the negative list, although certain provisions crucial for the maintenance of a stable foreign exchange market have been added. These measures accord with recent developments in international discussions, such as limiting short-term speculative capital movements, strengthening prudential regulations and improving external debt management. This second stage has four key features.

First, it significantly alleviates obligations to repatriate overseas claims. Restrictions remain in place to promote stability in the foreign exchange market and curb illegal transactions, but they have been eased to enhance the efficiency of overseas economic activities. The criteria for exemption and period for inbound remittance have been extended beyond export claims to services and capital transaction claims. Overseas claims can also be converted into overseas capital transactions, such as deposits and securities investments, as long as they are indicated to the regulatory body.

Second, the ceiling on residents' foreign currency payments abroad has been eliminated. This should bring positive effects to the economy, and the balance of payment surplus is expected to continue. The moderate capital outflow induced by the liberalisation of residents' foreign currency payments abroad will help alleviate appreciation pressure on the won from the persistent balance of payments surplus.

Third, regulation of spot purchases and sales of foreign exchange has been eased by relaxing restrictions that required residents and non-residents to identify business purposes of transactions underlying spot trading. Residents now may purchase more than $20 000 in the spot exchange market and non-residents can purchase any amount.

Fourth, residents may now open deposit accounts at financial institutions abroad and have seen almost all the remaining restrictions on their overseas borrowings removed. The limitation on short-term overseas borrowing by financially unsound firms stays in place as a measure to strengthen the prudential regulation of firms' overseas financing. Business conglomerates continue restricted from guaranteeing the local financing of

subsidiaries and the short-term foreign currency debt of their affiliates. Those in support of liberalisation claim that the market should decide whether to lend to Korean firms. They argue that firms with less credibility due to excessively high debt ratios, for instance, would have difficulty accessing the international capital market. Those objecting to liberalisation suggest that it should be postponed until a supervisory system is firmly established and financial institutions can be properly monitored and managed. In addition to restriction of non-residents' short-term deposits in domestic financial institutions, the restrictions on the borrowing of won by foreigners in the onshore market remain intact, due to concerns that speculative trading by foreigners in the domestic financial market may be encouraged. The restrictions include limitations on the issuance of KRW-denominated short-term securities by foreigners and the acquisition of these securities by residents, the limitation on option trades that pay a premium worth more than 20 per cent and trades of other financial derivatives used in the onshore market, and the limitation on borrowing more than 1 billion won from domestic financial institutions.

## Appraisal

Any attempt to appraise financial sector reform and liberalisation in Korea is difficult because the targets have been so wide-ranging. The ongoing nature of the process also makes it harder to assess. This paper approaches the question by looking at achievements so far towards the initial goals, namely recovery of the real economy, recovery of the sovereign credit rating, enhancement of the financial industry's profitability and efficiency, and conforming to international best practices.

*Recovery of the real sector*. Financial restructuring contributed significantly to real recovery (Table 10). By the end of 2001, foreign exchange reserves surpassed $100 billion, and the foreign exchange shortage was gone. GDP growth reached 10.9 per cent in 1999 and 9.3 per cent in 2000. The global slowdown pulled it down to 3 per cent in 2001, but it is recovering again in 2002. The inflation rate stabilised significantly, and a low interest-rate environment became firmly established.

Table 10. **Economic Performance**
(Amounts in millions of dollars; growth rates in percentages)

| | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 |
|---|---|---|---|---|---|---|
| Current Account | -23 004.7 | -8 166.7 | 40 364.9 | 24 476.7 | 12 241.2 | 8 616.9 |
| Capital and Financial Account | 23 326.8 | 1 314.4 | -3 196.7 | 2 040.3 | 12 110.0 | -3 583.6 |
| Foreign Exchange Reserves | 32 401.9 | 19 710.3 | 51 962.9 | 73 700.3 | 95 855.1 | 102 487.5 |
| GDP Growth Rate | 6.8 | 5.0 | -6.7 | 10.9 | 9.3 | 3.0 |

*Source:* The Bank of Korea.

*Recovery of the sovereign credit rating*. The financial sector reform deserves credit for helping here. International credit rating agencies have acknowledged Korea's financial reform efforts. Net foreign portfolio investment has increased and the spreads on the foreign exchange stabilisation fund bond have dropped significantly. All major international credit rating agencies have upgraded Korea's sovereign rating since 1999 (Table 11), even in the presence of increasing credit risk in emerging economies.

Table 11. **Korea's Sovereign Credit Rating Trends**

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| S&P | pre-crisis | 10.97 | 11.97 | 12.97 | 12.97 | 2.98 | 1.99 | 11.99 | 11.01 |
| | AA- | A+ | A- | BBB- | B+ | BB+ | BBB- | BBB | BBB+ |
| Moody's | pre-crisis | 11.97 | 12.97 | 12.97 | 2.99 | 12.99 | 11.01 | 3.02 | |
| | A1 | A3 | Baa2 | Ba1 | Baa3 | Baa2 | Baa2 (positive) | A3 | |
| Fitch IBCA | pre-crisis | 11.97 | 11.97 | 12.97 | 12.97 | 2.98 | 1.99 | 6.99 | 3.00 |
| | AA- | A+ | A | BBB- | B- | BB+ | BBB- | BBB | BBB+ |

*Source:* Ministry of Finance and Economy.

*Enhancement of the financial industry's profitability and efficiency*. The closing of insolvent financial institutions and continued reduction of NPLs have helped considerably to improve financial-sector profitability. Yet the potential NPL ratio remains high compared with the global standard. Under the current risk management and asset investment systems, this can temporarily destabilise financial institutions' net income. Therefore, further efforts will be needed to reduce the NPL ratio. The monitoring of financial institutions will also need strengthening to the global standard, and an incentive-compatible market mechanism should be established as well. Due to cost-saving efforts that streamlined financial organisations, the financial industry's efficiency has improved significantly. Some 1 200 bank branches have shut down since the crisis, for example. The removal of regulations that restricted financial institutions' activities has also contributed to enhanced efficiency in the financial industry. In one of the biggest achievements of the reform, investors have become more risk-conscious, with their investment preferences switching from high-risk to safer assets. This suggests an environment in which the forces of the market can reorganise the financial industry.

*Conformity to international best practices*. Significant efforts have been made to improve the institutional setting, especially to upgrade the prudential regulations in conformity with international best practices. They have produced a stricter review of financial institutions' capital adequacy, larger provision requirements, a more stringent PCA system, more transparent accounting, tighter accounting practices, tighter disclosure rules, advanced management of liquidity for foreign exchange risk and so on. The movement towards international best practices has been an unavoidable choice.

### *Effects of Liberalisation*

Simultaneous liberalisation and reform have had a number of positive effects. First, they have accelerated financial restructuring by attracting foreign capital. Selling troubled financial institutions to foreigners helped improve the financial situation of the whole domestic financial system. Second, they have helped to enhance the efficiency of the domestic financial system by disseminating advanced financial techniques on corporate evaluation, credit rating, risk management, funding and asset management, etc. Third, there is no doubt that they have promoted competition in the financial sector, as entry and exit are a lot freer now than before. With less government intervention, this expedites the spread of market principles. Domestic financial institutions cannot help but attempt to enhance productivity in the presence of more competition. Fourth, management in financial institutions with foreign capital has contributed to changing domestic financial institutions' management style by heavily emphasising shareholders' interests, profitability and risk management. Influenced by the foreign management practices that accompanied capital infusions, domestic banks have adopted new credit evaluation systems, conduct stricter loan reviews, and have strengthened risk management with a special focus on credit rating and cash flow.

The rapid entry of foreign capital into financial institutions in domestic markets has also had its negative effects, however. First, there is much concern that domestic institutions will quickly lose market share, particularly in retail banking. Second, the overall effectiveness of government policies has become weaker. Although one may argue that this phenomenon is natural and in some sense desirable, feebler policy could have great ramifications if the domestic financial system suddenly becomes unstable due to external shocks. Moreover, because foreign-based institutions are generally subject to strategies and decisions made by their headquarters, there is always a possibility of a rapid capital outflow, which would immediately create instability. This very serious issue is discussed below.

So far, foreign exchange liberalisation has achieved its intended objectives. It has helped build a more mature onshore foreign exchange market, which could become a cornerstone for establishing an international financial centre in Korea. Daily foreign exchange transactions in Korea, both spot and forward, more than doubled between 1998 and 2001. This rise is supported by the rapid increase in capital flows into and out of Korea. During the pre-crisis period (1995-97), the annual average capital flow amounted to $21.3 billion. Table 12 shows that the post-crisis period (1998-2001) witnessed a strong gain, especially after 1998. The 1998-2001 annual average was $73.9 billion. The spurt after 1998 reflected several macroeconomic events, but most of it stemmed from active foreign exchange liberalisation.

Table 12. **Foreigners' Portfolio Investment Flows**
($100 million)

| | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 |
|---|---|---|---|---|---|---|
| Inflow | 125.7 | 132.0 | 164.8 | 417.4 | 601.5 | 439.5 |
| Outflow | 80.0 | 121.2 | 117.0 | 362.5 | 488.4 | 364.2 |
| Total | 205.7 | 253.2 | 281.8 | 779.9 | 1 089.9 | 803.7 |

*Source:* The Bank of Korea.

Table 13 provides more detail. It shows that foreigners' portfolio investments rose particularly in the form of stock-market investments. $113.4 billion worth of such investments moved in and out of Korea during 2000. Foreign investment in the Korean stock market has been driven largely by the motivation to realise short-term capital gains. At the end of 2001 foreigners held $71.3 billion of stocks traded on the Korean Stock Exchange; 94.2 per cent of these holdings were short-term investments aimed at capital gains.

Table 13. **Foreign Debt and Foreign Stock Investment in Korea**
($100 million, percentages in parentheses)

| | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 |
|---|---|---|---|---|---|---|
| Total Foreign Debt | 1 635 | 1 592 | 1 487 | 1 371 | 1 317 | 1 199 |
| Long-term | 701<br>(42.9) | 957<br>(60.1) | 1,180<br>(79.4) | 979<br>(71.4) | 838<br>(63.6) | 810<br>(67.6) |
| Short-term | 933<br>(57.1) | 636<br>(39.9) | 307<br>(20.6) | 392<br>(28.6) | 479<br>(36.4) | 389<br>(32.4) |
| Foreign Stock Investment Fund Flows | 205 | 242 | 216 | 814 | 1,134 | 688 |
| Inflow | 124<br>(60.5) | 125<br>(51.7) | 128<br>(59.3) | 436<br>(53.6) | 628<br>(55.4) | 367<br>(53.3) |
| Outflow | 81<br>(39.5) | 117<br>(48.3) | 88<br>(40.7) | 378<br>(46.4) | 506<br>(44.6) | 321<br>(46.7) |
| Foreign Stock Holdings | 181 | 65 | 213 | 672 | 447 | 713 |
| Long-term | 35<br>(19.3) | 10<br>(15.4) | 26<br>(12.2) | 52<br>(7.7) | 52<br>(7.2) | 41<br>(5.8) |
| Short-term | 146<br>(80.7) | 55<br>(84.6) | 187<br>(87.8) | 620<br>(92.3) | 395<br>(92.8) | 672<br>(94.2) |

*Note:* Values for 2001 are through October for foreign stock investment fund flow and through December for total foreign debt and foreign stock holdings.
*Sources:* The Bank of Korea, the Korean Stock Exchange.

It is important to notice that the recent increase in short-term capital inflow does not necessarily imply that the Korean financial system is in a situation similar to that of 1997. External debt remains high but short-term debt has dropped significantly, below the level of the crisis period. Given the forecast continued balance of payments surplus in 2002, foreign exchange reserves, currently more than $105 billion, should increase further, thus becoming sufficient to absorb any one-time increase in short-

term capital outflow driven by adverse shocks. To prevent the rising short-term capital inflow from posing a potential threat to the Korean economy, an early warning system (EWS) has been established to provide enough time to prepare for adverse shocks that could lead to another financial crisis. A legal framework has also been introduced through which the government may activate a variable deposit requirement (VDR) in times of financial tension. Finally, the Financial Intelligence Unit (FIU), a financial information system designed to prevent illegal financial activities (such as money laundering and tax evasion) has been established.

## Concluding Remarks

The Korean crisis was caused mainly by structural problems that increased the country's vulnerability to external shocks. Unhedged and excessive foreign short-term borrowings led to inefficient investments and increased financial institutions' risk exposure. A strong dose of financial reform has been carried out, but not enough. Temporary relief can only disguise and not cure underlying weaknesses. The continuing financial sector reform should focus on eliminating factors that could destabilise the market. The principles of loss sharing and accountability of management need strict enforcement. Because the financial market mediates capital flows by identifying and dealing with risks, incentives for strengthened risk assessment should be provided. At the same time, financial institutions need closer monitoring through strict corporate governance and asset classification criteria. Financial institutions also need to strengthen their monitoring of the corporate sector. This will induce corporations to continue improving their capital structures and enhancing their core competencies. The adoption of advanced bankruptcy procedures, which minimise the banks' load from corporate workouts, is one way to strengthen such monitoring.

While Korea is well positioned to lead crisis countries in post-crisis management with its recent buoyant economic performance, more effort is required. Korea needs more fundamental changes in its economic structure to better cope with an open financial environment. To better prepare for a more volatile and competitive environment, where the government does not have absolute control of the economy, it is imperative that the economic structure should be strengthened to minimise the effect of adverse shocks stemming from the external sector. For foreign capital to be part of productive equity investment, a transparent and efficient system should be installed. Needless to say, strengthened prudential regulations and supervision must not remain mere rhetoric. A set of incentives compatible with a functioning market mechanism in an open environment should be devised.

A quick caveat for the international financial community is in order here. However much reform and liberalisation are carried out in Korea, nothing is certain. There is no assurance that the Korean financial market will not plunge into another crisis in the future. Thanks to continuing liberalisation and deregulation on the one hand, and the revolutionary pace of communications breakthroughs on the other,

national financial markets have quickly become integrated into one single, global financial market. Trillions of dollars move in and out of a national financial market in a second. The bad side of this globalisation is that a national financial market can be plunged into instant chaos and crisis at any moment that foreign capital suddenly moves out. This capital-flow volatility is an intrinsic characteristic of the increasingly integrated world financial market. Without substantial reform of this global financial market, crises like Asia's in 1997 can and would rock any country, except possibly for the United States and the European Union. This issue has been aired frequently by many authorities. In fact, we already know a good deal about what needs to be done. What is lacking is the international consensus and political leadership to stand up to Wall Street. Urgently needed are measures, like Tobin taxes, to dampen capital-flow volatility and bring more transparency to hot money. Korea's variable deposit scheme would operate somewhat similarly to the Tobin tax. It is public knowledge, however, that Korea would not dare to resort to it lightly. Korea alone cannot stand up against Wall Street. As capital-flow volatility is inherent in globalisation, its ill effects must be addressed globally through global norms. The OECD and ADB should take the lead in this regard.

# New Opportunities for Services Trade in China

*Miaomiao Shi*

After 15 years of difficult negotiations, China finally became a WTO member on 11 December 2001. Joining the WTO not only is an inherent development requirement for China's socialist market economy, but also accords with the trend of world economic progress. It will bring unprecedented opportunities for economic and trade co-operation between China and other countries and regions. As a member of the WTO, China will open service areas such as banking, insurance, telecommunications, foreign trade, domestic trade and tourism step by step. It will formulate a uniform, standard and transparent investment access policy. It will intensify efforts to enact and perfect laws and regulations related to its international economic affairs, improve the level of law-based administration of foreign economic relations and establish and perfect the foreign economic and trade regime consistent with prevailing international rules and the actual situation in China. Trade in services is an important part of China's commitment to the WTO. China started to liberalise its services trade gradually during the negotiation process, and this trade grew rapidly. Although they have advanced rapidly in the last decade, however, China's service industries remain underdeveloped compared with those in developed countries. They will play a more important role in China's economic development as incomes increase and with further opening of the market.

In the past five years, dramatic growth of secondary industry (10 per cent annually during the last ten years) mainly pushed China's economic expansion. Although the service sector grew at 8-9 per cent a year, its share of GDP has changed little. Tertiary industry's contribution to GDP in the last five years was only a little more than 30 per cent, according to the State Bureau of Statistics. In China, however, unlike in the WTO GATS classification, construction services are not counted as part of the sector. If they were, the sector would account for nearly 40 per cent of GDP. In 1994 for the first time, employment in services surpassed that in industry. China's service sector has become the most important for job creation. In the ninth Five-Year Plan (1995 to 2000), services created 27.15 million new jobs, 85 per cent of all employment creation during the period. There is an obvious, uneven geographic development of service industries and employment between the eastern coastal cities and the Middle West provinces. In the coastal cities where the development level is higher, service industries are more advanced.

During 1985-2000, the service sector became much more important to China's exports. The absolute value of services exports has increased tenfold since 1985. Their share of national exports (merchandise plus services) reached 10.8 per cent in 2000. China ranked 15th among the top 20 service exporting countries in 1994. In 2000, it ranked 12th. Throughout the 1990s, the deficit in services trade expanded, reaching $5.7 billion in 2000. This results partly from China's market opening and partly from the services imports accompanying dramatically increased foreign direct investment. In contrast, tourism and labour services (on construction projects abroad), in which China has comparative advantages, have maintained trade surpluses for many years.

The negotiation on trade in services was one of the most important and difficult in China's accession process. All WTO members attached great importance to China's liberalisation of services because they saw great development potential, a huge market and lots of trading opportunities in China. Therefore, China's commitments on trade in services are substantial; the liberalisation level of China's schedule of initial commitments is considerably higher than that of most developing countries and even higher than that of some developed countries in the WTO. The substance of these commitments is reflected in two ways:

— *Comprehensive coverage*. Among the 11 sectors and 160 sub-sectors in the GATS classification of services, China made commitments in nine sectors and 104 sub-sectors, well above the average for WTO members,

— *Modes of supply*. There are four modes of supply for trade in services, namely cross-border supply, consumption abroad, commercial presence and movement of natural persons. China made meaningful commitments for all of them in almost every sector covered by the schedule.

Services deregulation and liberalisation can accelerate reform towards a market economy, to create an environment favourable for domestic service industries to face foreign competition. Financial system reform is a good example. Before reform, the Chinese financial system was quite different from those in Western countries. All the main specialised banks had to provide policy-related loans to help state-owned enterprises and special projects, as directed by the government. The People's Bank of China could not play its role as a central bank. Under such circumstances, Chinese banks found it very difficult to compete with foreign banks with advanced management. China started to reform the financial system in 1994. The main objective is to transform the specialised banks into real commercial banks and make the People's Bank of China a real central bank. With reform, China's financial sector will compete with foreign banks on an equal footing.

Monopolies in some service sub-sectors (telecommunications and insurance) lead to low efficiency and poor service quality due to lack of competition. Monopoly power makes liberalising these industries more difficult. The first thing China must do to resolve the problem is deregulation. The People's Insurance Company of China, for example, took 98 per cent of the insurance market in 1993. To deregulate, China decided to issue more new licenses to domestic insurance suppliers and allow foreign insurers to enter the Chinese market on a trial basis.

Another difficulty involves the lack of laws and regulations governing the opening of service industries. Without them, China cannot guarantee the transparency required by the GATS, and foreign service suppliers find it very difficult to invest in China. In recent years, China has made its greatest efforts to improve this situation. China's service industry will be more open with the perfection of the legislation.

GATS members have concerns about national security and economic sovereignty when they consider possible liberalisation. Many hesitate to liberalise their financial services further because they want full control of their domestic financial markets. China worries about leaks of political, economic and financial information when liberalising information services. It also worries about the establishment of distribution networks by foreign service suppliers that would bring more foreign goods into the Chinese market and the hands of end users, because the liberalisation of retailing and wholesale services has direct effects on trade in goods.

Being a developing country with a weak services sector, China has taken the path of progressive services liberalisation. The opening of domestic services markets must be consistent with its level of development. Liberalisation measures should be taken step by step and with a co-ordinated plan among various industries. The GATS notes that all members shall "recognise the right of members to regulate, and to introduce new regulations, on the supply of services within their territories in order to meet national policy objectives".

In general, service industries are more sensitive to cultural variations than manufacturing or resource-based industries. Each member wants to keep its own cultural identity and heritage, and, for the reasons cited above, all members liberalise their domestic service industries cautiously. The fundamental question is whether the GATS will induce members to do much more in future negotiation rounds.

China's services sector needs further development to face current globalisation. If China's economy is to leap to a new stage in the new century, the services/GDP ratio and service employment must rise constantly over the next five to ten years. According to the State Planning and Development Commission of China, the following measures will be taken to accelerate such development:

— *Faster reform and restructuring of state-owned enterprises (SOEs).* In service sub-sectors where SOEs play a dominant role, other entities will be given more market access.

— *Looser market-access thresholds* for non-SOEs to enter into service sub-sectors where monopoly and excessive access restrictions exist. The government will remove unnecessary licensing procedures and increase transparency.

— *Progressive opening of services markets to foreign competition.* Through opening, the government wants to accelerate innovation in management, entrepreneurship and service production, advanced technologies and standards and the formation of China's own comparative advantages in services.

— *Income gains through growth, especially for people in rural areas*. If they can be achieved, then consumption of services could expand.

— *Training more professionals to provide high quality services*. China badly needs professionals such as lawyers, accountants, architects, dentists, doctors and high-level executives working in financial institutions.

With these reforms and deregulation, China's service industries are on the right development track. They — and services trade — are developing at an annual rate of 8-9 per cent. Although the development level of the sector as a whole remains low, we already see services booming in the coastal areas and big cities like Beijing and Shanghai. China has made substantive moves towards liberalisation in the WTO and believes it is good for the multilateral trading system and the world economy as well as the Chinese economy. Liberalisation will surely help the development of China's services and service trade in the future. With the appropriate measures taken by the government, they will grow rapidly in the next few years.

Having achieved membership in the WTO, China will open wider to the outside world with a more active attitude — an important step for further opening of trade in goods, in services and in other areas. China has a huge market with big potential and wide prospects. With the constant deepening of China's market-opening drive and greater economic strength, the Chinese economy will link more closely to the world economy. The huge market potential that China enjoys will turn into realistic purchasing power, and more business opportunities will be provided to the industrial and commercial communities of all countries. I believe that the Chinese market will become one of the most vital, energetic markets in the world and an important component of the competitive world market that allows no negligence.

# Postal Reform in the United Kingdom

*Stuart Sweetman*

Today I want to introduce you to the postal world in Europe. I'll take you through some relevant history of recent liberalisation in Europe and in the United Kingdom, then offer some concluding remarks for policy makers.

In the 1980s, nationalised service entities operating as monopolies overwhelmingly provided the network infrastructures across Europe. Most countries had single national champions in each sector, whether for electricity, telecommunications, railways, gas or postal activities. These predominately state-owned companies generally had legal responsibility for providing universal services and securing national supply. They planned network developments with government, and policy was typically organised through the appraisal of their annual business plans. To an important degree, the system worked. Energy supply expanded to meet the growing demands of the post-war economic boom, and the newer utility services, such as natural gas and modern telecoms, developed along coherent national lines.

During the 1980s and 1990s, however, this model came under sustained attack. Economic priorities shifted from investment to cost reduction. With little extra capacity needed, economic efficiency focused on sweating the existing assets. Critics advocated competition as a necessary part of the solution. The state found that competing demands on public finances increasingly forced trade-offs between current and long-term capital expenditures. The regulators and governments began to use competition as a policy instrument to drive economic efficiency. Initially, in most networks, they restricted competition to the input side of the model, to competitive tendering and contracting-out as well as franchising. Beyond that, however, some commentators questioned whether such things as natural monopolies existed at all.

Let's turn now to the postal world where I live, in the United Kingdom. This world distinguishes products and services by:

— physical characteristics — i.e. weight, size and shape. Is it a letter? Is it a parcel?

— the speed of service. Is it day-certain (i.e. next day, within three days, in a week…)? What delivery time governs (9 a.m., 10 a.m. …)?

— mail content. Is it direct advertising, social or financial mail?

— the direction of the mail flow: consumer to consumer, business to business, business to consumer, or consumer to business?

For many hundreds of years, the UK government supplied the postal service as a monopoly. In 1837, a man called Roland Hill published a revolutionary pamphlet, *Post Office Reform*. His proposal was very important because the mail services were in a mess, unreliable and expensive. With a well-argued economic case for its time, covering price elasticity and optimal taxation, he proposed a major reform. This led to the introduction of what we called "the penny post", with a single national price from anywhere in the country to anywhere else, paid by the poster. Very familiar to us all now, this was revolutionary then. Less well remembered is Roland Hill's strong argument against a postal monopoly. He said, "There can be no doubt that if the law did not prohibit it, the transmission of letters would be gladly undertaken by capitalists". The British parliament nevertheless set up the post office as a monopoly. He commented, "However inadequate it may be to the growing wants of the nation, the people must submit to the inconvenience, they cannot set up a post office for themselves". Very reluctantly, he started the monopoly that we know now.

In Europe, the pendulum is now swinging back away from state-run monopolies to much more open market structures. Regulators have a number of options for deregulation and liberalisation. They must devise a set of rules that move from the present to where the policy makers want to go. Policy makers have choices in balancing all these different rules for the introduction of competition and liberalisation. They and the politicians must choose what is most appropriate for the market. The immediate options include:

— free-for-all deregulation; this happened in Sweden;

— lowering the entry price that protects the monopoly;

— introducing or removing exemptions for certain types of mail (by weight or size);

— restricting geographic areas of service;

— charging a tax for entry into the market; and

— setting minimum prices.

The liberalisation of postal markets has been one of the major topics on the European Union's agenda. Despite general agreement that state monopolies should be dismantled, the extent of market opening has varied considerably among EU countries. At the end of 1997, the European Parliament and the Council of Ministers issued the EU directive on the liberalisation of postal markets. Besides endorsing the gradual and controlled liberalisation of markets, it was designed to introduce common rules for the development of the postal sector and for the improvement of the quality of service to customers. The directive's main points include a long-term guarantee for

the whole of Europe of universal postal service at an affordable price. The mail covered by this guarantee was defined as items weighing less than 350 grams with a cost up to five times the country's standard tariff for mail. Most countries have now adopted this maximum reserved (i.e. monopoly) area, and others have opened their postal markets somewhat further. As mentioned above, Sweden really opened everything. The Netherlands and Germany have set low weight limits and have introduced competition in direct (advertising) mail. Thus, although there is a common basis across Europe, individual countries still have the freedom to go further if they want.

In 2000, the EU Commission proposed the next stage of liberalisation, and it has now been agreed by the European Parliament. It sets out a timetable for reduction in the weight and price limits for the reserved monopoly area. In January 2003, the monopoly limit on item weight will shrink from 350 grams to 100 grams, and in January 2006 it will become 50 grams. This directive also posits a "substantial" further step in 2009 but doesn't actually specify whether it will amount to full liberalisation or set some lower limit, perhaps 20 grams. This final step will not be decided before a review of all EU postal markets to ascertain the impact of the first two steps.

Until March 2001, the United Kingdom had a statutory monopoly in line with the European limits (collection and delivery of mail weighting less than 350 grams and costing less than £1). The government — the ministry that owned us — was the regulator.

The United Kingdom decided to be different. In 2000, the government proposed and passed the Postal Services Act, which has achieved many changes.

— It created my company, Consignia, as a Public Limited Company, although it is still fully owned by the government.

— It created the Postal Services Commission (Postcom, for short) to act as the market regulator. Postcom has seven commissioners led by a chairman. It has a full-time chief executive and five part-time commissioners drawn from commerce, labour and the voluntary sector.

Postcom's main duties are:

— to ensure (the primary duty) that the United Kingdom enjoys continued provision of universal postal service; and

— to further the interests of postal users by promoting effective competition.

The act defines universal service as delivery of the mail every working day to all premises in the country, and collection every working day from each of about 100 000 post boxes. This service must be provided at affordable prices kept uniform throughout the country. The arrangements apply to mail weighing less than 20 kg, with physical dimensions falling within limits adopted by the Universal Postal Union. The act directed Postcom, from April 2001, to operate a licensing process to allow other operators to enter our monopoly market. The Department of Trade and Industry appoints the commissioners. They are not accountable to government ministers, but

only to parliament. This is sometimes inconvenient to the politicians, because the government cannot now tell the regulators what to do. They must decide their course of action independently.

Postcom has chosen the operators in a very transparent way, issuing consultation papers on a range of subjects, listening closely to the responses, producing draft proposals, again listening to the responses and finally publishing new decisions. They have recently completed this process on how best to introduce competition into the UK market. Postcom have concluded:

— that careful introduction of competition would not risk the provision of universal service because it will push us, the dominant player, to restructure our operations on a more efficient and much more controlled basis; and

— for competition to be effective, the path towards it must be certain, both for us and for new entrants.

Postcom has set an end-date of April 2007 for full competition in the UK market. Now we know that the United Kingdom will by then have a fully liberalised market well in advance of the rest of Europe. The set timetable will be achieved in three stages, each intended to expose about a third of the market to competition at intervals of two years. The first will start on 1 January 2003, the second on 1 April 2005 and the third in April 2007.

The *way* competition has been introduced also differs from the rest of Europe. From January 2003 bulk mail will be opened to other licensed operators (bulk mail means postings of more than 4 000 letters in a common format and coming from a single sender and a single site). This will open 30 per cent of the market. Licensed operators will collect, sort, transport and deliver this mail without it coming to us. Additionally, from January 2003 licences will be issued to operators to consolidate mail. They can collect mail from many companies and individuals, sort it and transport it, but they cannot deliver it: they must hand it over to us for delivery to individual addressees. Thus we will retain the right to deliver mail for other than bulk postings. In addition to bulk and consolidation licences, Postcom will also license other operators in limited, defined, activities, such as document exchange services.

Thus postal liberalisation now is happening faster than in the rest of Europe. Social customers have been protected because the prime objective of the regulator is to preserve the universal service obligation. Business customers, who account for 85 per cent of our business, will progressively benefit from choice. We plan to lose between 20 per cent and 30 per cent of our market share over the next five or six years. That is the impact on us.

In addition to opening competition in the postal market, Postcom regulates the prices Consignia charges. When we signed the first licence last year, we froze our prices until April 2003. Postcom are currently undertaking a price-control review to decide what method of price control should operate in the postal market. They will most probably copy what has happened in the other deregulated UK industries by

setting up an inflation-linked price regime. How extensive that regime will be will depend on negotiations and discussions that will take place in the rest of 2002. Another issue involves deciding: how much we can charge consolidators, who collect and sort mail, for final delivery — i.e. what is the access price that we as the dominant operator can charge other operators? This is sensitive: if Postcom get that price wrong by one penny per letter, that means £80 million in profit to me — a very high gearing effect.

At Consignia, we believe that:

— our success as a commercial business will depend on providing competitive services at attractive prices, supported by best-in-class infrastructure and delivered by excellent people. This is a normal commercial model;

— we must perform this commercial operation while fulfilling our essential social obligations to provide universal service within a uniform tariff structure;

— competition provides a powerful spur to performance. It will lead to innovation, increased customer focus and sustained economic performance in the eyes of all stakeholders; and

— our business must be keenly aware that customers already have numerous choices for how they communicate. Individuals now have almost instantaneous written communication through e-mail. The short message service (SMS) capability of mobile phones is now a real force for keeping people in touch with one another. The same alternatives exist for businesses; we see many routine business-to-business communications and transactions going electronic. Our role in supporting our customers' communications with their customers and potential customers brings our direct mail products into head-to-head competition with advertising through TV and radio, magazines, newspapers and street posters. We are already in competition with other forms of communication.

What are our responses to these challenges?

— We have a ceaseless drive for efficiency. In the United Kingdom, we recently announced a £1.4 billion cost-reduction program to get us fit for the competition. We look constantly for new products and new customers.

— We must manage the various stakeholders in the market place — the government, the regulator, customers and industry groups. All are now very relevant to our future and our plans.

— We must develop new commercial relationships. We have joined forces with the German post office (TPG) and Singapore post office to form a worldwide joint venture. We have our own delivery companies here in Paris and in Holland, and our own capability in Singapore. So we can compete and we can co-operate. The markets we operate in are consolidating and globalising. Europe now has powerful privatised post offices: Deutche Post-TPG and Deutche Post World Net. They are acquisitive and successful. Yet powerful state-owned companies also remain, like La Poste in France or Consignia in the United Kingdom.

Changes are taking place in Asia as well. Prime Minister Koizumi has set very ambitious targets for the Japanese post office. China is moving clearly to develop through joint ventures. Malaysia has a forward-looking privatised but not liberalised post office.

The market is changing throughout the world. It offers many solutions, many case studies to evaluate. Politicians and policy makers need to choose the routes they will follow. Complex stakeholder issues require management. These efforts need planning, rigour and a timetable. I believe they offer a significant prize to be shared among customers, new entrants to the market, existing operators and the economy as a whole.

# Opening Up of Asia's Insurance Markets: A European Company's View

*Fabrice Lorillon*

I would like to thank the OECD and the Asian Development Bank for this felicitous initiative and to compare the liberalisation approach in Asia with that in Europe. Although AXA is a European company, it has a very robust strategy in Asia.

Let me briefly say a few words about AXA.

— 50 million customers;

— 140 000 employees and sales associates around the world;

— 44 000 exclusive distribution outlets throughout the world;

— €75 billion in insurance revenues;

— €910 billion in assets under management this year; and

— €1.2 billion in net cash earnings.

AXA has a very international platform, with three strategic poles:

— North America;

— Europe (its initial base); and

— Asia-Pacific, where we have been present for about ten years. AXA now does business in almost all the counties of the Asia-Pacific region.

Earnings from Asia already account for 13 per cent of overall earnings. Insurance premiums there amount to €10 billion. We have 10 million Asian customers and aim to be one of the market leaders. In Japan, Australia and Singapore, AXA is already number two in terms of new business. In China, we have a licence to operate in Shanghai and hope to see that expanded very soon. AXA's earnings come mostly from mature markets. In the Asia-Pacific region these are in Japan, Australia and Hong Kong, China. The other Asian countries make up only a very small share of total turnover, but we think that by the middle of this century they will account for half of our *world* earnings.

**The Case of China's Opening Up**

We have been in China since 1997, when the Chinese government granted us a license for life insurance; the first policy was sold in 1999. The Chinese authorities allowed us first into Shanghai. We have six sub-branches, and we hope that in a joint venture with China's *Minmetals Group* we will be able to work China-wide.

Insurance contributes to economic development, which explains why China is very methodical and resolute in building an insurance market almost from the ground up and is opening it to foreign companies. Our job is to provide protection and asset management. We can cover houses, cars, health, life insurance, savings, retirement pensions and the conveyancing of inheritances. All these things are linked. This trade has to do with solidarity, assisting people who suffer random events, random damage. It is important that we reinsure so that worldwide disasters can be mutualised, because they cannot possibly be mutualised nationally. For example, European reinsurers, (German and French), will mainly foot the bill for the World Trade Center. The insurance industry, at the end of the day, allows individuals to take risks and to carry out economic activities. This is why it always has been closely associated with economic growth. Insurers also accumulate capital through the premiums that we set aside to pay out claims. These are our own funds. Increasingly, however, we also manage other people's capital. Pension funds, for example, are not reserves belonging to the insurers; they are funds that others place with us. Our importance for economic development lies in how we build up our own and others' assets — placing them at long term, which supports the economy to finance investments. The premiums collected in one country should get invested as a matter of priority in that country to help promote local economic development.

Thus, insurance companies take on a role rather similar to a public service. Even if we are independent enterprises, state supervision is appropriate and important. How it gets carried out can affect our contribution to development. In China, for example the regulators in the past controlled everything in fine detail, even the prices that could be charged. They now will concentrate on the solvency of insurance companies and leave us with more room for manoeuvre elsewhere, allowing us to develop.

Dual movements have governed the insurance industry's development in China, namely the effort to build an insurance industry out of nothing and then preparing and negotiating China's entry into the WTO. Developments along the way have occurred as follows:

— From 1949 to 1989, the PICC (People Insurance Company of China) had an insurance monopoly.

— From 1969 to 1979, there was no insurance activity except marine business, which is not surprising because insurance began the same way in Italy in the Middle Ages, responding to a need to insure ships.

— The first phase of liberalisation began in 1985 when PICC became a legal entity separate from the Bank of China. Previously it was a government department.

— In 1989, the PICC monopoly was abolished. China set up a private insurance company — Ping An — with a nation-wide licence.

— Developments sped up after that. In 1992, China Pacific Insurance received a national licence, and a series of other companies were licensed between 1996 and 1999.

— The Chinese insurance market also began opening to foreign interests. Foreign companies were allowed to come in beginning in 1992. Almost all the major companies were granted licences, one after the other, reflecting a firm and definite Chinese policy.

— In November 2001, AIG was granted five additional licences. In sum, about 27 foreign companies now have licenses to operate in China.

The rules governing foreign insurance companies have followed a gradual opening process. The percentage of foreign ownership in life is 50 per cent, although AIG has 100 per cent for historic reasons — they had personal relations with the Chinese government. Foreign ownership in property and casualty insurance will reach 100 per cent within two years of WTO accession. Insurers can work in all classes. For property insurance, for the time being, we can insure only foreign interests (basically multinationals), but within three years we should be able to insure national companies (individuals and collectives). Also for the time being, the number of cities in which foreign insurance companies can operate is restricted. In two years, five new cities will be added to the list, and in three years the geographical restrictions will disappear.

Thus, we have seen a striking march of progress. The market remains in its infancy and has tremendous growth potential. China has 800 billion yuan in savings, most of which for the moment are simply deposited in the banks. Their annual growth is currently at 20 per cent. Only some €18 billion is in the insurance market currently, but it's doubling every four years.

Why is China opening its market to foreign undertakings? I think this is a policy choice, made because China wants to take up the challenge of globalisation as it enters the WTO. What can foreign insurers contribute to the Chinese economy and to the Chinese national market? They will increase competition, so that national insurers will have to improve their solvency and solidity. They will also introduce new insurance products and adapt to customers' needs. There is a whole range of such new products: par products, unit-link products, universal life products and complementary health insurance. They all have been introduced recently because of intense competition among the foreign insurance companies arriving on the Chinese market. There has also been some flexibility introduced into the rules, which will leave us freer concerning where we place our assets as well. Currently the Chinese market is highly regulated (like the French market 20 years ago). The CIRC (the regulator), as noted above and in tandem with deregulation in other sectors, is moving from its earlier focus on fine details to attention to solvency.

I believe that the Chinese national companies will remain dominant on the insurance market as compared with foreign companies. Insurance products are intangible, they can not be patented, and they aren't like cars or medicines. Everyone copies everyone else and can't be stopped from doing so. Hence, national competitors will quickly take any innovations we introduce. In Europe, the largest companies are Allianz in Germany, Generali in Italy, AXA in France and so on. Despite the single insurance market and the EU's regulation to create and enable it, the national companies have remained the leaders in their own countries.

Before the single insurance market was introduced, French insurers, very worried, approached their government saying that they didn't want it because they feared competition from UK insurers — the market leaders then. Ten years on, how does it look? Germany is first, France is second and the Italians rank third. The history shows that national insurers have strong positions and are very well placed. This holds even when cross-border transactions become easier. Here again Brussels has produced very robust legislation, but people still prefer to write policies with their local national insurers because this is a service industry and the service is delivered locally.

The same points apply to China. In the Shanghai market now, the innovations come more from national than from foreign companies. Ping An for instance, has launched par products and unit-type products. In 1990, premiums on them were 7 million yuan. In 1999, they reached 3 billion, and by 2001 they had doubled in two years to 6 billion. I would predict also that Chinese insurers will soon be present internationally in a big way. Twenty years ago, AXA was the 20th insurer in France's then protected market. Thanks to internationalisation, AXA now is first in the world in terms of premiums underwritten.

# Financial Sector Reform in Slovenia

*Milan Cvikl*

I would like to follow up on what other speakers have said, especially the gentlemen from Korea and Thailand, and try to present our experience. As an introduction, let me deliver my one message by starting with a profile of Slovenia. Slovenia is, we believe, the most advanced market economy of Central and Eastern Europe. It has enjoyed very stable development in the last decade and has a GDP per capita of $10 000. It now is engaged in a new round of reforms, fostered by transition, to integrate with the European Union. Importantly, this transformation really is based on previous reforms. Reforms of the enterprise sector started more than a decade ago. The last decade also has seen financial services liberalisation as part of overall services liberalisation. Slovenia has several strategic advantages: its labour force, a low profit tax, low indebtedness and social cohesion.

As a result of reforms, Slovenia now is very well positioned as an entry point to the Central-eastern and Southern European market of more than 100 million people. All those reforms, however, could not have been effectively implemented without an appropriate economic environment. This is my single message today: an appropriate economic environment, including the macroeconomic and regulatory structure, will free the enormous potential of your people, your national resource. They can benefit whenever you are in the global production and trade nets. In this context, financial services liberalisation in Slovenia has a very important place.

My presentation is divided into three sections. To establish the Slovenian context, it starts with the reforms of the 1950s, 1960s and 1980s, then proceeds to the last ten years of financial services reform. Next, it covers the economic background just to confirm the message. It concludes with thoughts on next steps.

Since gaining independence in 1991, Slovenia has successfully transformed itself into a functioning multiparty democracy and a dynamic, market-based economy. With Austria to the north and Italy to the west, it lies at the heart of Central Europe. It thus is well positioned to benefit from increased trade flows. We believe that our progress allows Slovenia to qualify as a fast-track EU candidate, and we hope to finish these negotiations by the end of 2002. We have also applied for OECD membership, but are waiting for a new round of OECD expansion.

Let us look at key reforms before independence and then in recent years. Slovenian reforms really started as a part of so-called post-hard-communism in former Yugoslavia in the 1950s, with the first of what we called semi-enterprise liberalisation reforms. At that time, important for the financial sector, independent banking institutions were established. Hungary had to wait to establish banks in 1996, with the help of the IMF and the World Bank. In former Yugoslavia this happened much earlier, in 1956. In the 1980s these reforms, together with the collapse of the Berlin Wall, led to a complete enterprise-sector liberalisation. Since 1988 anyone has been allowed to establish an enterprise for €20. Slovenia has 50 000 limited-liability companies, and we do banking with the majority of them.

Financial sector liberalisation occurred in 1992-97. It included a necessary rehabilitation of the banking sector and a focus on internal banking institution development. Nova Ljubljanska Banka, in fact, has published annual reports based on international accounting standards for the last 30 years. In 1998-2001 a new reform got underway, linked with EU legislation and entry to the European Union. We have completed financial and capital-market liberalisation over the last five or six years. As a result, the macroeconomy is healthy. We have achieved 11 years of constant growth since independence. Inflation has dropped. The balance of payments is very sound. The central bank has played the roles of both prudential regulation and implementing good monetary policy.

How did we do it? We believed that financial sector reforms really depended on three key elements:

- an appropriate regulatory framework;
- an appropriate macroeconomic policy, with restrictive monetary policy and a responsible fiscal framework; and
- government-supported rehabilitation activities following the collapse of the country and losses incurred by the banking system. After that, we let the banks initiate rehabilitation activities themselves.

If you were bankers I would talk about what we have done in our bank; but since you are policy makers, let us start with what the government had to do. Rehabilitation started in 1993, with the basic goal of reducing real interest rates. It used the banking system both to reduce interest rates and to push restructuring of the enterprise sector at minimal cost. We call this "tough private sector development". When I was working at the World Bank we used the synonym PSD, but PSD is really about establishing a budget constraint at the enterprise level. Bankers can do that in the name of the government and in the name of capital.

The banks' situations in the Yugoslav years and at the beginning of independence were extremely bad, with negative cash flow, credit crunches, bleeding banks and negative capital. The government had to intervene because the banks were not only illiquid but also insolvent; depositors were about to lose their savings. In this context, the central bank issued a decree setting out bank owners' corporate governance rights and responsibilities. They were asked to recapitalise their banks, and if they could not

do it the government would do it by issuing bonds, replacing the owners and acquiring 100 per cent ownership. Of course, new teams were appointed, including a colleague of mine who worked a lot on the Latin American financial-sector reforms at the World Bank. The banks' assets were replaced by debt-equity swaps and supplemented by bonds. At the same time, new lending procedures were established. We wanted to prevent further bleeding because it doesn't help to make more bad loans. (As the case of Hungary showed three times over, if you do not really establish good new lending procedures you will continue to lose money.) As a result of all these measures liquidity borrowing from the central bank fell.

The new strategy was put in place in November 1993, and the government began the bond issues. It issued €700 million in bonds in that period. In the most recent sale of a third of the stock of our bank alone, it recouped more than €435 million. The investment thus turned out pretty well for the government, even without counting all the profits and taxes it collected while it owned us.

Reform progress accelerated from 1994-95, and by 1997 the rehabilitation of the banking sector was over.

The banks' self-rehabilitation activity went forward simultaneously with the government reforms. It focused on strategic planning and operational improvements, both of which led to better financial results. We reduced staff by one-third, resold unnecessary assets and introduced a very strict new credit process and risk management (really mainly appropriate prudential supervision). The Slovenian banking system today offers all the normal banking services and now has a return on equity of about 20 per cent, measured according to international accounting standards

How has financial reform reflected itself in economic performance? The Slovenian economy has proven resilient in recent years. Despite the global financial crises in 1997-98, we have constantly out-performed the EU average in terms of GDP growth by an average of 2 per cent each year, helped essentially by our strong financial sector. We see a potential for continued strong growth, because we can export competitively to the EU as well as to the now-stable markets of Southeastern and Central Europe. Slovenia's per capita GDP reached $10 000 in 1999; it is the highest in the region and puts us on an equal footing with EU members such as Greece and Portugal. (It is, of course, an issue for our budget negotiations with the EU.) These high income levels result only partly from the favourable financial position that the country inherited upon gaining independence. After all, at that time Yugoslavia had an average per capita GDP of only around $3 500-$4 500 in Slovenia and about $2 500 in the other countries of former Yugoslavia. We believe strongly that putting fiscal and monetary policy in good shape, plus the financial sector reforms, made the real difference that helped us to increase national income after independence.

Slovenia has a growing presence in foreign markets. Our trade (imports plus exports) has reached more than 130 per cent of GDP. The current account of the balance of payments is strong and has improved in the last two years. Two-thirds of exports go to the EU, but in recent years we have greatly increased export growth to

Central and Southeastern Europe. We foresee a recovery of growth in trade with the EU in coming years, and integration will of course enable that trade to grow even faster in the medium term.

Tight monetary policy, fiscal strength and wage policies contributed heavily to slowing inflation after 1992, which resulted in a reduction of interest rates. In 1992-93 interest rates peaked at 25 per cent in real terms. We have just announced, on 1 July, that the best clients will pay 10.8 per cent; with inflation at 6-8 per cent, the real interest rate is around 4 per cent. Slovenians can borrow in euros at euro LIBOR plus 75 basis points. Our banks can borrow at euro LIBOR plus 50 basis points, but with that small margin we still make good results. Some anti-inflation measures continue, and we expect inflation to fall to around 4 per cent by the time of EU entrance, expected in 2004. Fiscal policy has been conservative since independence. The general government deficit registered a low of 0.6 per cent of GDP in 1999. Although it increased a bit in 2000-01, it is still by the far the lowest in converging Europe. The primary budget balance (excluding net interest) has constantly showed high surpluses.

Public-finance reforms have enabled fiscal policy to act in an appropriate manner and support financial-sector reform. Overall government debt is extremely low, not more than 30 per cent of GDP. Since 1994 the budget has supported both banking sector rehabilitation and the export industry. A very small amount of money, $3 million, provided technical assistance to regulators and to the bank’s institutional development by providing appropriate transfers of knowledge from the west to our transition economy. In the medium term, the budget should be further reduced and we expect to reach budget balance on the cycles, in accordance with Maastricht, by the time of entrance to the EU.

One result has been strong inbound foreign direct investment, which has grown steadily despite the Russian and Asian crises in 1997-98 and the 1999-2000 Kosovo crisis. Slovenia also is one of the strongest foreign direct investors in Southeastern Europe, where some of its production is moving.

The reform process has never finished. The initial reforms have passed on to a new set of reforms geared essentially towards EU legislation. These reforms have resulted in a revision of the laws originally prepared around ten years ago. They all aim at aligning Slovenia with EU standards and further economic restructuring. The government continues to sell stakes in the banking sector and major industries like telecommunications, energy and some manufacturing entities. Along with further regulatory improvements, especially in insurance and banking supervision, that should enable smooth EU accession.

To conclude, Slovenia has made significant progress in creating an appropriate framework for a functioning market economy. The last decade of development, especially the last two years, has given us an appropriate macroeconomic framework — one that preserves macro-stability as well as internal consensus. Slovenia will continue to focus on reforms and privatisations. Banks like Nova Ljubljanska Banka will provide necessary products and services to foster economic environment. The lessons are, I believe, clear: financial services liberalisation links with financial services rehabilitation in an appropriate macroeconomic framework.

# PART TWO

# ANALYTICAL REPORTS

# Liberalisation and Competition in the Service Sectors: Experiences from Europe and Asia

*Bernard Chane-Kune, Kiichiro Fukasaku, Jean-Christophe Maur and Ramkishen S. Rajan**

## Section I. Overview

Despite differences in structures of production and employment, modern economies — developed or developing — all share a common feature: a significant and increasing share of services. Among OECD countries, the service sector has become the most important provider of both output and jobs; this sector accounted on average for roughly two-thirds of total gross value added and employment in 2000 (see Table 1). The role of services in the national economy is even more important for many European countries. In developing countries, too, the share of services has risen relative to total value added, as Table 2 shows for selected Asian economies. The adequate provision of services is increasingly recognised as one of the preconditions for — rather than a result of — development. For instance, inadequate infrastructure services, such as poor telecommunications and transport networks or a weak financial system, are perceived as critical bottlenecks for sustainable development. Distribution, trade finance, insurance, marketing and other business services are complementary to the healthy growth of industrial activities.

This analytical report aims to review both European and Asian experiences of progressive liberalisation of several service sectors[1], to assess their outcomes in Europe and draw policy lessons, and to discuss what Asia could gain from further services liberalisation. The report has three sections. This section presents an overview of the report and some concluding remarks. Sections II and III present detailed accounts of the liberalisation of selected service sectors in Europe and Asia respectively.

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In 2000, the value of world trade in commercial services amounted to $1 435 billion, equivalent to roughly 20 per cent of world total trade. Europe and Asia combined accounted for approximately two-thirds of it[2]. Furthermore, the services sector has attracted the majority of foreign direct investment over the past decade and has become the focus of cross-border mergers and acquisitions (M&As) among OECD countries (see Figure 1).

Table 1. **The Service Sector[1] as a Percentage of Gross Value Added and Total Employment in OECD Countries**

| Country | Gross Value Added | | Total Employment | |
|---|---|---|---|---|
| | 1990 | 2000 | 1990 | 2000 |
| Austria | 62 | 65 | 54 | 62 |
| Belgium | 65 | 71 | 71 | 75 |
| Denmark | 69 | 70 | 70 | 74 |
| Finland | 60 | 62 | 61 | 66 |
| France | 66 | 71 | 66 | 73 |
| Germany | 60 | 67 | 59 | 69 |
| Greece | 64 | 71 | 56 | 59 |
| Ireland | 55 | 55 | 61 | 64 |
| Italy | 63 | 68 | 60 | 66 |
| Luxembourg | 73[a] | 78 | 71 | 76 |
| Netherlands | 65 | 70 | 73 | 73 |
| Portugal | 60 | 66 | 64 | 64 |
| Spain | 60 | 66 | 64 | 64 |
| Sweden | 64 | 70 | 73 | 73 |
| United Kingdom | 63 | 70 | 72 | 78 |
| **EU 15 average** | **63** | **68** | **65** | **69** |
| Australia | 67 | 70 | 70 | 73 |
| Canada | 65 | 67[b] | 72 | 74 |
| Czech Republic | 43 | 55 | 43 | 54 |
| Hungary | 56[c] | 61 | 54 | 58 |
| Iceland | 58 | 60[d] | 60 | 65 |
| Japan | 58 | 67 | 58 | 64 |
| Korea | 46 | 51 | 47 | 61 |
| Mexico | 64 | 67[e] | 52 | 54 |
| New Zealand | 65 | 66[f] | 65 | 77 |
| Norway | 61 | 55 | 71 | 75 |
| Poland | 49[g] | 61 | 50 | 54 |
| Slovak Republic | 56[h] | 61 | 50 | 54 |
| Switzerland | n.a. | 68[b] | 61 | 65 |
| Turkey | 49 | 55 | 32 | 34 |
| United States | 70[i,j] | 74[e,i,j] | 76 | 78 |
| **Other OECD average** | **58** | **63** | **57** | **62** |
| **OECD average** | **61** | **65** | **61** | **65** |

*Notes:* 1) Excluding financial intermediation services indirectly measured. *a)* = 1995; *b)* = 1998; *c)* = 1991; *d)* = 1997, *e)* = 1999; *f)* = 1996; *g)* = 1992; *h)* = 1993. *i)* sanitary and similar services are included under industry; *j)* includes government enterprises.

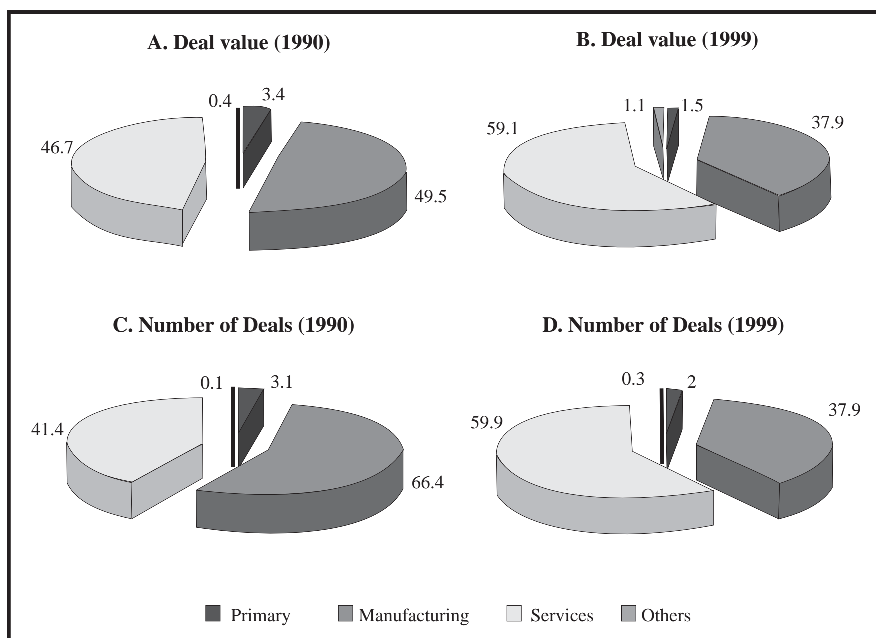
*Source:* OECD (2002). Extracted from *OECD in Figures 2002*.

Table 2. **The Service Sector as a Percentage of GDP in Selected Asian Economies**

| Country | 1980 | 1990 | 2000 |
|---|---|---|---|
| Bangladesh | 43 | 50 | 51 |
| Cambodia | n.a. | 33 | 39 |
| China | 21 | 31 | 33 |
| Hong Kong, China[a] | 68 | 74 | 85 |
| India | 36 | 40 | 49 |
| Indonesia | 32 | 41 | 36 |
| Malaysia | n.a. | 43 | 40 |
| Nepal | 26 | 32 | 38 |
| Pakistan | 46 | 49 | 51 |
| Philippines | 36 | 44 | 53 |
| Singapore | 61 | 65 | 66 |
| Thailand[b] | 48 | 50 | 49 |
| Viet Nam[b] | 27 | 39 | 39 |
| **Group Average** | **40** | **45** | **48** |

*Notes:* *a)* = 1999; *b)* = provisional.
*Source:* Asian Development Bank (2001), Table 13.

Figure 1. **Cross-Border M&As by Sector: 1990 and 1999**
(percentage)




*Source:* OECD (2001*a*), Annex Tables 1.3a.

Table 3 presents the shares of trade in goods and commercial services, respectively, relative to gross domestic product (GDP) for both OECD and selected Asian economies. A striking contrast appears in the relative importance of services in national economies on the one hand and international exchanges on the other. This occurs partly because the international exchanges recorded in balance of payments statistics tend to underestimate the true significance of international trade in services. Many service components (e.g. R&D, advertising and marketing) are embedded in the value of final goods exchanged in the international market. Technical constraints also explain in part the relatively low level of international trade in services. Most services must be produced and consumed quasi-simultaneously, and their non-storable nature makes international exchanges difficult. This often prompts domestic suppliers to invest abroad to provide services directly to consumers and end users in foreign countries. In a similar vein, restrictions on the movement of people likely hamper international transactions in services. Furthermore, services were regarded until quite recently as non-tradable and attracted little attention in multilateral trade negotiations.

Still, even after taking account of the underestimation of their real significance in world trade, services remain weakly internationalised. One main reason for this is the well-known existence of restrictive rules and legal systems within national economies. *Domestic* barriers to trade in services are numerous and often pervasive. Since, unlike for goods, trade in services requires the simultaneous liberalisation of both external and internal barriers to trade, the preferred mode of supply is often foreign direct investment.

Gains associated with more open trade in services do not differ fundamentally from those associated with open trade in goods. Given the significant and increasing linkage between services and the production of goods, however, the impact of liberalisation will not be confined solely to the services sector, but rather diffused across the entire economy. The crucial role played by services in linking various blocks of production activities within and across national borders has been emphasised in recent trade literature. This is often referred to as a "service link", that is, "a composite of activities such as transportation, insurance, telecommunications, quality control, and management co-ordination to ensure that the production blocks interact in the proper manner" (Arndt and Kierzkowski, eds., 2001, p. 4).

The aim of creating the European single market for services derives from this logic. As stated by the European Commission in its communication *An Internal Market Strategy for Services*, "[i]mproving the conditions for the free movement of services should release the dynamism inherent in the Internal market and so enhance competitiveness, growth and employment creation in our economy"[3]. The report reviews the progress made so far in establishing the single market in services on the basis of a sectoral approach. This approach also makes cross-country comparisons (between Europe and other regions) easier and more compatible with the ongoing multilateral negotiations under the auspices of the World Trade Organisation.

Table 3. **Trade in Goods and Trade in Commercial Services as Percentages of GDP in OECD Countries and Selected Asian Countries**

| *Region | Country | Goods Trade[a] | | Commercial Services Trade[b] | |
|---|---|---|---|---|---|
| | | 1990 | 1999 | 1990 | 1999 |
| EU 15 | Austria | 27 | 32 | 11 | 14 |
| | Belgium[c] | 55 | 61 | 12 | 13 |
| | Denmark | 25 | 27 | 9 | 9 |
| | Finland | 19 | 28 | 4 | 5 |
| | France | 18 | 20 | 5 | 5 |
| | Germany | n.a. | 24 | n.a. | n.a. |
| | Greece[c] | 14 | 13 | 5 | 6 |
| | Ireland | 45 | 59 | 9 | 21 |
| | Italy | 16 | 19 | 4 | 5 |
| | Luxembourg | n.a. | 50 | n.a. | n.a. |
| | Netherlands | 42 | 47 | 10 | 13 |
| | Portugal | 28 | 29 | 6 | 7 |
| | Spain | 14 | 21 | 4 | 7 |
| | Sweden | 23 | 33 | 6 | 9 |
| | United Kingdom | 20 | 20 | 5 | 6 |
| **Group Average** | | **27** | **32** | **7** | **9** |
| Other OECD | Australia | 13 | 15 | 4 | 4 |
| | Canada | 22 | 36 | 4 | 6 |
| | Czech Republic | n.a. | 51 | n.a. | 12 |
| | Hungary | 27 | 47 | 7 | 10 |
| | Iceland | 25 | 25 | 8 | 10 |
| | Japan | 8 | 8 | 2 | 2 |
| | Korea | 26 | 32 | 4 | 6 |
| | Mexico | 16 | 29 | 3 | 3 |
| | New Zealand | 20 | 23 | 7 | 8 |
| | Norway | 26 | 25 | 11 | 11 |
| | Poland | 23 | 24 | 5 | 6 |
| | Slovak Republic | n.a. | 55 | n.a. | 10 |
| | Switzerland | 36 | 35 | 6 | 8 |
| | Turkey | 12 | 19 | 4 | 7 |
| | United States | 8 | 9 | 2 | 2 |
| **Group Average** | | **20** | **29** | **5** | **7** |
| **OECD Average** | | **23** | **31** | **6** | **8** |
| Asian Economies | Bangladesh | 9 | 15 | 1 | 2 |
| | Cambodia[d] | 18 | 36 | 3 | 5 |
| | China | 13 | 18 | 1 | 3 |
| | Hong Kong, China | 110 | 111 | 19 | 19 |
| | India | 7 | 10 | 2 | 3 |
| | Indonesia | 21 | 29 | 4 | 6 |
| | Lao PDR | 15 | 30 | 2 | 8 |
| | Malaysia | 63 | 92 | 10 | 17 |
| | Nepal | 11 | 18 | 4 | 7 |
| | Pakistan[c] | 15 | 15 | 4 | 3 |
| | Philippines | 23 | 41 | 5 | 8 |
| | Singapore | 151 | 129 | 29 | 25 |
| | Sri Lanka | 26 | 31 | 7 | 7 |
| | Thailand | 31 | 40 | 7 | 11 |
| | Viet Nam[c] | 27 | 39 | 2 | 11 |
| **Group Average** | | **36** | **44** | **7** | **9** |

*Notes:* *a)* (Goods exports + imports) / (2*GDP), *b)* (Commercial services exports + imports) / (2*GDP); *c)* 1998; *d)* 1989.
*Source:* World Bank (2001).

The report is not intended to present a general description of the European dynamics of economic integration in all service sectors. Rather it focuses on four specific sectors. One is *telecommunications*, where full liberalisation within the European Union was achieved in January 1998[4]. The three others are *electricity, postal services* and *transport*, where the realisation of the single market has yet to be decided or is incomplete to differing degrees. Such differences may be explained by at least three factors. One is related to the definition of universal service obligations (USOs), which is an important aspect of the liberalisation of services of general economic interest for society at large. Second, liberalisation will cause industrial restructuring, which vested interests often oppose. Even if this is not insurmountable, restructuring will entail adjustment costs. Third, all the sectors reviewed here display "network characteristics", which pose major challenges to the liberalisation process. Since, unlike for most goods, liberalisation of such service sectors must deal with regulatory problems arising from this market imperfection, there is a need for national and supra-national *ex ante* or *ex post* regulatory intervention. These service sectors also may benefit most from a concerted regional approach.

The successful conclusion of the Uruguay Round trade negotiations has brought services under the framework of multilateral trade agreements for the first time. The *General Agreement on Trade in Services* (GATS) seeks to liberalise progressively trade in all services (except those supplied in the exercise of governmental authority and air traffic rights in air transport) through all modes of delivery: cross-border supply, consumption abroad, commercial presence and the movement of natural persons. At the same time, the GATS explicitly recognises the "right of members to regulate, and to introduce new regulations, on the supply of services within their territories in order to meet national policy objectives, and given asymmetries existing with respect to the degree of development of services regulations in different countries, the particular need of developing countries to exercise this right" (*Preamble*).

The experience of GATS negotiations and subsequent negotiations on basic telecommunications and financial services at the WTO suggests that many Asian countries have been reluctant to open the service sectors to international competition. Following the 1997-98 economic crisis, this situation may have changed significantly in some countries. Nonetheless, for a variety of reasons, most notably infant-industry protection, the costs of adjustment and national security considerations, services liberalisation often encounters strong domestic resistance.

It is therefore important to demonstrate the benefits to be derived from liberalisation and competition in the services sector. Such benefits may materialise in increased trade in both goods and services, higher inward investment in the service sectors and, above all, better access to services by consumers at lower prices[5]. These benefits have an important implication for national strategies to reduce poverty. Recent experience suggests that insufficient liberalisation in service sectors has been detrimental to attracting private foreign investment in Asia[6]. This report will discuss Asian experiences in three most important sectors, namely *telecommunications, financial services* and *energy services* (see the section on Asia for details)[7]. Here, the central question for Asian countries

is not whether to liberalise the service sector but how best to do so. The European experiences since the late 1980s provide useful examples of the liberalisation of services of general interest. They can be used to demonstrate the aforementioned benefits as well as to pinpoint some of the policy failures that can pervert outcomes.

## Factors Driving Services Liberalisation

Two broad sets of factors underlie recent trends in services liberalisation. For Europe, key common external and sector-specific factors are illustrated in Table 4. In addition to these, Asian economies face similar pressures for liberalisation: globalisation of markets, rapid advances in information and communication technologies and multilateral and regional pressures for further liberalisation.

In the European Community, removing obstacles to trade in services was regarded from the outset as an integral part of the internal market process[8]. Yet substantial undertakings to this end had to wait until the 1980s, because many service sectors were to a considerable extent subject to domestic regulation. This reflected in part the (proclaimed) desire on the part of national governments to protect consumer interests. Various licenses and qualification requirements were usually applied to providers of professional and other business services (e.g. lawyers, auditors, engineers and traders). As for services of general interest, namely telecommunications, energy, postal and transport services, direct provision through public agencies was quite common at that time, due to natural monopoly characteristics.

Services were not fully part of the EC 1992 Programme as first conceived in 1985. According to one close observer, the liberalisation process may be described as "recent, gradual, uneven and complex" (Pelkmans, 2001). A key aspect of major regulatory changes stems from the separation of non-competitive and competitive segments in a vertically integrated industry (see Table 5). A recent OECD report (2001*b*) highlights the benefits to an economy that can accrue through the introduction of competition in potentially competitive activities. These benefits are: *i)* the stimulation of innovation and efficiency; *ii)* an increased range and variety of services available to consumers and end users; and *iii)* the possibility of targeting regulatory interventions on the core part of the underlying market failure (such as "wire" networks in electricity).

As regards liberalisation at the EU level, the European Commission and the European Court of Justice have played a crucial role in devising and supporting such instruments as mutual recognition (of the quality of control in the home country), minimum EU-wide harmonisation and a single licensing system. At the same time, the EC Treaty also recognises (Art. 53) that some member states may wish to undertake the liberalisation of services beyond the extent required by the directives issued by the Council. Each member state must apply restrictions remaining in place on a national basis to all EU persons providing services, without distinction on grounds of nationality or residence (Art. 54).

Table 4. **Factors Driving Services Liberalisation in Europe**

| Common External Factors | |
|---|---|
| | 1. Globalisation of markets<br>2. Technical changes<br>3. "Europeanisation" of national firms in the EU<br>4. EU initiatives to create the single market<br>5. GATS/WTO negotiations on services |
| **Sector-Specific Factors** | |
| Telecommunications Services | 1. The break-up of national monopolies and liberalisation trends in the United States and the United Kingdom in the early 1980s had spread globally to many other countries.<br>2. Technological advances led to the emergence of new services and a multiplication of service providers.<br>3. A loss of European firms' market share in the global ICT sector increased public awareness for telecom liberalisation.<br>4. Political pressures for liberalisation increased during the Uruguay Round trade negotiations. |
| Electricity Services | 1. Economic arguments appeared in favour of establishing a new regulatory framework, based on: separation of generation and transmission; private ownership; competition in generation and in retail markets; non-discrimination and transparency in access to transmission and distribution networks; and an independent regulator.<br>2. Necessity to complete the internal market has appeared. |
| Postal Services | 1. New forms of communications (e.g. fax, e-mail and the internet) compete with direct (advertising) mail and have changed the classical natural monopoly paradigm in the postal sector.<br>2. Liberalisation of other network industries has had influence.<br>3. The growth of competition in the competitive segments of postal services (express mail, parcel delivery and financial services) has led private operators to claim that public operators use their reserved markets to finance their competitive activities.<br>4. Incumbent operators tend to move outside the traditional geographical and product boundaries of postal services. |
| Transport Services | 1. The objective of free movements of goods and people envisaged by the creation of the single European market cannot be achieved without liberalising transport services.<br>2. The 1985 ruling by the European Court of Justice underlined the absence of common provisions specific to this sector.<br>3. Complete liberalisation of air transport in the United States in 1978 increased pressures on the EU to follow suit.<br>4. A relative decline in rail transport for more than 30 years under public monopoly has led to restructuring of this industry by allowing for the entry of private operators. |

*Source*: See the section on Europe for further discussion.

Table 5. **Industries Featuring both Non-Competitive and Competitive Components**

| Sector | Usually Non-Competitive Activities | Potentially Competitive Activities |
|---|---|---|
| Telecommunications | The provision of a ubiquitous network.<br>Local residential telephony in rural areas[a]. | Long-distance services.<br>Mobile services.<br>Value-added services.<br>Local loop services to high-volume business customers, especially in high-density areas.<br>Local loop services in areas served by broadband (e.g. cable TV) networks. |
| Electricity | High-voltage transmission of electricity.<br>Local electricity distribution[a]. | Electricity generation.<br>Electricity "retailing" or "marketing" activities.<br>Electricity market trading activities. |
| Postal Services | Door-to-door delivery of non-urgent mail in residential areas[a]. | Transportation of mail.<br>Delivery of urgent mail or packages.<br>Delivery of mail to high-volume business customers, especially in high-density areas. |
| Air services | Airport services such as take-off and landing slots. | Aircraft operations.<br>Maintenance facilities.<br>Catering services. |
| Railways | Track and signalling infrastructure[b]. | Operation of trains.<br>Maintenance facilities. |
| Maritime transport | Port facilities (in certain cities). | Pilot services, port services. |

*Notes:* *a)* Services in lower-density, lower volume residential areas are less likely to be competitive than services to high-density, higher volume commercial areas.
*b)* Scope for competition varies depending on geography and nature of demand, among other things.
*Source*: OECD (2001*b*)

## Lessons from Europe

The second section of this report reviews key policy initiatives for liberalisation at the EU level, assesses the impact of the liberalisation achieved so far and discusses the current state of play in each of four sectors (telecommunications, electricity, postal and transport services). The European experiences point to a number of important lessons. First, the regional and multilateral approaches are complementary, particularly

where physical access to infrastructure networks is needed (electricity, railways). Moreover, internal and external liberalisation (from the intra-European point of view) can be conducted simultaneously. The flexible structure for the implementation of the single market bears many useful lessons for other countries (subsidiarity principle, the importance of competition law, etc.).

Second, services liberalisation needs to strike a balance between regulatory convergence and regulatory competition. It has been argued that the single market has been more an exercise in harmonisation than in market access, as convergence has been negotiated but competition has remained weak (Messerlin, 2001). Services liberalisation has not been conducted without a certain focus on competition, however. The application of EC competition laws has provided a strong impetus towards reform. One lesson is the importance of giving competition laws a wide scope of application, which will then act as a safeguard against any capture of the liberalisation process. A corollary is: be cautious on the number and the nature of the safeguard clauses incorporated in the liberalisation process.

Third, there remain important differences among member states over such fundamental issues as universal service obligations (USOs), public vs. private ownership (on which the EC Treaty is silent) and the general approach towards regulation (Germany is reluctant to support *ex ante* regulation). While a diversity of approaches could express a necessary flexibility, it also underlines the capacity of some countries to escape from the liberalisation process.

Fourth and related to the above, the EU's gradualist approach to services liberalisation has both advantages and disadvantages. One advantage is that it allows member states to accommodate differences in liberalisation approaches and to ensure that every country is included in a single process. Another is that it makes the transition period less painful by providing a breathing space for adjustment. Yet Europe's gradualism also entails some costs. The gradual approach is too often synonymous with a slow and sometimes stalled process. Politics can often "highjack" it by starting a new negotiation at every stage of liberalisation. This is very hazardous and costly. Uncertainty and the lack of vision of the entire outcome of liberalisation make the process less predictable, which may impair the preparation of the transition.

Fifth, European liberalisation in services could be reversible, for a number of reasons. These include the persistence of state subsidies, the use of new protectionist instruments, the extensive interpretation of safeguards (such as protecting USOs), the collusive behaviour of incumbents and the possibilities that exist for the harmonisation of restrictive rules (Messerlin, 2001).

Last but not least, the overall positive effects of liberalisation certainly suggest liberalisation as an attractive option. A reduction in the price of services is generally steeper in more liberalised markets (e.g. electricity). A significant drop in the price of equipment has also been observed in some service sectors (notably telecommunications).

Liberalisation has made available to consumers a greater diversity of services (notably in postal services and air transport). It is hard to isolate the impact of liberalisation *per se* from other causes, however. Unilateral liberalising initiatives have contributed a great deal to the positive outcome. Industrial restructuring in many service sectors also shows that intra-European establishment is relatively free. Cross-border exchanges, on the other hand, remain relatively weak (electricity is the obvious case in point).

**Recent Experiences in Asia**

An examination (in Section III of this report) of the process of deregulation of the *telecommunications* sector in five Asian economies (China, Indonesia, Korea, Malaysia and Thailand) suggests that despite a common move to greater openness, policy choices towards this goal have varied markedly. While the Asian economies have been among the first to liberalise the *fixed line* segment, the paths taken have varied. Korea is the only country to have committed itself to liberalising almost all telecommunications service sub-sectors (with the maximum number of commitments in the GATS among the five countries concerned). China has also made commitments in all but two basic telecommunications services (telex and telegraphic services), although it remains to be seen whether it will in fact liberalise these services within the agreed time. Malaysia, too, has made commitments in all but two value-added telecommunications services: electronic data interchange (EDI) and on-line information and/or data processing services. In contrast, Thailand has offered the fewest specific sub-sector commitments for liberalisation. Indonesia too has taken a rather cautious attitude to liberalising value-added compared with basic telecommunications services, partly because the state-owned enterprises PT Telkom (the sole local and long distance service carrier), PT Indosat and PT Satelindo (exclusive providers of international services) are among the few firms that remain financially viable in the aftermath of the 1997-98 economic crisis (Abrenica and Warren, 1999).

Regulatory functions in Indonesia, Korea, Malaysia and Thailand continue to be exercised by the sector ministry or other government bodies. The regulator remains responsible for the arbitration of disputes. It is commonly recognised that by far the most challenging task for regulators is to deal with interconnection. There is a high degree of variability in the pattern of regulation in terms of both the degree of autonomy and the domain of the regulator (Fink *et al.*, 2001).

The rapid growth of *mobile networks* is due more to the introduction of digital cellular technologies along with reforms to open mobile service provision to new operators. Korea now has more mobile than fixed-line telephone subscribers. Governments appear more willing to open this segment of the telecommunications sector because there is less political need to protect state-owned incumbents. The mobile markets in the region are expected to receive a further impetus from the introduction of third-generation (3G) mobile technology launched initially in Japan.

As regards the liberalisation commitments for *financial services*, in broad terms governments have adopted three different approaches to multilateral negotiations. These are: *i)* to bind the *status qu*o; *ii)* to make binding commitments that represent less than the *status quo* in policy terms; and *iii)* to promise future liberalisation, which may or may not have been planned prior to the negotiations (Mattoo, 1999). These categories are not necessarily mutually exclusive when the set of a country's commitments is taken as a whole, nor is it always easy to determine the precise category in which a policy position falls. These observations apply to all five of the Asian economies under consideration.

Many Asian economies have bound their multilateral obligations at less than the *status qu*o. They include Korea, which has recently undertaken aggressive steps towards liberalisation to reflect dual objectives. It seeks to encourage foreign investment in the financial sector while simultaneously avoiding a repeat of the turmoil and instability following the premature and ill-sequenced liberalisation prior to the regional crisis of 1997-98, not to mention providing some degree of protection from immediate competition to incumbent national suppliers. All these economies, especially Korea and Thailand, have continued to take important steps towards the *de facto* relaxation of limits on foreign equity. They appear to have a clear policy preference for promoting foreign equity investments over the promotion of market competition.

With regard to insurance, restrictions on foreign equity accompany entry limitations in Indonesia, Malaysia and Thailand. Although the acquisition by foreigners of stocks listed on the Korean stock exchanges is restricted, their participation in new direct investment is not. These economies appear to have relatively greater willingness to undertake more liberal commitments in banking than in insurance, and to allow consumption abroad rather than permit cross-border supply.

*Energy services*, despite their strategic importance, have been relatively neglected in the GATS. The WTO's 1998 "Services Sector Classification List" does not include a separate comprehensive entry for energy services. Consequently, WTO members have made few commitments in energy services, the sector often being considered beyond the scope of international negotiations. Indeed, it has hitherto largely been considered a domestic issue involving "in-house" supply by monopolistic state-owned enterprises or government-linked companies that often exclusively control both production and distribution[9]. Domestic regulations governing this sector have been relatively non-transparent and in some cases rather underdeveloped and *ad hoc*, being administered at political levels. The energy sector at the international level is characterised by a complex myriad of institutional and regulatory barriers, with security, politics and diplomacy heavily influencing decisions in energy markets.

Yet there is growing recognition that, as with other services, the liberalisation and trade of energy services needs considerable attention. There are two complementary objectives: first, to use them as effective instruments in development strategies and, second, to improve the economic efficiency of energy services by including measures

to facilitate competition in some of the activities they involve. In Asia, there is no doubt that ensuring stable and low-cost energy supply is paramount to sustaining growth in the many economies that continue to be net importers of oil from outside the region.

Partly in response, some noteworthy steps towards introducing market competition and privatisation have been undertaken by the five Asian countries studied. Most have permitted private foreign participation in areas such coal mining, production and exploration in oil and natural gas and production of electric power. Korea has taken the lead domestically, having deregulated its oil refining industry and "conceived the most comprehensive energy reform strategy in the region, with one of the most progressive and committed electricity deregulation programs in Asia" (Jaffe and Barnes, 2000, p. 12). China too has begun to take ambitious steps towards opening the power generation sector to attract FDI. Nonetheless, considerable scope for further liberalisation remains. Distribution and transmission services remain largely state-controlled, for example.

In Asia, both ASEAN and APEC have played important roles in expanding the scope of services liberalisation and enhancing technical co-operation in individual service sectors. For example, since 1995 the member states of ASEAN have established the ASEAN Framework Agreement on Services (AFAS), with initial negotiations focused on a number of service sectors (telecommunications, financial services, professional business services, tourism and transport) (see Box 1). In energy services, ASEAN has also been very active in attempting to ensure the security and sustainability of energy supplies as well as the efficient use of natural energy resources and the development of Trans-ASEAN energy networks[10]. Besides ASEAN, APEC also instituted in 1990 an Energy Working Group (EWG) engaged in various projects involving power infrastructure, energy standards and energy efficiency. The APEC Energy Ministers meeting in Edmonton in August 1997 launched a new initiative to examine ways to accelerate investment in energy services in the APEC region. These activities are not strictly comparable to the EU approach, since they lack the enforcement capacity that the EU has in place.

The available empirical evidence on Asian countries emphasises that there are significant economic gains from liberalisation of services, although they may be somewhat unevenly distributed across countries. Many arise from the introduction of competition rather than from change of ownership *per se*. As with the liberalisation of trade in goods, however, services liberalisation could involve short-term adjustment costs, which need appreciation and appropriate management. Services liberalisation itself also requires strengthening of the institutional and regulatory environment prior to and during the process of liberalisation.

## Concluding Remarks

Many countries in both Europe and Asia tend to share the so-called gradualist approach to services liberalisation. As noted earlier, it has both advantages and disadvantages. To minimise the risk of liberalisation stalling, the regional institutions in Europe (notably the European Commission and the European Court of Justice) have played critical roles in injecting dynamism into it over recent decades, repeatedly when deemed necessary. In Asia, without comparable institutions, the countries of the region would need to develop further an effective mechanism through which national and regional initiatives for services liberalisation can be sustained beyond GATS commitments.

In recent years an increasing number of empirical studies have attempted to quantify the impact of liberalisation in services, involving both developed and developing countries. While they need further refinement and improvement in both methodology and data, the evidence so far seems to support the view familiar from earlier studies regarding trade in goods: countries with the most restrictive regimes will benefit most from liberalisation. As the next section discusses in detail, evidence from Europe also shows that liberalisation is associated with less expensive and better-quality services and products, greater product diversity and new services, while providing consumers and end users with a wider choice of providers.

Ill conceived and flawed liberalisation would do more harm than good. A few recent incidents, such as California's power crisis, point to the potential risks in restructuring network service industries for greater competition, although in this case deregulation *per se* was not the primary cause[11]. A key message for Asian developing countries is that these mistakes must be avoided by ensuring the integrity and sustainability of regulatory reform associated with liberalisation.

Box 1. **ASEAN Framework Agreement on Services (AFAS)**

The ASEAN Framework Agreement on Services (AFAS) was signed at the 5th ASEAN Summit in December 1995. The AFAS aims to enhance co-operation in the service sector among ASEAN member states by eliminating intra-regional trade restrictions and expanding the scope of liberalisation in services beyond those already undertaken under the GATS. In other words, the AFAS is meant to be GATS-plus. The AFAS negotiations focused initially on financial services, transport, telecommunications, tourism and professional business services. The 29th ASEAN Economic Ministers (AEM) meeting in October 1997 in Malaysia endorsed the first package of commitments. A second package emerged from the 30th AEM in October 1998 in the Philippines. This Box compares the commitments in telecommunications and financial services made by Indonesia, Malaysia and Thailand under the AFAS with those made under the GATS and highlights the extent to which the AFAS commitments are truly "GATS plus".

Box 1. (contd.)

**Indonesia**

*Telecommunications Services*: The sub-sector commitments offered under the AFAS are the same as those under the GATS, except for value-added services. Similar limitations on market access and national treatment apply as in the GATS schedule, except that foreign equity participation has been restricted to 40 per cent, as opposed to 35 per cent under the GATS.

*Financial Services*: Indonesia has made no specific commitments in this sector under the AFAS and has stated only general conditions for entry into the banking sector. The AFAS commitments do not cover insurance services at all. The AFAS schedule details no specific sub-sector commitments even under banking. On the other hand, under the GATS all limitations on market access commitments in the banking sector are to be eliminated by 2020, subject to similar moves by other members. Under the AFAS, the time frame for removing such limitations is advanced by a decade to 2010. In another GATS-plus feature, the opening of branch offices of foreign banks and joint ventures is allowed in three more cities under AFAS (Padang, Manado and Amban). Those already allowed under the GATS are Jakarta, Surabaya, Semarang, Bandung, Medan, Ujung Pandang, Denpasar and Batam Island.

**Malaysia**

*Telecommunications Services*: The commitments offered under the AFAS match identically those offered under the GATS. (i.e. all categories of services, except for electronic data interchange (EDI) and on-line information and/or data processing services), with only one difference: the aggregate foreign shareholding limit is 35 per cent as opposed to 30 per cent under the GATS (Mode 3).

*Financial Services*: Under the AFAS, Malaysia has offered commitments on advisory, intermediation and auxiliary financial services, including credit reference and analysis, investment advice on acquisitions, corporate restructuring and strategy, operational headquarters (OHQ) for financial firms, and on life and non-life insurance. The schedules indicate that, as in the GATS, limitations on market access and national treatment pertain mostly to the presence of natural persons (Mode 4) as opposed to commercial presence (Mode 3). Temporary presence of natural persons in these services (excluding OHQ and insurance) has been offered only when supply of services is via commercial presence under AFAS, which was kept unbound under the GATS. While entry is limited to a maximum of five years, the number of posts offered to foreign experts is restricted. Yet there are some GATS-plus offers. For instance, under AFAS, three foreign nationals may set up a representative office for advisory, intermediation and auxiliary financial services, including credit reference and analysis, investment advice on acquisitions and corporate restructuring and strategy.

Box 1. (contd.)

**Thailand**

*Telecommunications Services*: Thailand's commitments under the AFAS schedule cover domestic Very Small Aperture Terminal (VSAT) services (not covered under the GATS schedule) and telecommunications terminal equipment leasing, with the requirement that cross-border suppliers use the public telecommunications network for VSAT operators. There are no limitations on telecommunications terminal equipment leasing through commercial presence (Mode 3) as long as foreign equity is below 49 per cent. VSAT operators are subject to 40 per cent maximum foreign equity and shareholder participation through the same mode, however. Commercial presence under AFAS is subject to the same limitations on market access and national treatment as apply to the country's horizontal GATS commitments. There are no commitments under AFAS in the other major sub-sectors of telecom services.

*Financial Services*: There are no commitments in banking and insurance services under the AFAS, but commitments have been made for securities brokerage, securities dealing and underwriting, as well collective investment schemes involving asset management companies. A maximum foreign equity participation up to 100 per cent of paid-up capital is allowed in these areas (as opposed to 49 per cent under the GATS). Yet the schedules indicate that there are significant limitations on market access and national treatment in these areas, mostly those prevailing in the GATS schedule. Notably, market access is limited to acquisition of existing companies and has been kept unbound for new licenses.

# Section II. Experiences from Europe: Four Case Studies

This section reviews recent changes in the European regulatory environment in four service sectors (telecommunications, electricity, postal and transport services), assesses the outcomes of the liberalisation of services in the region and draws policy lessons. It focuses on member states of the European Union.

## Telecommunications Services

The telecommunications sector includes companies that manufacture telecommunications equipment, including fibre optics and satellite, switching and microwave equipment. It also embraces telecommunications infrastructure operators and telecommunications service providers such as local and long-distance phone companies and cable and satellite television companies. In January 1998, the last barriers to competition in the telecommunications sector within the European Union were removed (with derogations for five member states, namely Greece, Portugal, Ireland, Luxembourg and Spain)[12].

### *Before Liberalisation: Public Telecommunications Operators and National Champions*

Until the beginning of the 1980s, the EU was not really concerned with telecommunications policy. The Rome Treaty had no special provision about this sector[13], and even the well-known White paper on "Completing the Internal Market" (COM/85/314) published in 1985 did not talk about telecommunications. For decades, the telecommunications sector in the EU countries rested in the hands of public monopolies, often operated in association with postal services[14]. Frequently these activities were considered part of the government and were supervised and organised directly by the competent ministry[15]. These national monopolies engaged in all stages and the full scope of the telecommunications industry, integrating, for example, service delivery as well as customer terminal equipment and the physical networks terminal equipment. Moreover, this vertically integrated market structure was often associated with policies to create and defend national champions in the member states[16]. At this time telecommunications were "not merely a technical system, but a social, political

and economic institution" (Frieden, 1996). The main reasons advanced in support of this policy were national security concerns and the need for the provision of telecommunications service at a uniform and affordable price for all domestic consumers ("universal service" later).

During the first half of the 1980s, the conjunction of several factors led to questioning of this market structure and caused the initiation of a radical transformation. Three of these factors had a paramount influence. First, this period witnessed on practically all continents a general process of liberalisation and deregulation in telecommunications. In 1982 initially, following a long legal procedure, the *de facto* monopoly of AT&T in the United States was broken up (for local calls) into seven regional companies, the Baby Bells[17]. In a second stage, the complete liberalisation of the sector was decided in the Communication Act of 1996. In Japan, a 1984 law resulted in the opening of the sector and in the partial privatisation of the public operator, NTT. Australia, New Zealand and Chile also introduced competition into telecommunications. In the United Kingdom, the Telecommunications Bill of 1981 made possible the creation of a duopoly between BT and Mercury before the decision for total liberalisation of the market was taken in 1992. These evolutions, underlined by an increasing number of public and private actors, exerted growing pressure on European decision-makers. The pressure grew all the more intense and audible as foreign companies entered the European market[18] and raised the fear of foreign domination in the sector. One other ominous prospect: European firms were losing market share, especially in information technology, which is considered part of the sector. The US government also pressured for liberalisation of the European market, as did non-European private firms engaged in liberalisation objectives elsewhere, particularly in the framework of the Uruguay Round negotiations.

A second push towards liberalisation originated in the technological changes that the sector has enjoyed for 15 or 20 years. Initially, increases in computer power benefited the sector a great deal, reducing the gap between telecommunications and information technology and allowing a reduction in the cost of infrastructure. Then networks and equipment were digitalised, which increased possibilities for offering new services under better conditions. Further improvements came when mobile telephony appeared as telephony by satellite, opening opportunities to communicate by means other than the fixed networks of the historical operators. Last, line speed and capacity truly exploded with optical fibres. These technological evolutions fundamentally modified the natural-monopoly paradigm, lowering fixed costs and bringing competition with new, substitute services. They caused the multiplication of service providers who challenged the monopoly status: the cable operators want to carry telephone services, while the operators of energy and rail transport want to use their infrastructure as alternatives to the network of the historical national operator (Tronc, 1996).

A third reason for liberalisation was the growing internationalisation of production, especially the "Europeanisation" of production processes in EU firms as well as the integration of financial markets. EU firms, and above all the multinationals,

complained about the inflexibility of the national operators, their high tariffs and the low quality of services offered, whereas EU firms had an increasing demand for efficient telecommunications services at the European level[19]. European producers called for Europe-wide services, and their requirements became more and more sophisticated, such as the demand for interoperability of services between providers or the uniformity and compatibility of functions among operators. The rise of global user demand and the corresponding need to operate in international markets persuaded France Télécom and Deutsche Telekom to accept liberalisation (Bartle, 1999).

### *Main Phases of European Telecommunications Policy*

For a long time, the EU did not have a true telecommunications policy. The first and almost single common action in the sector began in 1979 when such policy was recognised for the first time as an important factor in European industrial competitiveness. This led to the launch in 1984 of the European Strategy Programme for Research in Information Technology (ESPRIT) and of Research and Development in Advanced Communications Technologies in Europe (RACE), which aimed at developing common European research in these sectors[20].

The second and more important European action in telecommunications started in the summer of 1987 with the publication of a Green paper on "The Development of the Common Market for Telecommunications Services and Equipment" (cf. COM(87)290 final). This Green paper marks the real point of departure for a European policy in telecommunications and the beginning of the liberalisation process in this sector. Since its adoption, an initiative has continued to create a competitive European common market in the sector. Its policy objective was to initiate competition in the EU telecommunications market and to introduce a higher degree of harmonisation.

The legislative translation of the orientations contained in the Green paper constituted the first phase of the journey towards the single market. Directives adopted introduced competition into terminal equipment; imposed within each member state separation between national telecom regulation and exploitation activities — networks and services operations — in order to ensure transparency; established the opening of certain services, particularly enhanced or value-added services[21]; and encouraged Europe-wide technical and legal harmonisation or approximation. The directives did not, however, put into question the existing market organisations for network infrastructure and basic telecommunications services, especially voice telephony services. These activities could be maintained under the exclusive control of national monopolies.

The most fundamental decision at the time was certainly that to open third-party access for all operators to the infrastructure networks, which remained under the monopoly of the incumbent operators. This was the goal of the so-called "Open Network Provision (ONP) framework" directive[22], which posed the principle of an open telecommunications network: the essential condition to allow new entrants to offer their services. This condition was accompanied by harmonisation measures intended

to ensure that all telecommunications service providers would benefit from equal treatment within the EU. In that respect, the harmonisation aimed at establishing transparency and non-discrimination, particularly relating to technical interfaces and tariff principles.

The technical interface harmonisation sought to prevent the establishment of technical barriers to entry, to guarantee minimal requirements in order to protect network integrity and the quality of service, and to ensure the compatibility and interoperability of equipment. In 1988, the European Telecommunication Standards Institute (ETSI) was created to meet these needs. The standards it develops are published and their use is encouraged[23]. The approach adopted for this harmonisation process was to agree on "essential requirements" from which standards could be created and product certifications developed, whatever the products' origin. In the European system the standards are thus voluntary and can be used for certification of the products developed in third countries. Once the certificates are mutually recognised, freedom of movement becomes a reality and competing offers have access to every member state. That facilitates the circulation of the products in the EU and supports the development of competition. One finds here an approach similar to the principle of "mutual recognition" which gave force to the 1992 European single market programme.

In the same spirit, the Council adopted in June 1992 the directive (92/44/EEC) on the application of ONP to leased lines. Its aim was to ensure the availability throughout the EU of a set of lines with harmonised technical characteristics. It aimed to eliminate technical restrictions for interconnection between leased lines and public networks[24]. To prevent excessive access tariffs for the network from limiting or preventing competition on services, the first provision invited network operators — still under monopoly — to practise transparency and to charge prices based on "objective" criteria, "non-discriminatory and costs-oriented", for access to their networks.

Other directives gradually expanding the segments of the telecommunications sector opened to competition quickly followed these measures. For example, in October 1993, on the basis of a Green paper on "Satellite Communications", published in 1990, the directive (93/97/EEC) introducing mutual recognition for satellite earth station equipment was adopted. A directive abolishing special and exclusive rights for the provision of satellite services and equipment was adopted in 1994 (94/46/EEC, October). The Council also adopted in 1992 two recommendations to promote harmonisation in public packet-switched data services (PSDN) and in integrated services digital networks (ISDN).

As one can notice at this point, liberalisation in European telecommunications, as in all the other areas, was gradual. The realisation of the single market came through the gradual opening of segments of the industry. Second, the process was conducted in co-ordination with the operators. For example, for the harmonisation of the technical standards, until then defined at the national level, it was necessary to agree on minimal or essential requirements. Experts from the industry accomplished this approximation working together in committees under the auspices of ETSI. Last, from a technical point of view, telecommunications liberalisation in Europe has followed a "vertical"

approach, with a distinction between infrastructure, equipment and services. In this respect, it differs from the "horizontal" approach of the United States, which separates between local, national and international calls.

The second major stage in the realisation of the single market in telecommunications came with the decision in 1993[25] to liberalise services completely and the adoption in 1994 of the principle of full liberalisation of supply in infrastructure[26]. In both cases the opening was fixed for 1 January 1998 at the latest. These decisions resulted in a number of preparatory measures. Several directives were adopted over a short period. The first, on cable television networks, allowed as of January 1996 their use to offer telecommunications services (already liberalised). The second, on liberalisation in mobile communications, dates from January 1996. Finally and more importantly, the directive establishing the total opening of telecommunication services and infrastructures to competition was approved in March 1996. It also lifted, as of July 1996, the remaining restrictions on the use of alternative infrastructure, such as the telecommunications networks of railway, energy or water firms, which were then authorised only for internal use, for the services already liberalised.

*The March 1996 Directive*. The provisions of the March 1996 directive aimed at creating early certainty with regard to national legislation and the rights and obligations of market players in the liberalised telecommunications environment. Three provisions have particular importance, because they define the fundamental conditions for market opening. First the directive defines the procedures of attribution for general authorisations and individual licenses[27] and the conditions associated with them. Its goal is basically to enable the regulator to ensure that agents can offer services and/or networks of quality. As the requirements defined and implemented by the National Regulation Authorities (NRAs) can also be used to limit competition, however, the directive also defines conditions of attribution according to the principles of transparency[28], non-discrimination, proportionality[29], objectivity and diligence. On this last point, however, only a system of the "single office" or "one-stop shop" is proposed (to simplify procedures). It is all the more regrettable that the authorisations are primarily recognised at the member state level and there is no mechanism for license attribution at the European level[30].

Interconnection of networks is another essential dimension of liberalisation. As in all network activities, the value of any telecommunications network depends on its size, i.e. the number of people it can reach and the range and number of products it allows on offer. Moreover, as the cost of establishing a telecommunications network is very high, particularly at the local level, it is certain that without regulation the incumbent operators would maintain all or parts of their networks under monopoly and impose their conditions for access. New entrants would not be able to use the networks to deliver, transit or terminate traffic to and/or from their customers, and competition may never appear, especially in local networks. However, at the same time, interconnection of networks "should not damage equipment, software, etc. (network integrity) or compromise operators' ability to keep services running in the event of a breakdown or crisis (network security)" (Pelkmans and Young, 1998, p. 101).

To address the issue of interconnection, the directive requests member states to publish the terms and conditions for interconnection to the basic functional components of the network. It also requires that interconnection to voice telephony service and to publicly available switched telecommunications networks be granted on non-discriminatory, proportional and transparent terms. The NRAs are in charge of enforcing these rights and obligations with respect to the designated providers of publicly available telecommunications networks and services, when negotiating interconnection with each other, so as to ensure national and Europe-wide services (EC, 1999, INFSO/A/1). Once again under the directive framework, through this requirement for commercial negotiations between parties the priority was given to the operator's active participation in the liberalisation process. In so doing, the directive seeks to establish a balance between rights and obligations, the latter being the key principle of the EU telecommunications regulations.

Finally, the March 1996 directive also contains some provisions related to USOs in the member states. The questions raised by the USOs are of both social policy and economic concern. It was politically significant not to create (because of the single market) a conflict with the tradition of public services embodied in traditional telecommunications services. It was necessary to avoid eviction of the most modest consumers or the residents of less densely populated areas, while preserving an affordable price and a certain tariff uniformity for some basic services. On the economic side, introduction of competition in telecommunications posed the problem of financing the USOs. When the sector was monopolised, the tariff structure rested on a logic of cross-subsidy of individual customers by companies. It also associated start-up and subscription costs lower than the actual costs of the services — to increase the number of subscribers and benefit from network effects — with an unbalanced schedule of communication costs, where long-distance and international calls financed local calls. With the arrival of competition, this tariff structure got reconsidered, and the historical operators complained that the most profitable market segments could no longer subsidise the loss-making ones.

The financing of USOs thus had to follow other lines. The conditions for it were to be defined this time at the European level, because if left under the sole responsibility of the member states it would have been tempting to protect incumbent operators by over-estimating the costs of USOs and forcing new entrants to finance them. The directive therefore required tariff rebalancing, taking into account the need to secure USOs. Tariffs not reflecting costs, particularly those relating to USOs, would have to be brought in line with the real costs incurred. The directive specifies that the services deemed appropriate for financing under USOs are those relating to the connection of customers to the fixed public telephone network and the provision of voice telephony services. Conditions and rules to calculate the specific costs of USOs are also specified[31]. The directive identifies the possible financial contributors: only providers of vocal telephony services and of the publicly available telephone network can be asked to contribute. Finally, it proposes means of financing. Two are envisaged. The first provides for setting up a specific fund (managed by an independent body), and the second takes the form of an additional rate added to the interconnection charge.

Liberalisation and harmonisation measures created the necessary conditions to introduce competition and to maximise the profit possibilities offered by the creation of the European single market in telecommunications. In addition to these provisions, it also was essential to specify the conditions of application of the European competition laws to this "new market". Such was the objective of the general "guidelines" published in 1991, which provide direction on the Commission's intent to apply competition legislation to the sector. Indeed, the process of the creation of the telecommunications single market meant the transition from a situation of monopoly to one of competition. In others words, it implied, at least initially, the presence of segments of the industry still under monopoly, while others would be liberalised. It also meant the coexistence of dominant companies — old incumbent monopolies as well as newcomers. At this stage, economic relations between agents on the market would not be subjected to the competitive forces of a market, and some adaptations were essential. A specific competition regulation for the sector became crucial to ensure a real capacity to compete for the new operators.

The specific regulation took an asymmetrical view, according to the quality of the operators and to a lesser extent to the sectors concerned. On the operator side, those with Significant Market Power (SMP) were subject to additional rules. Specifically, they would be compelled to apply interconnection tariffs on a cost basis. They would have to meet all reasonable requests for access to their networks and to give access following principles of objectivity, transparency, and non-discrimination. They would also have to compensate for any imbalance in negotiating power with much smaller new market entrants. For operators providing services or infrastructure upon which other telecommunications services would depend, the NRA would have the possibility to subject them to additional conditions. Four categories of operators are listed in the Interconnection directive[32].

As there is difference according the market power of the operators, EU regulation also introduces difference between sectors. The general principle of this distinction is that rules for fixed telephony are stricter than for mobile telephony. As the mobile sector is more recent than the fixed sector it has almost always been subject to some level of competition.

Creating an effective single market in telecommunications supposes, as in other activities, a direct and adequate transposition and implementation of the EU rules in member states' legislation. Without a full translation of the directives' measures it would be difficult, if not impossible, for producers to benefit from the advantages of a common market. During the beginning of the 1990s, the transposition of the common regulation by the member states was deficient. According to some authors, the implementation of European telecommunications legislation reveals divergent transposition at national levels across the EU, flagrant violation of the underlying spirit of the policy aims, or worse, non-implementation (Sun and Pelkmans, 1995).

The European Commission reports on the implementation of the telecommunications policy all raise numerous defaults of implementation. They recount, according to countries and/or years, the lack of independence of the NRA and the

recurrent absence of clear separation between the regulatory function and the economic participation of the state in the historical operator. They conveyed concerns about delays in obtaining interconnections as well as high and discriminatory tariffs. They also recorded delays in implementing tariff rebalancing and the absence of mechanisms guaranteeing that historical operators apply cost-based tariffs.

Nevertheless, the sixth report on the implementation of the telecommunications regulatory package, published in December 2000, indicated that new and important improvements have been accomplished in the implementation of the current regulatory framework. The seventh and latest report, published at the end of 2001, underlined that "national legislation that removes major concerns on the part of the Commission has been notified by three member states (France, Italy, Luxembourg)" and that "the national framework has been consolidated in a further member state (Greece), bringing increased clarity and legal certainty" (COM/2001/706). Thus, even if the report still highlights that a number of regulatory deficiencies and bottlenecks still persist in Europe[33] 15 years after the first Green paper on telecommunications, the main objectives pursued by the European Commission are carried out. The EU telecommunications market is to a large extent now completed.

The major difficulties now reflect that the current framework is not always implemented consistently across the Community and that some degree of regulatory divergence still exists between member states (COM/2001/706). The two first problems in the implementation of the European legislation relate to local components. One is the difficulty of access to the local market. As underlined in the seventh report, the implementation of local loop unbundling has been very disappointing. The other involves the high call termination charges in mobile networks.

### *Impact of the Liberalisation in EU Telecommunications*

During the last 15 years, the European telecommunications sector has undergone very significant changes. They have come from different sources, such as the technological evolution and general economic growth. They are also the outcome of the regulatory changes instituted by the programme of liberalisation. The evolution of the behaviour and performances of the European companies in the sector illustrates the effects of the modifications of the regulatory framework, even if it is not easy to isolate the specific effects of the changes in regulation.

A first assessment of the impact of liberalisation can cover telecommunications equipment. Two studies compare the situation before and after the introduction of market competition. The first one (Atkins, 1998) was carried out within the framework of the *Cecchini* report on the "cost of non-Europe". It measures for five EU countries the possible reductions in price due to liberalisation for switching equipment and telephones. The results show potential gains varying, according to countries, between 40 per cent and 70 per cent of the domestic prices for switching equipment and between 20 per cent and 40 per cent for telephones.

The second study (Analysys, 1996) carries out a double comparison. It first compares a price index of telecommunications equipment in Europe with an index of the world market price. Second, it studies the evolution of these two indices between 1985 and 1995. It reveals a significant reduction of equipment prices in Europe. In 1995, they were equivalent (in real terms) to approximately a quarter of their 1985 level. Moreover, the price difference between the European and the world market diminished from 20 per cent in 1985 to 8 per cent in 1995. Admittedly, this reduction is not due only to the construction of the internal market, as the world prices decreased during the period, but the reduction in price occurred in a greater proportion in the EU. Finally, the authors add that without liberalisation measures, the EU would have foregone average equipment price falls of approximately 7 per cent (in total, 1985 to 1995), equivalent to between ECU 1.5 billion and ECU 2.0 billion per annum of additional cost to equipment purchasers in the EU.

These two studies demonstrate developments in the same direction: an improvement in the price competitiveness of the telecommunications equipment companies in Europe. The transition towards the single market modified agents' behaviour. The service providers, faced with competitive pressure, went in search of the best equipment at the lowest price and were no longer constrained by exclusive supply agreements or integration with the producers of national equipment. Confronted with the same competitive environment, the equipment manufacturers intensified their efforts to improve their competitiveness in a broader, less fragmented market.

Another remarkable illustration of the breadth of changes and the accrued dynamism in the EU telecommunications sector comes from the multiplication of cross-border M&As and strategic alliances involving European companies during the 1990s. Indeed, even if several factors can explain these operations, the introduction of liberalisation and competition, which surrounded this evolution, is certainly a central factor[34]. The creation of a unified EU market has increased the availability of opportunities. The liberalisation measures have also increased the incentive for companies to extend beyond their domestic markets to seek possible economies of scale and to reach a minimal size to face competition in a larger market. The creation of the single market also changed companies' forecasts of development of the telecommunications market. They came to expect a more constant and higher growth of demand. One of the most striking facts is that between 1998 and 2000, seven of the 20 most significant cross-border M&As in the world involved telecommunications, and all of these involved at least one European company. Five of them were entirely intra-European operations. Cross-border M&As of European firms in the United States telecommunications sector really began in the middle of the 1990s, whereas in the beginning of the decade this sector was far from a target of choice for Europeans (Table 6). Telecommunications also became the major sector for cross-border M&As between European companies during the second half of the 1990s (Table 7). These figures demonstrate the overall dynamism of European telecommunications companies. The central importance of the creation of the single market is undoubtedly underlined by the 54 per cent of the total value of M&As in the telecommunications sector accounted for by intra-EU cross-border M&As (OECD, 2001*a*, Fig. 4.5).

Table 6. **Top Ten European Target Industries in the United States**

| Sectors | Deal Value ($ billions) | | | Share in Total (%) | | |
|---|---|---|---|---|---|---|
| | 1990-94 | 1995-99 | 1990-99 | 1990-94 | 1995-99 | 1990-99 |
| Telecommunications | 3.8 | 75.0 | 78.6 | 3.3 | 14.7 | 12.6 |
| Petroleum | 1.0 | 55.8 | 56.6 | 0.9 | 10.9 | 9.1 |
| Transportation equipment | 0.3 | 48.1 | 48.4 | 0.3 | 9.4 | 7.7 |
| Insurance | 8.3 | 35.2 | 43.6 | 7.3 | 6.9 | 7.0 |
| Pharmaceuticals | 15.8 | 24.2 | 40.0 | 13.7 | 4.7 | 6.4 |
| Business services | 5.8 | 30.2 | 36.1 | 5.1 | 5.9 | 5.8 |
| Computers and machinery | 7.0 | 26.7 | 28.6 | 1.7 | 5.7 | 4.6 |
| Commercial banks | 1.8 | 22.5 | 24.6 | 1.6 | 4.5 | 3.9 |
| Electronic and electric equipment | 6.0 | 16.5 | 22.9 | 5.3 | 3.3 | 3.7 |
| Chemicals | 8.0 | 14.0 | 22.0 | 7.0 | 2.2 | 3.5 |
| Top ten total | 53.0 | 348.8 | 401.5 | 46.1 | 68.2 | 64.2 |
| Industry total | 114.8 | 511.1 | 625 .9 | 100.0 | 100.0 | 100.0 |

*Source* : Thomson Financial in OECD (2001*a*).

Table 7. **Top Ten European Target Industries in Europe**

| Sectors | Deal Value ($ billions) | | | Share in Total (%) | | |
|---|---|---|---|---|---|---|
| | 1990-94 | 1995-99 | 1990-99 | 1990-94 | 1995-99 | 1990-99 |
| Insurance | 19.76 | 60.08 | 79.4 | 11.6 | 9.9 | 10.3 |
| Telecommunications | 1.36 | 76.11 | 79.46 | 0.8 | 12.9 | 10.3 |
| Chemicals | 8.86 | 46.79 | 55.65 | 5.2 | 7.7 | 7.2 |
| Pharmaceuticals | 3.88 | 49.55 | 53.76 | 2.3 | 8.7 | 6.9 |
| Commercial banks | 8.81 | 34.66 | 43.47 | 5 .2 | 5.7 | 5.6 |
| Food and products | 18.06 | 18.84 | 36.90 | 10.6 | 3 .1 | 4.8 |
| Petroleum | 6.20 | 20.13 | 26.32 | 3.6 | 9.3 | 9.4 |
| Investment and commodity | 4.54 | 21.35 | 25.69 | 2.7 | 3.5 | 3.3 |
| Electricity and gas distribution | 1.41 | 73.26 | 24.67 | 0.8 | 3.8 | 3.2 |
| Electronic and electrical equipment | 8.77 | 15.63 | 24.60 | 5.2 | 2.6 | 3.1 |
| Top ten total | 81.04 | 368.73 | 450.37 | 48.0 | 60.9 | 58.1 |
| Industry total | 169.98 | 605.48 | 775.45 | 100.0 | 100.0 | 100.0 |

*Source:* See Table 6.

The impact of the European single market in telecommunications is also and perhaps more directly measured using the evolution of three indicators: the quality of services, the availability of supplier choice for consumers and tariffs. Quality can be measured with various statistics, such as the waiting list for main lines, the number of telephone main lines or the number of complaints per 1 000 bills (ITU, 2001). Data relating to the waiting list for main lines are the most readily available for all EU countries. They show a clear improvement during the 1990s; the indicator reached zero in a majority of member states as early as the mid-1990s and decreased quickly in the four remaining countries where such a list still exists (Eurostat, 1999).

Improvement is also obvious in consumers' choice of operators. For local call services, the entire population of six member states can now choose from more than five operators. In the others, a choice of between three and five operators is available to 100 per cent of the population (Luxembourg and Spain), 85 per cent (Italy), 40 per cent (Belgium), and 22 per cent (Germany). The choices remain limited in the Netherlands and even more so in France and Greece where only 30 per cent, 1 per cent and 0 per cent of the population, respectively, can make calls with operators other than the incumbents (COM/2001/706). The improvement is even more marked in consumers' choice of long-distance operators. Only Greece does not offer consumers the choice of a long-distance operator other than the incumbent. In Belgium and in Luxembourg the choice is between three and five operators, while in the other twelve member states more than five operators are likely to offer these services.

An outcome of these developments is that the market shares of the incumbent operators are decreasing, even though they remain dominant in all fixed-call service segments in most of the member states (COM/2001/706). This evolution is particularly strong for long-distance and international calls, opened to competition earlier[35]. The market share of the incumbent operators for long-distance calls, expressed in terms of retail revenues, is 32 per cent in Finland, 59 per cent in the United Kingdom, 70 per cent in Germany, 76 per cent in Italy and 79 per cent in France. For international calls, the incumbent share reaches 48 per cent in the United Kingdom, 54 per cent in Finland, 60 per cent in Italy and Germany, 75 per cent in France and 86 per cent in Spain. The shift in market shares in terms of call length is similar. Note, however, that the reduction of historical operators' market shares has occurred in a growing market. The telecommunications service market was estimated at €163 billion in 1997 and reached €218 billion in 2001. This supports the assertion that although competition introduces a sharing of the telecommunications market, it involves such an increase in the market size that all the actors can obtain success (Miléo, 1996, quoted in Trone, 1996).

On tariffs for fixed calls, a clear distinction appears between the prices of local calls and those of long-distance and international calls. For the first, prices charged by the incumbent operators have remained stable over 1998-2001. For three-minute calls they moved little, from €0.13 in 1998 to €0.14 in 2001, while those of ten-minute calls remained unchanged at around €0.42[36]. Nevertheless, both of these prices remained higher in the EU than in the United States and Japan in 2001, which suggests that further reductions could occur[37]. In contrast, the tariffs for long-distance and international calls displayed strong reductions in the EU. On average, the cost of a three-minute long-distance call in the member states fell by 45 per cent between 1998 and 2001, from €0.72 to €0.40. The price for 10-minute calls dropped even slightly more, to €1.24 in 2001 from €2.35 in 1998. The cost of international calls (excluding VAT) declined from €1.84 to €1.18 for private individuals and from €1.33 to €0.81 for businesses.

### *Current Issues*

Following a consultation launched in September 1997 by the European Commission, it appears that the legislative framework will be revised to adapt it to the phenomenon of convergence between telecommunications, broadcasting and information technology. Such a revision also accords with the more general objective of the *eEurope* Action Plan, which aims to change the EU into "the most competitive and dynamic knowledge-based economy" of the world within the ten next years (COM/2001/711 final).

The "new reform package" proposed by the Commission in July 2000 seeks to deal with these new requirements[38]. It also aims at defining a more flexible framework in order not to slow down the development and diffusion of new technologies and new services. More specifically, it proposes several principal innovations, some of which were adopted by the Council in January 2002 and will certainly enter into force during 2003. The proposals are:

- the adoption of a common regulatory framework for all communications networks and services;
- a different set of definitions and regulations for SMP operators, an approach closer to the "competition law" notion of dominance;
- a new system of general authorisation for licensing;
- introduction of mobile number portability; and
- USOs would be maintained, but their scope could be revised.

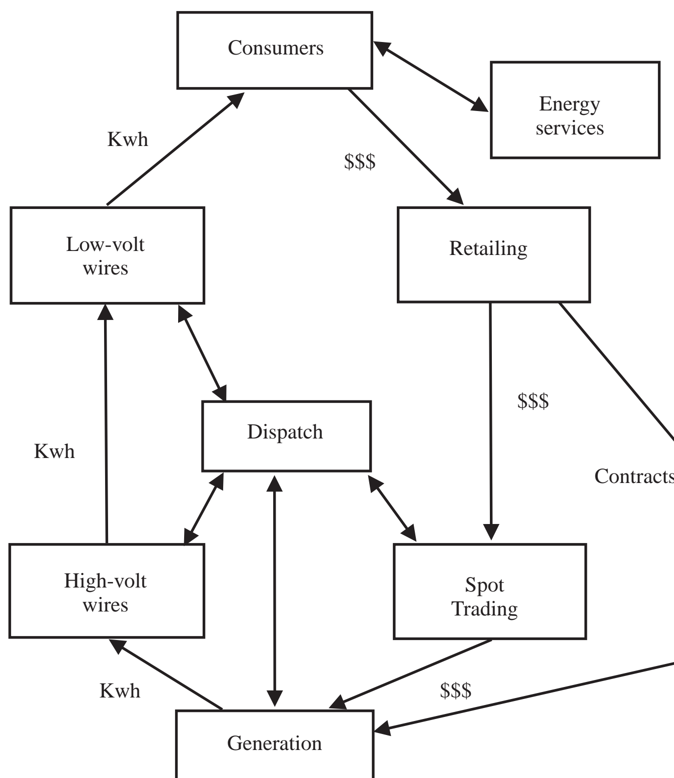
Box 2. **Telecommunications Services in Europe: A Summary**

| | **Main Points of Discussion** |
|---|---|
| *A. Key policy initiatives for liberalisation at the EU level* | 1. The Commission's 1987 Green paper initiated the process of establishing a competitive European common market in the telecoms sector, followed by Council directives in:<br>• June 1990 to ensure "Open Network Provision (ONP)" framework and harmonisation measures (technical interfaces and tariff principles); and<br>• June 1992 to ensure interconnection between leased lines and public networks.<br>2. The date for full liberalisation was set at 1 January 1998 with respect to the supply of both services and infrastructure (Council Resolution July 1993 and December 1994).<br>3. 1996 Council Directive (new initiatives):<br>• Introducing "one-stop shopping" to simplify business procedures.<br>• Defining "rights and obligations with respect to interconnection of networks" to ensure competition at the EU level (1997).<br>• Rebalancing a tariff structure by taking into account the need to secure universal service obligations (USOs). |
| *B. Assessing the impact of liberalisation* | 1. There has been a significant drop in the price of telecoms equipment in Europe over time (in real terms) and in comparison with world market prices.<br>2. Major restructuring has occurred through cross-border M&As worldwide and within Europe.<br>3. Declining market shares of incumbent operators, although still dominant, occurred in all fixed-call service segments in most member states, notably long-distance and international calls.<br>4. Tariffs for local calls remain stable but still higher than those in the US and Japan. There were substantial reductions for long-distance and international calls. |
| *C. Current state of play* | 1. The EC proposed the latest reform package in July 2000. It covers such regulatory issues as *i)* a common regulatory framework for all communication networks and services (telecoms, broadcasting and information technology); *ii)* dominance of SMP operators; *iii)* a new system of issuing licenses; *iv)* mobile number portability; and *v)* revising the scope of USOs. |

## Electricity Services

The electricity industry includes the several stages of the electricity supply chain: generation, spot trading, dispatching, high-voltage transport, low-voltage transport and retailing[39] (Figure 2). The industry is characterised by long-lived, capital-intensive specific assets and by high transaction costs.

Figure 2. **The Basic Elements of Electricity**




*Source:* Ruff(1994)

The particularities of the electricity market stem from its physical constraints. Electricity is mostly non-storable[40], and transmission is almost instantaneous, requiring the electric network operator to achieve a constant balance between supply and demand. Generation and transmission are closely tied; they share economies of scope in investment and operation. There is a need for technical co-ordination and provision of ancillary services at the scale of the entire network, in order to avoid network

breakdowns such as blackouts, brownouts, etc. The second implication of these physical constraints is that economy exchanges must be reconciled with non-appropriable costs of transport and need to be integrated with physical dispatch. To summarise, the transmission constraints result in the need for co-ordination (dispatching) and also for organising economy exchanges between generation and retailing, in addition to the mere transportation of electricity. The three functions (transportation, dispatching, trading) exhibit natural-monopoly characteristics. The nature of the network also implies dealing with such issues as potential free-riding and network externalities.

Vertical and horizontal integration as well as public ownership were standard in almost every country until 15 years ago, and integrated utilities were associated with the objectives of universal and public services, characterised by a high level of security, service and reliability. Vertical integration ensures that co-ordination and balancing between generation and transmission are efficiently achieved.

Why then liberalise?[41] Because from an economic point of view, not all segments of the industry are natural monopolies, and one consequence of vertical integration is to extend monopoly inefficiency to the whole supply chain. Generation is potentially competitive, since it is characterised by limited economies of scale, which can now be achieved over relatively small geographic areas.

Liberalisation entails several dimensions, such as regulation, privatisation and restructuring. The necessity of some form of regulation deserves particular emphasis. As opposed to the telecommunications sector, where monopoly elements have been eroded because of technological advances, electricity will retain a permanent element of regulation[42].

While this may sound like a simple and straightforward approach, liberalisation of the electricity industry is in fact incredibly complex[43] and still at an early stage. The general prescription for liberalisation rests on the so-called "standard model", i.e. separation of generation and transmission, private ownership, competition in generation and in the retail market, non-discrimination and transparency of access to transmission and distribution, as well as independence of the regulator (Littlechild, 2001 and Joskow, 1996).

### *The Framework of Liberalisation in the EU*

Energy services were not originally included in the 1985 EC White paper (COM/85/314). After initial proposals for a common market in 1988, the first truly major initiative towards the establishment of the Internal Energy Market (IEM) took place following a painstaking nine-year process. The European electricity directive 92/96/EC was adopted on 19 December 1996 and implementation started two months later[44]. The directive established a common approach in five major areas: competition in generation, unbundling of generation and transmission, rules for opening of access to networks in order to give the final consumer freedom to choose between suppliers, the establishment of an independent regulator and the provision of public services. It

foresaw a gradual opening of the retail market in three steps, starting on 19 February 1999 with final consumers whose annual consumption exceeds 40 GWh (26 per cent of the market). At the second stage, beginning on 19 February 2000, the threshold was lowered to 20 GWh (28 per cent). At the third stage, from 19 February 2003 onwards, it drops further to 9 GWh (33 per cent), before the next major step towards liberalisation in 2005. The directive also allows member states to choose freely the eligible customers benefiting from the opening, provided that all those above 100 GWh are included. The directive thus provides for vertical unbundling of generation, transmission and distribution, however limited this may be in terms of the need to separate and publish accounts for the three activities to avoid cross-subsidisation and the extension of monopoly powers to potentially competitive areas.

Access to the transmission and distribution networks is the central element of the directive (Art. 16-22). The choice between three modalities of access is offered: negotiated third-party access (nTPA), regulated third-party access (rTPA) and the single-buyer procedure. Under the nTPA regime, access to the network is negotiated, subject to a dispute settlement procedure managed by a competent authority. For the sake of transparency, indicative average prices shall be published. Under rTPA, the right of access is priced, according to a pre-published tariff. This system is considered the most liberal, because it guarantees the absence of discrimination on the basis of tariffs. Finally, the single-buyer option allows for a single entity to manage the transmission system and/or the centralised purchasing and selling of electricity. Obligations for this option are the publication of non-discriminatory tariffs, the purchase of electricity at sale price minus the cost of using the network and a profit margin[45] and the separation of activities. The transmission system operator (TSO) is bound to use an appropriate method of regulation, control and transparency and will seek to avoid any abuse of dominant position[46].

To deal with differences in the degree of liberalisation across countries, the directive authorises a departure from the principle of equal treatment by instituting the reciprocity clause (Art. 19.5). This clause functions as a safeguard, as it has to be transitory and progressive. It allows a member state that is more open than the European average to refuse access to its customers' market to another member state that is not offering the same conditions of liberalisation[47]. Another safeguard is provided in the form of transitional regimes (Art. 24), in order to take into account the issue of "stranded costs"[48].

Moreover, the directive addresses issues related to public services provisions (Art. 3). Three major areas of concern are security of supply, universal service (regularity and quality) and environmental considerations. Most of these obligations are "grand-fathered" from historical regulations in the member states. Therefore, the directive allows a wide margin of discretion in their definitions under the general principle that they be "clearly defined, transparent, non-discriminatory, verifiable and published"[49]. Tariffs may be regulated to that effect. Finally, the directive does not touch on dispatch or balancing in the network, which are left entirely to member states' initiatives.

### *Completing the IEM: Connecting European Networks*

The Lisbon Council in March 2000 agreed to speed up liberalisation in the electricity market and endorsed ambitious Commission proposals[50]. The Council first considered the issue of interconnection and cross-border flows between the 15 national networks, then decided to amend the 1996 directive and set new targets for liberalisation in the so-called "acceleration directive". Its conclusions were quite remarkable, and certainly went beyond the real desire for liberalisation of some member states (*The Economist*, 29 March 2001). The proposal to amend the electricity directive aimed principally at removing its most illiberal provisions. First, rTPA would become the only option. Second, unbundling requirements would be strengthened with legal unbundling of generation and transmission (although no constraints were specified on ownership). Third, establishing an independent regulator setting *ex ante* tariffs and reporting regularly to the Commission would be required. Finally, the goal of opening 100 per cent of retailing by 2005 was added.

Interconnection of national grids had largely been left out of the 1996 directive[51]. Inefficient interconnection reduces the choice of suppliers in other member states. These inefficiencies are characterised by differences in access tariffs across countries, severe bottleneck problems, different pricing policies and "pancaking" of tariffs[52]. The new regulation aims at harmonisation between member states regarding congestion pricing and capacity allocation.

Because of strong opposition from member states, the Stockholm Council of March 2001 failed to reach an agreement over the steps initiated at Lisbon. As a result, the Commission has since pursued a less ambitious strategy (Buchan, 2001) focussing on two aspects: making the implementation of the directive effective and regulating cross-border exchanges. The Stockholm Council concluded that "…the creation of an effectively internal market in services is one of Europe's highest priorities…and…must go hand in hand with a framework for developing effective cross-border markets supported by adequate infrastructure capacity"[53].

The Barcelona Council of March 2002 reached a compromise to liberalise non-household electricity supply by 2004. France opposed the original plan of full liberalisation by 2005. Germany's opposition to the establishment of an independent regulator resulted in a moot resolution calling for a "regulatory function" aiming at controlling tariffs. Finally, member states agreed to improve interconnection levels to at least 10 per cent of installed capacity by 2005. The European liberalisation process remains eminently political, and there is still ample opportunity to circumvent and escape liberalisation by using ploys such as public services obligations or interpretation of the details upon which agreement has been reached (*Financial Times*, *Energy Review Supplement*, April 2002). One of the latest developments following the Barcelona Council was the European Energy Council of 4 October 2002 in which France accepted the principle of liberalising the market for non-industrial customers, but no earlier than 2007. France insisted on the importance of public services provisions. (See Box 3 at the end of this discussion of the IEM.)

### *State of Implementation of the IEM*

The first and second annual reviews on the implementation of the internal market (SEC/2001/1957 and SEC/2002/1038) examine the state of market opening in electricity. Overall, liberalisation has made good progress (see Table 8, summarising the current state of implementation as of February 2002). Nonetheless, the last report has raised concern over such problems as a wide variance among member states in terms of the degree of market opening, a high concentration of market power in the generation sector (see Table 9), disparities in access tariffs and insufficient interconnection infrastructure. Some countries also lag behind in transposing the directive into national legislation. For instance, France passed the directive into national law only in February 2000. Designation of the TSO was delayed in Belgium and Ireland, while it has not occurred in Germany.

Achievement of the quantitative target for retail liberalisation varies from 100 per cent in five countries (Austria, Finland, Germany, Sweden and the United Kingdom), to a little above the minimum required by the directive (Denmark, France, Greece, Ireland, Italy and Portugal, all ranging between 30 and 45 per cent). Four countries have not yet committed to full opening (France[54], Greece, Italy and Luxembourg). Since the first report, Belgium, Portugal and the Netherlands have extended the degree of market opening.

Capacity generation is subject to an authorisation procedure in 14 countries[55]. Only Portugal has opted for a mixed system, keeping tendering for the non-eligible market. High degrees of concentration characterise the electricity market in most countries, thereby raising concern over the exercise of market power. The market share of the three biggest generators is over 50 per cent for all countries but Austria, Finland and the United Kingdom.

The level of unbundling remains unsatisfactory as well. Several countries have complied with minimum commitments, opting for the management option[56]. Of the three options of unbundling available (management, legal and ownership), ownership unbundling, the most advanced form, is now implemented in Finland, Greece, Italy, the Netherlands, Spain, Sweden and the United Kingdom. Lack of total independence for the grid operator also causes concern, since it leaves a potential for discrimination in favour of related operators (in generation and supply).

Only Germany has opted for the negotiated third party access (nTPA) scheme. Most member states organise balancing around spot markets defined by the regulator. In Belgium and Luxembourg, balancing is controlled directly by the TSO with no regulation. In France, Italy and Portugal, prices are subject to direct regulation.

There is no uniform structure for transmission tariffs around Europe. Most often, tariffs include a geographical component, either set on a zonal basis (Ireland, Italy, the United Kingdom), or including some distance-based component (France, Germany and the Netherlands). In some countries, tariffs are "postalised", i.e. uniform across the territory. It is important for network tariffs to carry the right incentive for capacity investment.

Table 8. **Implementation of the Electricity Directive, February 2002**

| | Third Party Access | TSO | Refusal of Access | Dispatch Priority | Transmission Charges | Market Opening | Tender/Authorisation | Unbundling of TSO | Supply Unbundling |
|---|---|---|---|---|---|---|---|---|---|
| Austria | rTPA | 3 | K/R | RES | published | 100% | authorisation | legal | accounts |
| Belgium | nTPA (international)/rTPA | 1 | K/R | RES/CHP/Auto | published | 42% | authorisation | legal | - |
| Denmark | rTPA | 2 | K | RES/CHP/Waste | postal | 30% (distrib./wholesale 100%) | authorisation | legal | - |
| Finland | rTPA | 1 | K | - | postal | 100% | authorisation | ownership | accounts |
| France | rTPA | 1 | K/USO | RES | postal | 30.3% (partial distrib.) | tender for RES/authorisation | management | - |
| Germany | nTPA/optional temporary SB (2005) | 6 | K/R | RES/CHP | point tariff | 100% | authorisation | management | accounts |
| Greece | rTPA/SB (islands) | 1 | K | RES/CHP/Lignite | - | 34% (2001) | authorisation/ tender islands | ownership | accounts |
| Ireland | rTPA | 1 | K | RES | postal | 30.3% | authorisation | legal | accounts |
| Italy | SB (franchised mkt.)/rTPA | 1 | K/R | RES/CHP | postal adj. for distance | 35% | authorisation | ownership | legal |
| Luxembourg | rTPA | 1 | K/R | RES/CHP | postal | 57% | authorisation | management | accounts |
| Netherlands | rTPA | 1 | K/R | CHP/small non renewable | postal/point tariff | 33% | authorisation | legal/ownership | legal |
| Portugal | SB (franchised mkt.)/nTPA/rTPA | 1 | T | RES/CHP | postal | 48.9% | tender/ authorisation | legal | - |
| Spain | rTPA | 1 | K/R | RES/CHP | postal | 53% (100% in 2003) | tender/ authorisation | ownership | legal |
| Sweden | rTPA | 1 | - | - | nodal tariff | 100% | authorisation | ownership | legal |
| United Kingdom | rTPA | 4 | T | - | connection fee and zonal charges | 100% | authorisation | ownership | legal |

*Notes:* SB = Single Buyer, K = lack of capacity, R = reciprocity, T = technical constraint, RES = renewable energy resources, CHP = Combination Heat and Power, - = n.a.
*Source:* Eurelectric (2002), http://public.eurelectric.org/

Table 9. **Market Structure of the European Electricity Industry**

| Country | Top Three Generators (Share in per cent) | | Top Three Retailers (Share in per cent) | | Main Retail Supplier Types |
|---|---|---|---|---|---|
| Austria | 45 | | 67 | | Cross-border sales, internal |
| Belgium | 96 | [2] | 53 | | Cross-border sales |
| Denmark | 78 | [2] | 38 | | Cross-border sales, internal |
| Finland | 45 | | 33 | | Cross-border sales, internal |
| France | 92 | [1] | 90+ | [1] | Capacity auctions, cross-border sales |
| Germany | 64 | | 50 | [2] | Internal |
| Greece | 97 | [1] | 100 | [1] | n.a. |
| Ireland | 97 | [1] | 90+ | [1] | Capacity auctions, cross-border sales |
| Italy | 69 | [2] | 72 | [2] | Cross-border sales |
| Netherlands | 59 | | 48 | | Cross-border sales |
| Portugal | 82 | | 99 | [1] | Cross-border sales |
| Spain | 83 | | 94 | | Internal |
| Sweden | 90 | | 47 | | Cross-border sales, internal |
| United Kingdom | 36 | | 42 | | Cross-border sales, internal |

*Note:* The number in brackets indicates the total number of competitors in the market concerned.
*Source:* European Commission Second Benchmarking Report, SEC(2002)1038.

Most but not all countries have appointed an electricity regulation agency. For example, this function is assumed by the telecom regulator in Luxembourg and by the line ministry in France[57], Greece and Spain. On the other hand, Germany has no regulator, since it has chosen to regulate electricity using its competition laws. The German system is plagued by many complaints, which suggests that the setting of tariffs is not satisfactory[58]. As noted by the Commission, the power and independence of regulators vary across countries, from very independent (Italy, the United Kingdom) to confinement to an advisory role in setting tariffs. The procedures for setting access tariffs and conditions are generally *ex ante*, except in Denmark, Finland and Sweden, where they are *ex post* thanks to the unbundling of ownership that rules out discrimination in favour of related suppliers.

Seven member states have invoked the reciprocity clause[59]. In the case of the electricity directive, action has been motivated by political considerations around the EDF monopoly in France. Given the relative speed of electricity liberalisation, the sheer size of EDF and its reliance on mostly nuclear power, some countries feared that France might exploit the openness of other markets to its advantage, while not reciprocating on its closed market (Pelkmans, 2001).

Existing public service obligations were reviewed in detail in the Commission's second benchmarking report. Security of supply currently is not a major concern, as Europe has over-capacity and capacity investment in peripheral areas (Greece, Ireland,

Italy and Spain) is planned. Obligations relating to the provision of a minimum standard of services have been enforced almost everywhere in the EU. In most member states, suppliers must offer similar terms to all groups of customers. Most countries provide minimum levels of service by restricting disconnections[60] and sometimes offering some free supply or special tariffs. Finally, environment-related measures have been widely enforced. All countries have instituted some kind of scheme to promote the use of renewable energy. Energy taxes and green quota systems also find frequent use.

### *Measuring the Effects of Achieved Liberalisation*

Electricity liberalisation is expected to drive down prices for end user customers at the same level of quality. Most European countries saw reductions in nominal electricity prices between 1997 and 2000[61]. Prices for industrial customers have clearly declined since 1995, with spectacular reductions in Germany (Oxera, 2001). Opening markets in Germany led to immediate price competition between the eight regional incumbents (*The Economist*, 11 November 1999). In England and Wales[62], prices have been driven down by 35 per cent since 1999[63]. Prices have risen in some countries, however, which may reveal the incompleteness of their liberalisation processes (Shuttleworth, 2000).

In the wholesale markets, the Commission points out that convergence in prices across member states continued in 2002. On the contrary, European retail prices remain largely dispersed despite fairly similar wholesale conditions, which may reflect varying degrees of market opening, network charges and market power among incumbent utilities (SEC/2002/1038). Europe has prided itself on the absence of big price swings and has successfully avoided problems such as the California crisis. Yet some analysts warn that this should not be construed as an indicator of the superiority of the European regulatory design. Stable demand, a certain degree of over-capacity and the large share of long-term contracts (an indication of the limit of existing power exchanges) have acted as mitigating forces (Newbery, 2002).

Liberalisation also generates allocative effects. The ratio of prices paid by households to those paid by industries has more often than not tended to increase over 1995-2000 (in England and Wales, Greece, and to a lesser extent, Italy and Spain). The recent trend seems to indicate a slight rebalancing in favour of households, however, particularly in countries with 100 per cent retail competition (Germany is the exception) (Oxera, 2001). This suggests that industrial consumers are benefiting disproportionately from the liberalisation. The explanation for this may lie in their direct access to wholesale markets so that they can benefit more directly from competition at the generation level. Yet this lasting discrimination possibly points again towards the exercise of market power rather than to liberalisation measures *per se*, which tend to reduce the wedge between industrial and household prices[64].

Another indicator of competition is the level of consumer switching. For large users, switching or renegotiation reaches high levels in the liberalised markets — 100 per cent in Italy, Sweden and the United Kingdom. At the other end of the spectrum, switching is non-existent in Greece and less than 20 per cent in Belgium, France, Ireland, Luxembourg and Portugal[65]. Logically, these levels are lower for small users still not eligible to select suppliers in ten member states. Countries such as Finland, Germany, Sweden and the United Kingdom have positive levels of switching by (mainly) small consumers, indicating the effective exercise of competition in these markets.

The impact of liberalisation on efficiency and quality is another critical element. Electricity supply has continued without major disruptions. Although the effects of liberalisation on quality still need more careful study[66], the aggregated indicators of continuity of supply, for instance, seem to indicate a satisfactory and generally improving situation. A cross-sectional examination of liberalisation shows that higher utilisation rates and smaller deviations from the optimal reserve margins correlate positively with liberalisation indicators (Steiner, 2001). Another recent study shows that vertical unbundling explains a 6 per cent permanent reduction of costs (Newbery, 2000). The recent demise of British Energy is interpreted by some as a healthy market rationalisation, revealing the non-profitability of nuclear power. This is a direct consequence of the reduction in prices, which has eroded the profitability of electricity utilities (Eurelectric, 2001).

The flows of cross-border investments witness Europe's openness to establishment. In 2001, seven of the ten M&A deals in the world electricity industry were wholly European affairs. As a target for M&A, Europe led both in volume (60 of 115 transactions) and in value (80 per cent of the total)[67]. Experience in the United Kingdom shows that the liberalisation process has proceeded with significant changes in ownership (see Table 10)[68]. Moreover, generation assets dominated in volume, representing half of the transactions for 2000 and 2001 (albeit 25 per cent in value). These developments, however, have raised concern about further concentration in an already oligopolistic industry. It appears that the tendency towards market concentration has not been counter-balanced by significant new entries, which would merit further analysis.

Table 10. **Who Owns Whom in the British Electricity Industry?**

| Company | Parent | Country | Stakeholder |
|---|---|---|---|
| BNFL Magnox generation | British Nuclear Fuels | UK | government |
| British Energy | British Energy | UK | government, publicly quoted |
| East Midlands electricity | Powergen | UK | private |
| Edison Mission Energy | Edison International | USA | private |
| EPN distribution | Electricité de France | FR | government |
| Innogy | Innogy Holding Ltd (RWE) | DE | publicly quoted |
| International Power | International Power | UK | publicly quoted |
| LE Group | Electricité de France | FR | government |
| Manweb | Scottish Power | UK | publicly quoted |
| Midlands Electricity | Aquila Inc. | USA | private |
| National Grid | National Grid | UK | publicly quoted |
| Northern Electric | MidAmerican Energy Holdings Co. / Xcel Energy | USA | private |
| Northern Ireland Electricity | Viridian Group | UK | publicly quoted |
| Npower | Innogy Holding Ltd (RWE)[a] | DE | publicly quoted |
| Npower Yorkshire | Innogy holding Ltd (RWE)[a] | DE | publicly quoted |
| Powergen | Powergen | UK | publicly quoted |
| Scottish and Southern Energy | Scottish and Southern Energy | UK | publicly quoted |
| Scottish Hydro-Electric | Scottish and Southern Energy | UK | publicly quoted |
| Seeboard | American Electric Power Co Inc. | USA | private |
| Southern Electric | Scottish and Southern Energy | UK | publicly quoted |
| Swalec | Scottish and Southern Energy | UK | publicly quoted |
| Sweb supply | Electricité de France | FR | government |
| TXU Europe | TXU | USA | private |
| United Utilities | United Utilities | UK | publicly quoted |
| Western Power Distribution | Mirant Corp. & PP&L Resources | USA | private |
| Yorkshire Electricity Distribution | MidAmerican Energy Holdings Co. with Xcel Energy | USA | private |

*Note:* *a)* completion expected in July 2002.
*Source:* Financial Times, 17/12/2001, Electricity Association "Who Owns Whom in the UK Electricity Industry", May 2002.

### *The Incomplete Electricity Market*

*Institutional Issues.* The 1996 directive remains incomplete despite providing the first sketch for a common regulatory approach and giving a strong impetus for liberalisation. This "uneven, incomplete, complex and gradual" establishment of the IEM results partly from the institutional idiosyncrasies of the European Union (Pelkmans, 2001 and Smeers, 2001). The EU is not endowed with a common energy policy. IEM implementation has been subject to the principle of subsidiarity, which

restricts the domain of intervention of European institutions to areas in which member states would be less well placed to act[69]. This explains why most of the design of the electricity regulatory structure has been left to individual member states. Two examples are sufficient to make this point: the non-prescriptive approach adopted for unbundling and the domestic regulation of wholesale markets, both of which have resulted in wide domestic variations. This European flexibility, by necessity, has led to several real-life experiments, providing many lessons for other countries wishing to liberalise.

One area where Europe has some legitimacy for direct intervention is in cross-border interconnection, allowing the Commission to design new regulations with direct effect on national legislation. Still, the Commission finds it more efficient to have recourse to some *ad hoc* alternatives, such as informal advisory bodies, which offer flexibility and momentum as well as technical expertise[70].

*Competition Policy*. Competition policy plays a central role in electricity liberalisation. While the debate between *ex post* intervention (using antitrust laws) or *ex ante* regulation as a means of introducing competition in the industry has been settled in Europe in favour of the pre-eminence of the latter, the two approaches have been applied in a complementary manner. Given the context of the gradual approach to liberalisation and the transition from government-owned monopolies to competitive markets, competition rules are often found useful in both speeding up and safeguarding the process of liberalisation.

The Commission possesses two potent competition policy instruments to pursue liberalisation. The first is Art. 86.3 of the EC Treaty, which accords the Commission the power to issue directives, thereby bypassing the approval of member states when it has to achieve the objective of the internal market. The Commission very clearly and repeatedly voiced this “menace” before the Barcelona Council[71].

The second instrument is competition rules[72]. Merger control has been instrumental in restructuring by allowing the Commission to order divestitures or obtain specific undertakings from big power players — particularly dominant companies (such as EDF) in countries where liberalisation has been limited — such as in the EDF/EnBW and VEBA/VIAG mergers[73]. A second important role for competition rules is in policing state aid, which is a central problem given the rising necessity to compensate companies for stranded costs. The Commission has examined numerous aid schemes and issued principles for dealing with stranded costs[74]. France has been under recent scrutiny for aid schemes[75]. Third, the Commission has supervised state behaviour, first when special or exclusive rights are granted (which touches on the issue of public services) and second when freedom of establishment is impeded, notably through the recourse to golden shares (Schaub, 2002). Last but not least, classical Art. 82 of the EC Treaty (competition law) has been evoked to deter abusive conduct by dominant power companies, in particular exclusionary behaviour and exploitative conduct such as customer “lock-in” by exclusive long-term contracts. This particularly concerns network operators, forcing them to use non-discriminatory and cost-reflective tariff policies and contractual obligations.

*Issues in the Actual Regulation of Electricity Markets*. Defective regulation and the lack of contestability of wholesale markets may favour the exercise of market power even in the most liberalised markets[76]. Several non-mutually exclusive solutions exist. For instance, Italy and the United Kingdom have started to address the issue by imposing divestiture of generation capacity. Norway and Sweden (with Finland), and Spain and Portugal have opted for a bolder option of expanding the geographical market beyond their borders. Overall, the most favoured option has been to create wholesale spot markets. In any event, the regulation of these markets is key.

Regulatory failure is undoubtedly a matter of serious concern since the California crisis. The EU is here faced with a double challenge. First, because of the degrees of concentration of generation in many markets, positions of dominance may arise in the short run. In some instances, even modestly sized generators can exert significant market power by offering only marginal capacity. Market power is not solved only by regulating the natural-monopoly segment of the industry, but also by checking the generation segment, an aspect of regulation that the EU has neglected in the belief that regulating wholesale and retail markets would be enough to guarantee competition. *Ex ante* competition enforcement powers for the generation sector (such as licensing systems), information requirements and licensing rules have been overlooked, leaving scope for the abuse of market power (Newbery, 2002). *Ex ante* competition rules are viewed as more efficient than *ex post* scrutiny, which is too legalistic and penalty based (therefore less flexible) than would be a system of licenses, adjustable if needed. On a less technical note, useful lessons could be drawn from the variety of European experiences[77] (a benefit of the flexible European approach).

Second, contestability, which is guaranteed by free entry in the competitive segments of the industry and interconnection of the networks, is crucial in promoting competition and eroding potential market power. Regarding the latter, creating a single wholesale market would be the most desirable solution in theory (Klein, 1996), but, there are obvious trade-offs between the complexity of the whole system and its regulatory design on the one hand and redundancy in generation and transmission capacity on the other. Arguably for Europe, the short-term solution would be to increase capacity in transmission rapidly even though defining the appropriate level of interconnection is almost intractable (Newbery, 2002). This requires international co-ordination too, because the added transmission capacity is a public good whose costs must be shared and regulatory systems must be compatible. The objective remains to achieve by 2005 interconnection capacity equivalent to at least 10 per cent of available generation capacity.

The European market benefits from already high levels of interconnection compared with other regions of the world. The infrastructure for cross-border exchanges is not sufficient, however[78], and it suffers from several serious capacity constraints as well as a lack of interconnection with some isolated zones. The current network can be seen as a hub involving Austria, Belgium, France, Germany, Luxembourg, the Netherlands and Switzerland, with six spokes (Greece, the Iberian Peninsula, Ireland,

Italy, Scandinavia and the United Kingdom)[79]. Congestion is acute for Italy, the Netherlands, Portugal, Spain and the United Kingdom, where import capacity is used at its maximum. Different tariff structures and different methods of allocation of the limited capacity[80] have added to the distortions.

For the medium term, the Commission has proposed new regulations for cross-border trade in electricity[81]. Areas for immediate action have been identified as well: revision of the Florence guidelines on interconnection by April 2002 and a proposal by the TSO of minimum requirements to be adopted under the draft regulation; implementation of the existing guidelines; and adoption of technical measures to increase interconnection capacity. The Commission has also proposed, before the regulation comes into effect, a temporary and uniform cross-border tariff system by 2003. At the eighth meeting of the Florence Regulatory Forum, it was agreed to put in place a one-year provisional system, starting on 1 March 2002.

### *Lessons from European Liberalisation: Electricity Services in the International Context*

Liberalisation of electricity markets in Europe is now conducted under a dual and complementary process of both domestic and external liberalisation. It faces two major challenges: implementing efficient and competitive wholesale markets and ensuring international arbitrage between the segments of the IEM. International liberalisation therefore matters.

The status of electricity under the GATT is not firmly established, since it was originally considered as outside the GATT's scope (exceptions under Articles XX(g) and XXI) (WTO, 1998*a*). Electricity is present only tangentially in the GATS sectoral classification, with explicit reference to energy in only three sub-sectors (GATT, 1991). WTO members still do not agree over the desirability of classifying energy services under a specific entry or under several horizontal sectors. Even the separation between generation, which would fall under the scope of the GATT, and transportation and distribution, which would come within the scope of the GATS, is not straightforward from an economic point of view. Identifying such a thing as electricity services may be impossible, since "there is no separate transmission service in the integrated locational energy market and hence there is no separate price for such a service" (Ruff, 1994). This lies at the core of the disagreement between the EU and the United States on the definition of energy services (WTO, 2000*a* and 2001*b*).

The eventual break-up of the electricity sector under the GATT and GATS rules may result in an unbalanced approach to the application of multilateral trade rules to the sector. The GATT does not address the issue of establishment, which is problematic as regards generation. It does not include competition issues either, whereas the GATS Article XVIII provides for additional disciplines on restrictive business practices. This has been used in the separate reference paper on basic

telecommunications, "which includes rules on transparency, use of market power, interconnection, independent regulator and universal services". WTO states that "GATS also present[s] the interest of having binding rules on monopolies and exclusive service suppliers" (WTO, 1998*a*, paras. 39 and 44).

The above issues illustrate that one cannot expect as much from less integrated international agreements as under the aegis of the European Community. Regional agreements seem well suited to address issues related to cross-border delivery. Because of the externalities and public-good characteristics of trade in electricity, exchanges cannot take place without close co-ordination between regional trade partners. Multilateral efforts can provide examples of good practice and criteria to be met before undertaking reforms, however, as well as credibility and a focal point for reforms.

The European experience indicates that international co-operation for network interconnection is probably a first accessible goal. Interconnection would be important for countries with small markets or little diversified generation, as international trade liberalisation for electricity will help increase the generation mix (for instance, European interconnections with France allow supply of nuclear electricity), and thus increase security of supply. Because immediate externalities are created on the network when electricity is imported, common principles for capacity allocation and congestion management have to be decided, and additional levies at the interconnection level must reflect these constraints. The principle here is to rule out the most illiberal forms of import and export taxation, such as non-transaction based pricing (for interconnection). Other principles, such as cost-reflectiveness for congestion management and "postal" tarification for transit trade, also seem advisable. Unbundling of interconnection management is also possible.

Another lesson from the European experience concerns, as stated earlier, the importance of competition rules, which have acted both as safeguards against the capture of the liberalisation process and as an incentive mechanism for parties slow to agree with liberalisation. Competition cannot replace regulation, but it presents the obvious advantages of versatility and usefulness for other service sector liberalisation.

These prescriptions may run the risk of over-simplification. Parallels are often drawn with telecommunications liberalisation. While it is certainly interesting to examine the institutional mechanisms that have been used, which may hold some lessons for electricity liberalisation, one should be cautious in adopting simple "copycat" solutions. The electricity sector does not face the same economic pressures for liberalisation from competing network services (IT and broadcasting) as telecommunications. Therefore, the telecommunications experience is not directly transferable to the electricity sector (Shuttleworth, 2000).

Box 3. **Electricity Services in Europe: Summary**

| | **Main Points of Discussion** |
|---|---|
| *A. Key policy initiatives for liberalisation at the EU level* | 1. The 1996 European electricity directive aims at establishing a common approach in five main areas:<br>• Competition in generation;<br>• Unbundling of generation and transmission;<br>• Rules for opening up access to infrastructure networks;<br>• Creation of an independent regulator; and<br>• Public service provisions (security of supply, universal service obligations and environmental considerations).<br>2. Completing the Internal Electricity Market (IEM):<br>• EC proposals to the Lisbon Council (March 2000) with a view to speeding up the liberalisation process: amendment of the electricity directive provisions and regulation on inter-connection.<br>• A political failure of the Stockholm Council (March 2001) to reach an agreement over the liberalisation steps envisaged at Lisbon.<br>• A compromise reached at the Barcelona Council (March 2002) to liberalise non-household electricity supply by 2004. No final decision on independent regulator. |
| *B. Assessing the impact of liberalisation* | 1. Price reductions are generally steeper in more deregulated markets, with some convergence in wholesale prices across member states.<br>2. Industrial consumers tend to benefit disproportionately from the process of liberalisation.<br>3. The level of consumer switching is higher in more liberalised markets.<br>4. The liberalisation process, such as in the United Kingdom, has led to significant changes in ownership structure through cross-border direct investments and M&As. |
| *C. Current state of play* | 1. Liberalisation has been advanced beyond the required minimum level, but there is a danger in the incompleteness of the approach in several key areas, such as interconnection of the networks, privatisation and market power issues.<br>2. There is a wide variance among countries with respect to the degree of market opening.<br>3. Insufficient unbundling between generation and transmission.<br>4. The lack of interconnection of the networks serves as a significant hurdle to the completion of the IEM.<br>5. Lack of transparency and very high tariffs for network access. |

**Postal Services**

Postal services are neither transport services nor communication services, although the two interact heavily with each other in postal systems. Postal services may best be characterised by physical delivery (Campbell, 1999), and postal delivery can be broken down into several distinct activities: collection, outward sorting, transportation, inward sorting and delivery. Final delivery accounts for 60-80 per cent of total costs[82]. A rather wide consensus holds that most potential economies of scale and scope are found here[83]. Unlike in other network activities, sunk costs have less importance in the postal sector, where the investment is essentially in vehicles, buildings and sorting equipment. In another specificity of postal services, each piece of mail is unique and therefore can not be stocked to facilitate optimisation of the transport network. Furthermore, relatively few businesses generate a significant portion of the mail. They are likely to be the biggest beneficiaries of economies of scale, as they tend to send mail to a large portion of the population in all geographic areas[84]. Finally, parcel services, express mail and mailbox advertising relate closely to mail delivery, with possible economies of scope.

Liberalisation and privatisation of postal services did not emerge on the reform agenda in Europe until very recently. The need for introducing competition into postal services has increased as a result of several external pressures (Biggar, 2001). First, new forms of communication, particularly fax and e-mail but also internet (which competes with direct mail[85]), have changed the natural-monopoly paradigm[86]. Second, impetus has arisen from liberalisation moves in other network industries and from attempts by the European Commission to complete the missing pieces of the internal market. Third, thriving competition in the open segments of the postal sector (i.e. express mail, parcel delivery and financial services) has led to the claim that incumbent postal operators use their reserved markets to launch predatory behaviour in the competitive markets. Finally, postal operators by themselves have started to move out of their traditional product boundaries[87].

More than any other commercial activities run by public entities, postal services associate very closely with the notion of USOs. They are viewed as an essential element of the so-called core services that contribute to social cohesion and well-being of European nations. The provision of universal service is a major difference between public postal services and other delivery services. Regulation in the postal sector therefore faces two different and conflicting objectives: the demand for universal service and the need to introduce competition in vertically integrated monopolies. Redistribution concerns motivate meeting the first objective. This political-economy dimension must also take into account that postal providers are big employers. The competition objective is driven by efficiency motives, and competition is expected to bring economic benefits for the society as a whole.

### *Overview of the Liberalisation Process in Europe*

Postal services were not part of the initial plan for the single market[88]. Postal liberalisation was among the last to be initiated, in 1991, when the Council of Ministers requested the EC to start designing a single market for postal services. After issuing a Green paper (COM/91/476 final) and a communication (COM/93/247 final) on the guidelines for the development of postal services in which the strategy for liberalisation was sketched, the Council enjoined the Commission in February 1994 to propose legislation to implement a Community policy on postal services (OJEC48/2, 16/2/94).

The Council adopted the postal directive in December 1997, with entry into force on 10 February 1998[89]. The Commission simultaneously adopted a notice on the application of competition rules to the postal sector[90]. The 1997 directive sets the framework for the first stage of liberalisation, due for completion by the end of 2004 (Table 11). It provides for rules of separation of reserved and competitive activities by opening 3 per cent of the market: express special mail and letters above 350g, provided that the tariff does not exceed five times the standard basic tariff for first class mail (Art. 7). This separation foresees gradual liberalisation by progressively reducing the boundaries of the reserved sector. Principles for the governing/licensing of the competitive sector are set (Art. 9), with the appointment of an independent regulator (Art. 22) and the separation of accounts between the reserved and the competitive sector (Art. 14). The directive establishes a timetable for further liberalisation (Art. 7.3). The European Parliament and the Council were to decide before 1 January 2000 on "gradual and controlled liberalisation…in particular with a view to the liberalisation of cross-border and direct mail as well as on a further review of the price and weight limits, with effect from 1 January 2003".

A central element of the regulation concerns universal service, defined (Art. 3) as the "…permanent provision of a postal service of specified quality at all points in their territory at affordable prices for all users". Postal services include mail and cross-border mail up to 2kg and packages up to 10kg. Permanent service is door-to-door delivery every working day and a minimum density of points of contact (post offices, boxes, etc.) taking account of users' needs[91]. This last requirement is subject to the qualification that it will not apply in "exceptional circumstances or geographical conditions", which in effect voids the provision (Rawsley and Lazar, 1999). Prices are governed by the principles of affordability, non-discrimination, transparency and cost reflection (Art. 12). The directive defines minimum standards of quality for national (Art. 16) and intra-Community cross-border mail services (Art. 18). Provisions for alternative methods ensure USOs: member states can set up compensation funds (Art. 9.4), or resort to licensing (Art. 9). Art. 4 mandates notifying the names of the Universal Service Providers (USPs) in charge of the USOs.

The second step of the liberalisation process, initially planned to start as early as 31 December 1998, was delayed before being put back on track by the Lisbon Council of March 2000. The Commission adopted in May 2000 a proposal to amend the 1997 postal directive, and the Council finally approved further liberalisation on

7 May 2002, although several key aspects of the Commission's initial proposal were watered down. Illustrative of the compromise reached by the Council, the most important measure is a reduction on 1 January 2003 of the maximum limits for the reserved area to 100g and three times the basic standard tariff for ordinary domestic mail and outgoing cross-border mail. The reserved area will be further reduced in 2006 to 50g and 2.5 times the basic rate. The weight limits for direct mail and inward cross-border mail remain unchanged.

Table 11. **Current State of Liberalisation of Postal Services in the European Union**

| Country | Letter Monopoly | Direct Mail | Outgoing International Mail |
|---|---|---|---|
| Directive 97/67/EC | Up to 350g and five times basic tariff | Up to 350g and five times basic tariff | Up to 350g and five times basic tariff |
| Austria | | 100% liberalised | *de facto* liberalised |
| Belgium | | | *de facto* liberalised |
| Denmark | Up to 250g and five times basic tariff | Up to 250g and five times basic tariff | 100% liberalised |
| Finland | 100% liberalised | 100% liberalised | 100% liberalised |
| France | | | *de facto* liberalised |
| Germany | Up to 200g and 5 times basic tariff, including catalogues | Up to 50g | Up to 200g and five times basic tariff (*de facto* liberalised) |
| Greece | | | *de facto* liberalisation under EC proceeding |
| Ireland | | | *de facto* liberalised |
| Italy | | | |
| Luxembourg | | | *de facto* liberalised |
| Netherlands | Up to 100g and three times basic tariff | 100% liberalised | 100% liberalised |
| Portugal | | | |
| Spain | Local mail delivery and inter-city mail | 100% liberalised | *de facto* liberalisation under EC proceeding |
| Sweden | 100% liberalised | 100% liberalised | 100% liberalised |
| United Kingdom | Up to 350g and £1 | Up to 350g and £1 (to be 100% liberalised in April 2002) | 100% liberalised |

*Note:* Blank spaces indicate that no liberalisation measures other than the one provided by the directive have been taken.
*Source:* AICES (2001).

The principle of total opening for outgoing cross-border mail to full competition (price limit and maximum weight would be abolished) is affirmed, with the possibility for member states to continue to reserve these services for the USOs. Inward cross-border mail is not further liberalised, however, because the Commission fears that bulk domestic mail might then be posted from abroad. This practice is called "re-mail": a sender in a country where tariffs are not competitive enough will arrange to have its mail posted from abroad either for a domestic or an international destination[92].

An important issue in the amended directive is the non-resolved status of express services, for which proposed amendments to clarify the distinction between standard and express mails were finally rejected. The original proposal, aimed at narrowing the scope of the reserved area to standard mail services (in other words, excluding express services), was not retained[93].

The timetable for the next liberalisation measures has been significantly altered from the initial proposal. Instead of starting the implementation on 1 January 2007, the current draft says only that the Commission will conduct a study in 2006 to assess by 2009 whether full liberalisation or an additional step should be undertaken. Therefore, the final date for full liberalisation has yet to be decided upon. Two further changes in the new directive are the preparation of a report every two years on the state of implementation of the directive and the greater power granted to the National Regulation Authorities with regard to USOs.

These new liberalisation measures open an estimated 20 per cent, in revenue terms, of the existing reserved sector. Fifty per cent of the revenues of the USPs will remain reserved (compared with 70 per cent today). The Commission acknowledges, however, that competitors will be able to capture only a very small share of the newly opened segments, as the USPs are expected to retain 80-90 per cent of them.

***Current Efforts and Results of Liberalisation across Europe***

It is widely agreed that the first liberalisation step under the 1997 directive resulted largely from a compromise to preserve the existing public monopolies to a large extent. The existing directive, while providing a harmonised framework, has not provided much if any competition in the market[94]. The rationale that supported the persistence of statutory monopolies, that they are necessary to ensure the provision of indispensable universal service, remains in the actual approach to liberalisation; the reserved areas are believed to be crucial to the provision of universal service.

The process of liberalisation in the postal sector can be seen as the introduction of competition with safeguard measures to guarantee the provision of universal service (Postcomm, 2001). As a result, consensus is far from established on which approach to choose, and member states indeed have taken different paths. When addressing liberalisation, several aspects need consideration. The first relates to the issue of ownership. The second is about what to regulate. The underlying question is, what is the desirable regulatory regime?

*Ownership*. For historical and institutional reasons, the European directive is silent on the question of ownership. In the absence of a common framework, member states have chosen different options. The Netherlands has gone the farthest on the road to privatisation. The government retains a minority share of 34.9 per cent of the capital of TPG but keeps a golden share. In Germany, the government holds a 69 per cent stake in Deutsche Post A.G. (DPAG) (after partial privatisation in

November, 2000). In the other European reformers, postal operators remain in government hands (Norway, Sweden and the United Kingdom). In the last two, however, the public operators have been converted into limited liability companies, Posten A.B. and Consignia plc[95]. It appears that the importance of economies of scope has affected the way of thinking in the transition from public to private ownership. This is indeed exemplified by how divestiture has not been envisaged in any case, which suggests the belief that eventual natural-monopoly issues and the potential threat to competition posed by these vertically integrated operators can be dealt with by relatively light regulation and competition law.

Public status brings about a host of distortions. On the one hand, postal operators benefit from significant advantages in soft budget constraints[96], no need to pay returns on their capital, exemption from value-added[97] and income taxes and shielding from a number of regulatory regimes, such as some parts of competition law. On the other hand, they are constrained in their ability and incentives to raise tariffs (which may be distorted by government), their capacity to raise capital (limited by their statutes, although they may have access to cheap government-backed bonds), the obligation to hire people (sometimes more than they need) with civil-servant status and other regulations imposed by the government (e.g. the use of national carriers for transport).

*Defining the Sector to Regulate*. A second challenge of liberalisation is the identification of the sector to regulate. There is no unique understanding across Europe of what should be regulated. Consensus is limited to the basic concept of USOs, i.e. the provision of reasonable access to regular postal service at an affordable price. This definition contains three elements: regularly scheduled delivery (generally at the customer's residence); universally easy access to the post; and a generally uniform and affordable price for single-piece letter mail (Haldi and Schmidt, 2000). These principles remain vague and provide considerable scope for interpretation when transposed into national regulations. Exact notions of what services should fall under the USOs therefore diverge significantly. Since USOs are essentially redistributive, they are bound to differ from country to country. Harmonisation will be kept at a minimum, and the focus at the European level should be on best-practice principles. As a result, the European directive is relatively unspecific; does not say what products fall under the USOs — although it fixes a weight limit — or require a uniform price (Reay and Rodriguez, 2001).

### *The European Liberalisation: A Difficult Process*

Several conclusions can be drawn (See Box 4 at the end of this discussion as well). First, the European policy is a liberalisation *by default*, narrowing statutory monopoly gradually. Member states confront a double challenge: to redefine the provision of universal service and to place big employers and unions under competitive pressures. Defining the correct size of the reserved area is complex, as the tough negotiations to reach a European compromise proved. While it would probably be

more efficient to arrange the provision of universal service by directly subsidising loss-making activities by competitive firms, one reason why vertically integrated public utilities have been so popular is that they conveniently hide subsidy and redistribution policies that might otherwise be politically costly to implement. It is also notoriously difficult to know precisely the true cost of meeting the USOs (NERA, 1998).

Second, the lack of implementation of the liberalisation provisions in member states challenges the whole process. The Commission has received infringement complaints relating to the implementation of licensing fees and requirements (Greece, Portugal, the United Kingdom), the independence of the regulator (Greece, Italy, Spain) and the re-monopolisation of cross-border mail (Spain)[98]. There are indeed worrying attempts to reverse the liberalisation process, such as the re-monopolisation of direct mail in Italy, or to put it on hold, as in Germany with the postponement of the next stage of liberalisation. Other limits to the liberalisation process will be examined below with regard to competition issues.

### *Effects of Liberalisation*

Evidence to date on the impact of market opening in postal services has been rather limited, given the few countries with significant liberalisation experience. Nonetheless, the impact of liberalisation can be assessed along several dimensions: prices, quality and variety of the services, entry to the sector or cost efficiency. National operators exposed to competition have lost very little market share. In Finland, licensing criteria have prevented entry[99]. The market shares of the Swedish Posten, DPAG (Germany) and TPG (Netherlands) are 94 per cent, 98 per cent and 90 per cent[100]. These figures indicate either incomplete liberalisation (in Germany and the Netherlands the reserved areas still are major sources of regular mail revenues) or more probably (as in Sweden) advantages for incumbents in the form of brand recognition, economies of scope and control over essential facilities such as mailboxes or postcode systems.

This does not mean, however, that entry has not occurred or will not occur. Experience in express mail services shows that opening has contributed to widespread entry in the sector (there are 4 000 operators in the United Kingdom alone) (Postcomm, 2001). Potential candidates for entry appear to be abundant. Express and delivery service operators, other network operators (advertising, newspaper distribution, etc.) and postal operators from foreign countries would certainly have interest in gaining access in new markets. Yet actual evidence of entry is limited. In Sweden, 50 competitors now serve the local delivery market (Senior, 2001).

A widely shared view holds that the European postal market is bound to consolidate with the emergence of three or four "super posts". This view has urged the United Kingdom to start liberalising (Postcomm, 2001). Such market evolution does appear to have taken place. Countries where liberalisation has occurred have seen a significant increase in mergers (Table 12), often involving cross-border deals together with a redefinition of activity domains. Deutsche Post has expanded in parcel

services (through the control of DHL), freight forwarding (by acquiring Danzas and AEI), financial services and e-commerce (Campbell, 2001*c*). TPG has a majority ownership of TNT Express Worldwide. It now intends to sell TNT's international mail services and bargain with Consignia and Singapore Post to strike the deal, and a recent press report reveals that TPG has started to talk with Consignia about a possible merger (*Financial Times*, 1 April 2002). Operators from liberalised markets (TPG and DPAG) are undoubtedly the most active players on the European scene, and DPAG has grown rapidly to become twice as large as La Poste in France.

Table 12. **Postal Merger Activities in Europe, 1998-2002**

| Date | Operators | | Sector |
|---|---|---|---|
| February 2002 | City Courier (NL) | Hermes Versand (DE) | joint control of EP Europost |
| November 2001 | Posten (SWE) | DSV (DK) | joint venture freight |
| November 2000 | Post Office (UK) | TPG (NL) | joint venture w/ SPPL Singapore |
| July 1999 | Deutsche Post (DE) | ASG | Transport / logistics |
| May 1999 | TPG (NL) | Tecnologistica (IT) | Logistics |
| May 1999 | Chronopost (FR) | Correos (SP) | parcels / express |
| February 1999 | TNT (NL) | Jet Service (FR) | express |
| February 1999 | Deutsche Post (DE) | Danzas (BE) | freight / logistics |
| February 1999 | Deutsche Post (DE) | Securicor (UK) | express / parcels |
| February 999 | La Poste (FR) | Denkhaus | parcel |
| July 1998 | Deutsche Post (DE) | DHL | express |
| Withdrawn | Deutsche Post (DE) | trans-o-flex (DE) | parcels / logistics |

*Source*: European Commission, DG Competition.

Even if entry has not occurred on a grand scale, competitive pressure still has had an effect on profits. In Sweden, profits dropped by 9.4 per cent in 1996-2000. Germany's DPAG has also experienced a reduction in profitability since the 1999 liberalisation[101]. On the other hand, Finland's experience confirms that monopoly rents are handsome; Finnish Post, relatively unchallenged, enjoyed 20 per cent growth in profits during the same period (Senior, 2001).

The available evidence suggests a positive relationship between the degree of postal liberalisation and the quality of service. If the percentage of three-day deliveries (which also serves as a criterion for universal service) is applied as a yardstick, the most liberalised countries surpass the 90.7 per cent quality target set by the European Commission. Finland and Sweden exhibit the highest ratios in the EU. The proponents of a more cautious and gradual approach to liberalisation, who argue that competition lowers the quality of service, do not share this assessment[102]. Their view tends to equate quality with gold-plated services, however, and fails to acknowledge that product diversity gets brought to the market, often through product innovation, from tailored services for direct mail in the Netherlands to high-end services (special delivery times) in Germany.

One of the concerns raised by liberalisation is a possible rise in tariffs[103]. Another is that business users might benefit from more competitive prices, whereas consumers would pay higher ones. Evidence on prices is mixed. The price of regular mail in the Netherlands remained stable from 1992 until a rise of five cents in July 2001. Liberalisation has resulted in price increases in Sweden (although price of bulk mail has dropped by a third)[104]. Because the postal directive does not impose tariff uniformity, some countries have abandoned it. In Sweden and to a certain extent the Netherlands, there are separate tariffs for local and regional mail.

One rationale for liberalisation of the competitive segments of public service is the perception that private and competitive management will result in cost efficiencies. While this is hard to demonstrate rigorously, recent assessments of the impact of liberalisation have found a discernible effect of increased efficiencies in the form of the introduction of modern tools (Frontier Economics, 2002, Senior, 2001). Gains in efficiency often mean a reduction in employment. The Swedish operator, for instance, witnessed a significant reduction in its workforce following liberalisation (a 12 per cent decline in 1995-99). Yet in the same period Consignia's employment rose by 16 per cent (Frontier Economics, 2002). Fears regarding employment act as a powerful deterrent to liberalisation initiatives: Consignia, nonetheless, has recently announced that it will shed 30 000 from its workforce (*Financial Times*, 4 April 2002).

### *Challenges and Pressures for Liberalisation of Postal Services*

Postal services are a large employer of a highly unionised workforce. Hence their liberalisation becomes a sensitive labour issue. In the EU, postal services directly employ 1.7 million people (1.2 million in the USPs)[105]. The gradual approach advocated by the EU is justified partly on the grounds that a transitional period is required for the employed work force to prepare for liberalisation.

*Regulation via Competition Laws*. Government monopolies providing services of general interest are authorised by Art. 90(2) of the EC Treaty, which seeks to balance the Community's interests (market integration) against those of member states' (Pelkmans, 2001). In 1993, the *Corbeau* case[106] introduced a necessity test for allowing monopolies on services beyond those of general interest. The assumption behind the test is that such monopolies will be justified by cross-subsidisation needs. One result of the case was to restrict significantly the Art. 90(2) exemption and also to create a channel under competition rules for challenging public-services monopolies. The 1997 postal directive integrated this jurisprudence, notably by defining the maximum scope of universal service, and allowed reserved areas only "to the extent necessary to ensure the maintenance of universal service" (Temple, 1999).

The 1998 Postal Notice outlines the application of competition rules to the sector, while accommodating the continued existence of monopoly rights. The Notice centres on foiling discriminatory access to the postal network[107], unjustified cross-

subsidy deals and application of state aid rules, as well as preventing monopoly positions from being used to distort competition. It also states that "it is appropriate that after a certain period of development, possibly by the year 2000, the Commission should carry out an evaluation of the postal sector with regard to the treaty rules...." (Ungerer, 1998).

European competition laws have been invoked several times in recent years. The Commission has taken two decisions with respect to the postal sector under Art. 86(3) of the EC Treaty. In a decision of December 2000 against Italy[108], it addressed the scope of the national monopoly, as in the *Corbeau* case. It forbade the inclusion of hybrid services in the monopoly. In October 2001 the Commission issued the SNELPD decision[109] in which the French government was found in breach of competition laws for not exercising sufficient monitoring on La Poste activities and the abuse of its dominant position[110]. These decisions signal the clear intention of the Commission to watch closely how the member states define their services of general interest and also how they operate them[111].

The competition laws also police state subsidies to postal services under Articles 87-89. In March 2002, the Commission issued a ruling in relation to measures supporting Poste Italiane[112]. A state aid investigation against Deutsche Post, opened in July 1999, is under review. An investigation was also opened against Belgium in April 2000, and the Court of First Instance has nullified a decision by the Commission that France has not infringed the state aid provisions.

Several competition cases have been concluded against the abuse of dominant position by incumbent operators. In December 2001, the Commission fined the Belgian postal operator, De Post/La Poste, because it used its reserved area position to take the leverage in a related market. In another recent ruling, in March 2001, the Commission found that Deutsche Post was abusing its dominant position by granting fidelity discounts to the mail order industry. This ruling resulted in the divestiture by DPAG of its parcel services. The Commission also now keeps a close eye on how far postal monopolies, especially entrenched ones, should be permitted to acquire other companies operating in the liberalised segments.

A growing area of interventions involves European cross-border exchanges, which are not yet liberalised. For instance, in the International Express Carriers Conference case, it was ruled in September 1998 that a postal monopoly cannot halt multilateral re-mail agreements on terminal dues ("Reims II"), in spite of the alleged claim that they do not cover the cost of delivery. In July 2001, the Deutsche Post II case produced a ruling against the German operator for intercepting and overcharging cross-border mail in an abusive manner. DPAG was fined only a symbolic €1 000, however, because of the legal uncertainty that prevailed at the time of the abuse.

Finally, numerous competition law actions have been undertaken in member states. In Finland, Germany, Italy and the Netherlands, there are several ongoing investigations of the abuse of dominant position by the regulated postal operator[113].

*Cross-Border Mail.* In addition to enforcement of competition laws, a second pressure for liberalisation is the growing demand for opening international mail flows. Opening the borders to incoming cross-border mail would obliterate any effort to maintain reserved areas on the part of incumbent postal operators because of arbitrage. International competition comes in the form of re-mail. The "danger" of opening cross-border incoming mail is acutely perceived, and this explains why the incumbents are so reluctant to allow any international cross-border competition.

Cross-border mail did not become a really important and strategic market until recently. It accounts for only 4 per cent of mail in most industrial countries (Campbell, 2001*a*), and bulk mail — the strategic segment of the market — is carried within domestic borders. International agreements prevented re-mail, purely and simply forbade it, before being reformed in 1994 with a discriminatory scheme of higher terminal dues[114]. The system of terminal dues, non-cost based fees, distorts international exchanges. Cross-border mail is charged for the distribution service provided by the USP in a country of import. The system of terminal dues has evolved from a harmonised fee without regard to origin and destination to a two-tier tariff system in which developing countries are subsidised (lower dues) by developed ones.

The international agreement on re-mail and the system of terminal dues had been relatively unchallenged until the 1988 complaint by the International Express Carriers Conference under EC competition laws[115]. This contributed to initiating reforms[116]. The 1992 Green paper ensued. It proposed to reform intra-European mail by liberalising cross-border and direct mail[117]. Fierce opposition from postal operators and postal unions forced the European Commission to back down on the proposal. In a stretched argument, the Commission dismissed the case on the grounds that postal operators had made arrangements not to apply their agreement[118], while still maintaining that these arrangements were not consistent with competition rules[119]. More importantly, the Commission upheld the right to intercept non-physical re-mail and re-mail destined for domestic delivery[120]. As already noted, liberalisation of cross-border mail was largely watered down in the postal directive.

The cross-border regime for postal services in Europe is now two-tiered, with a gradual but still timid liberalisation between member states on the one hand and the Universal Postal Union (UPU) framework for the remaining international mail on the other[121]. As for terminal dues on intra-European mail, Europe departed from the application of the UPU rules with the REIMS II agreement put in place in October 1997 (although not signed by the Netherlands). Under its last revision[122], REIMS II states that by 2002 terminal dues will be increased to 80 per cent of the basic domestic postal rate[123] and that the anti-re-mail provisions of the UPU convention will cease to apply in the internal market[124]. The agreement also provides for quality targets, which makes a further increase of terminal dues possible. A degree of price flexibility is allowed with the introduction of discounts for, say, various degrees of mail preparation by the sender. Under this system, re-mail can still be prevented, since USPs can retain

the right to charge domestic postal rates[125]. The Reims II agreement has benefited from the 1999 exemption by the DG Competition which was due to expire on 31 December 2001. The parties filed a new notification of the agreement in June 2001. Meanwhile, they also have signed a supplementary agreement, amending REIMS II, for an extension of the transitional period. The 80 per cent target will now be reached only in 2004[126].

The REIMS II terminal dues system is far from desirable as an incentive-based access pricing scheme. Dues are not cost-based and are set at levels that seem too high. Nonetheless, the European framework could serve as a good basis for rethinking the design of economically efficient third-party access pricing, a design which could be replicated at the domestic level for liberalising the postal sector beyond the reserved area approach. The reality seems more prosaic, however. It is the desire to protect the residual monopolies from international competition.

*GATS and Postal Services*. The existing framework (European and UPU) governing cross-border mail is not compatible with international trade rules. Terminal dues and re-mailing provisions contradict the WTO's most-favoured-nation (MFN) principle[127], although no single country has cared to take an exemption to the MFN clause in the GATS commitments (Sinclair, 2001).

In the absence of comprehensive agreements on most postal and delivery services under the GATS (although commitments have been made in adjacent markets such as courier services), the very illiberal UPU framework remains the only international agreement on exchanges of postal services. Multilateral liberalisation of postal services would benefit from inclusion in the GATS, but there is sharp disagreement on what postal services should be covered by GATS negotiations and how much liberalisation should be allowed in this sector[128]. Despite mounting pressure to redefine and increase the coverage of postal services, countries not willing to liberalise are resisting. One strategic approach taken by the United States is to expand the definition of express services, where there are more opening commitments, at the expense of the less liberal postal services category. The European Communities have taken a conservative approach, arguing for a standstill and urging their member states to reflect the UPU rules in their schedules[129].

European member states face the challenge of meeting the demand for USOs, which is compatible with further liberalisation. Pressures for liberalisation are too great to be resisted. Under the double exigencies of multilateral and regional liberalisation and the drive towards a more complete internal market, it is difficult to see how existing postal monopolies can survive. Europe is slowly coming to grips with this challenge.

Box 4. **Postal Services in Europe: Summary**

| | **Main Points of Discussion** |
|---|---|
| A. *Key policy initiatives for liberalisation at the EU level* | 1. Postal service liberalisation was among the last to be initiated, with the issuing of a Green paper in 1991 and of the EC Communication in 1993 on guidelines for the development of a single market for postal services.<br>2. The postal directive, adopted in December 1997, set out the framework for the first stage of liberalisation of postal services until end-2004:<br>• Separation of competitive and reserved activities.<br>• Definition of USOs in terms of weight of mail and packages.<br>• A timetable for gradual and controlled liberalisation.<br>3. The second stage of liberalisation came with a political agreement in October 2001 regarding the maximum limit of reserved activities in terms of weight and tariffs. The final date for full liberalisation has yet to be decided. |
| B. *Assessing the impact of liberalisation* | 1. Where liberalisation has occurred, a significant increase in M&As has followed, often involving cross-border M&As.<br>2. Liberalisation has brought about greater diversity of products.<br>3. Uniformity of tariffs has already been abandoned in some EU countries (Sweden and the Netherlands). Tariffs vary widely across member states.<br>4. Productivity (letters handled per employee) has significantly increased. |
| C. *Current state of play* | 1. The limited approach at the EU level contrasts with more affirmative initiatives taken by some member states. The EU approach can be described as one in which greater liberalisation is introduced in the competitive segments of the sector, while safeguarding provision of universal services.<br>• Ownership: the approach varies across countries.<br>• USOs: the concept is evolving.<br>• Natural monopoly: the conclusion remains mixed.<br>2. The cross-border regime for postal services in the EU is a two-tier system, with a gradual but still timid liberalisation between Member states and the Universal Postal Union (UPU) framework for the rest of international mail. |

## Transport Services

Traditionally, the transport sector comprises the operations directly related to moving goods and/or passengers, by air, road, rail and sea. A broader definition also incorporates ancillary services, such as handling, storage, travel planning, etc. Whereas the 1957 Treaty of Rome included transport among the sectors for which a common policy could be developed, no common action was undertaken until the beginning of the 1980s. Before 1992 and the adoption of the White paper (COM/92/494) on the future development of the common transport policy, each part of the transport sector was subject to a specific and separate approach. From 1992 on, an integrated approach based on the concept of "sustainable mobility"[130] developed.

Two rationales lie at the origins of the common transport policy. First, given the ambition to create a single European market by 1993, it appeared increasingly unrealistic to achieve free movement of people and goods without liberalising transport, whose object is precisely to enable such exchanges. Liberalisation to improve the quality and effectiveness of transport in Europe became all the more necessary because these activities determine the competitiveness of the whole economy. The internationalisation and "Europeanisation" of the production process further accentuated the need to ensure constant and increasing "flux of stock". Second, the European Court of Justice in 1985 confirmed the traditional application of the competition rules to the transport sector and underlined the absence of common provisions specific to the sector, as envisioned by the treaties[131].

### *The Liberalisation Process*

*Air Transport*. The 1944 Chicago Convention organises international air transport according to a multitude of bilateral agreements between states, based on the principle that each state has full and exclusive sovereignty over the air space above its territory. Until the middle of the 1980s, these principles also determined intra-community air relations. Then, in addition to the general reasons outlined above, the liberalisation of air transport services within the EU gained impetus from the deregulation of air transport in the United States, which completely liberalised its air transport in 1978. Since then the US authorities have exerted increasing pressure on their European partners to follow a similar approach.

The European Community took the first measures in 1987, starting with a regulation extending the competition rules to air transport. The publication of two directives on scheduled-service fares and seat capacity allocation among scheduled carriers between member states followed. These two directives form the first package in the liberalisation of EU air transport. The second package, adopted in 1990, involved three regulations[132]. It contained provisions related to government requirements for fare approval and envisaged further tariff liberalisation. It allowed the designation of several airline companies on specific lines. It also permitted access to the third, the

fourth and — under some conditions — the fifth freedom traffic rights[133] on scheduled flights within the Community. Furthermore, it began the elimination of quota sharing for air passenger transport.

The third and last package foresaw the full liberalisation of EU air transport. It was adopted in reaction to the so-called "open sky" agreements, from 1992 on, between the United States and some member states[134]. The package comprised three directives (EEC/2407, 2408 and 2409/92, all dated 23 July 1992). The first derivative defined the criteria of the licensing system required for providing air transport services across the EC. Any member state can now deliver licenses to any EU national; the operator thus becomes a Community operator.

The second derivative organised the progressive abolition of restrictions on access to intra-community connections by Community operators. The first stage would ensure free access to Community operators from 1 January 1993 to all international connections between EC airports. The liberalisation for cabotage (eighth freedom) also began from this date[135]. Intra-European connections were authorised under the following conditions: they must precede or follow an international flight, and the capacity offered must not exceed half of the international flight capacity. The next stage of free access, which entered into force on 1 January 1996, liberalised European connections for companies established in any member state. Last, since 1 March 1997 total free access is established; in other words, Community conveyors have full freedom to carry out cabotage.

This total liberalisation comes with five safeguard clauses, however, among them the possibility to regulate the allocation of traffic between airport systems[136]. There is also the possibility of imposing USOs, to bring together a competing framework and policies of regional planning. Most often, the universal service obligation translates into requirements of minimum capacity and frequency and regulated tariffs that governments impose on some connections. Once these obligations are published, and if no air carrier applies to provide the connection, the member state can decide to grant an exclusive right to the route to only one operator, to whom it can also grant financial compensation[137].

The third directive supplements the third packet by fully liberalising tariffs for all intra-EU connections. Since 1 January 1993, tariffs applied by companies are free, and member states can no longer refuse them when they present reasonable relationships with costs. Member states also can no longer resort to preliminary authorisation of tariffs, but can only require advance notification 24 hours before their application.

*Road Transport*. Member states long controlled road transport strongly because it was considered strategic and because the overall control of this activity was a means specifically to protect rail transport. Protection of EU road transport was achieved chiefly by bilateral traffic quotas and control of tariff setting. Therefore, the first European provisions for the sector's liberalisation concerned the removal of these restrictions. In 1989, Regulation 4058/89/EEC liberalised rates for the carriage of goods between member states. The system of bilateral authorisation and quotas was

removed in 1992 (Regulation 882/92/EEC, 26 March 1992) and replaced by a five-year renewable Community licence that can be delivered by the member state in which the carrier is established.

A system of mutual recognition of diplomas and qualifications and the harmonisation of access conditions have accompanied these provisions. For access, Community quotas were removed, with admission since subjected to qualitative criteria only (Regulation 96/26/EC, 29 April 1996). Under the new requirements, carriers must comply with only three criteria to enjoy free access to the European market: reputation, financial soundness and professional credentials.

As usual, the liberalisation of cabotage has been introduced very progressively. For goods transport, cabotage was subject to fixed quotas between July 1990 and January 1994. With the adoption of Regulation 3118/93/EC of 25 October 1993, authorisations regularly increased until full liberalisation arrived on 1 July 1998. For passenger transport, cabotage is only partly liberalised, for occasional services or services covered by a contract between the organiser and the carrier, but not for regular services.

*Rail Transport*. Organised in all the member states under public monopolies, railway transport has been in decline for more than 30 years. It accounted for 21 per cent of internal freight in 1970 but carried hardly 8 per cent in 2000. Revitalising this mode of transport became one of the major aims of the common policy. Europe chose to modify the structure of the industry and allow entry of private operators, in three main stages.

The first major European provision on rail transport came in July 1991. The directive (EEC/91/440) aimed at creating the necessary conditions for competition in the sector and at initiating liberalisation through access to the railway infrastructure under certain conditions. It posits as essential principles the management of railway companies without assistance from state budgets; separate accounting for transport operations and infrastructure management; railway companies' debt reduction; and access to the railway infrastructure for international combined-transport services (freight) and for international groupings (passengers). The last two principles introduced only limited liberalisation, because the international combined-transport market is small in the EU and because it required the companies of two member states to provide such service jointly[138].

The second set of significant initiatives was decided in 1995. It concentrated on harmonisation and improvement of market access conditions. The measures introduced common criteria for licensing companies established in the EU (Directive 95/18/EC)[139]. They laid down rules for the capacity allocation of railway infrastructure (Directive 95/19/EC). To this end, the directive required the member states to set up an authority in charge of the path allocation between the operators on an equitable and non-discriminatory basis. It also established general principles of charging for the use of the infrastructure: the tariffs must be market-based, non-discriminatory and fair.

Following a 1996 White paper (COM/96/421) that advocated a greater role for competition to reduce costs, improve service quality and support the development of new products, three directives, known as the "Rail Infrastructure Package" were adopted in 2001 (Directives 2001/12, 13 and 14/EC). They constitute the third stage of liberalisation and initiated an important move towards the EU single market in rail transport, as they improve the effectiveness of the current legislation and organise progressively greater access to the entire European network.

By 15 March 2003 at the latest, European railway companies will have access to international freight transport to a specific network, the Trans European Rail Freight Network (TERFN)[140]. Moreover, access to customers and terminals will be guaranteed, even if they are located outside this network (Directive 2001/12/EC). As from 15 March 2008, the entire European rail network will be opened to international freight service. Finally, from 2010 on, free access to that network will be also assured for passenger transport.

The Rail Infrastructure Package also stipulates that separate accounting for transport operations and infrastructure management is no longer adequate. Separate organisations must carry out these functions. To ensure equitable market access for new operators, essential functions such as capacity allowances, fees for infrastructure use and licensing must be separated from the operation of transport services. The new package also amends the provisions of Directive 95/18/EC and stipulates that a licence obtained in the member state where the company is established will be valid everywhere in the EC (Directive 2001/13/EC). Finally, it lays down principles for capacity allocation and management as well as the tariff structure for the use of the network.

*Water Transport*. Seas and waterways carry over 70 per cent of EU external trade and around 30 per cent of intra-EU trade. Liberalisation in this sector began relatively early; since 1986 the EU has been fully open to all flags for international shipping services (Regulation 4055/86/EEC). This liberalisation has involved relations both between member states and between member states and third countries[141]. The right to provide cabotage within the Community (Regulation 3577/92/EEC), has been progressively[142] opened to all EU operators since 1992. For maritime transport, Regulation 3577/92 of 7 December 1992 established the principle of liberalisation, effective from 1 January 1993 for community operators and vessels registered in the EU. Since 1 January 1999, intra-EU cabotage has been fully open. The only exemption, until 2004, concerns island cabotage in Greece. Regarding inland transport, Regulation 3921/91, which entered into force on 1 January 1995, authorises any carrier established in a member state to do cabotage. The main result of the liberalisation of inland cabotage has been to abolish the "chartering by rotation" system, which prevented companies using these services from choosing their carriers freely[143]. Liberalisation of fluvial transport has been fully established since 1 January 2000.

A policy to reduce the fleet's over-capacity accompanied the liberalisation. The system adopted required a company using a new vessel to discard an equivalent capacity or to make compensation to a special fund. This "old for new" scheme, initiated in 1989, was extended in 1999 to April 2003 (Regulations 11/01/89/EEC and 7/18/99EEC).

Provisions to liberalise contractual relationships and to harmonise the rules of access to the profession accompanied the opening of the sector. First, a 1996 regulation (4055/86/EEC) introduced full freedom to conclude contracts and negotiate tariffs between companies. These requirements were fully implemented in 2000. Second, the eligibility criteria for providing this type of transport were harmonised. Two directives (92/672/EEC of 16/12/91 and 96/50/EEC of 23/7/96) establish the principles of mutual recognition within the EU of the principal required qualifications, diplomas and certificates (in particular the master's certificate) as well as the conditions for obtaining these qualifications.

***Implementation***

Insofar as the creation of the European market did not follow the same sequence or the same logic in the various transport sub-sectors, the degree of liberalisation is not the same in each of them. Opening is far less advanced in rail transport, for example, than in other activities. Compared with the beginning of the 1980s, however, when a multiplicity of national regulations and the heterogeneity of networks crippled realisation of the single market, the transport sector in Europe has since made considerable progress. Generally speaking, implementation is satisfactory, although some failures must be noted (See Box 5 at the end of this discussion).

In rail transport, the state's role sometimes remains significant[144], especially with respect to operators' management autonomy. USOs are not always precisely defined or negotiated. The separation between transport services and infrastructure management has not become a reality everywhere; in some member states companies remain fully integrated (Oudin, 2001). In maritime transport cabotage, the implementation of the regulation with regard to universal services has yet to be realised (COM/2002/203 final).

In air transport, the main implementation difficulty relates to the regulation of market access and more particularly to the safeguard clause on traffic allocation between airports belonging to the same city system. In the various problem cases, the distribution of traffic proposed by the national authorities privileged the principal national carrier — often the public one — disadvantaging other national and/or European operators[145].

***Impact of the Liberalisation***

For air transport, the first assessment of liberalisation realised by the European Commission in 1996 emphasised the beginning of the implementation of the third regulatory package. It stressed that the fundamental structures of the European market had not been challenged. No major conveyor had disappeared, and the penetration of domestic markets by foreign competitors remained modest. To a large extent, the conclusions of the report remain valid today. For instance, the large majority of routes within the Community — more than 90 per cent — remain under monopoly or duopoly. On average, no spectacular reduction of fares has occurred, and price reductions benefited only a limited number of connections.

One should also note some positive effects. First, new companies entered the market, offering broader choice for certain destinations. In 1998, the EU had 164 scheduled community carriers, against 147 in 1995 and 132 in 1993. If market entry and exit indicate the competitive nature of a market, the EU air transport market is more competitive now than in 1993. On average, between 1994 and 1998 there were 25 entries and 17 exits against 16 and 19 in 1993. Second, the number of connections has significantly increased. In January 1993, 488 international routes linked airports within the EU. This increased to 520 in 1996 and almost 540 in 1997. Also, although the proportion remains weak, the number of lines with more than three carriers has trebled from ten (2 per cent of the total) in 1993 to 31 (6 per cent) in 1996. Finally, even if no significant overall tariff reduction has resulted from the liberalisation, passengers have benefited from significant fare discounts on scheduled flights and from a multiplication of special offers. To compete for market share, large companies regularly offer reduced tariffs on certain destinations. Smaller and often younger companies offering fewer destinations and less frequency provide discount tariffs on all their flights. As a consequence, the share of passengers travelling on discount fares reached 71 per cent in 1995. Given that charters' market share lies between 50 per cent and 55 per cent, one can estimate that between 85 per cent and 87 per cent of all passengers benefited from reduced prices.

In maritime transport, the creation of the European single market, particularly the authorisation of coastal traffic, did not give rise to a strong penetration of national markets by the European fleet. Measured by tons transported, national flags still enjoyed in 1999 the vast bulk of the traffic in most member states. The shares were 91 per cent in Italy and Portugal, 89 per cent in Spain and 68 per cent in France and Germany. The non-national European carriers had the most weight in Ireland (71 per cent) and the United Kingdom (33 per cent) (COM/2002/203 final, 24 April 2002). The liberalisation of coastal traffic is recent, however, and a reduction of the costs of the national registers and a modernisation of the fleets accompanied the opening.

The creation of the single market in road freight transport caused two opposing effects. On the one hand, it either triggered or accelerated structural change in the sector. The liberalisation accelerated market entry and increased competition. According to some observers, the answer for larger carriers pointed to logistic chain management and the development of stable long-term relationships with shippers willing to outsource transport activities at European or even global level (Coopers and Lybrand, 1996). Other, smaller companies, concentrating on simple and single transport operations, responded with strong price competition. It resulted in reductions of trans-border costs ranging from 5.2 per cent for a carrier from Spain to 6.2 per cent for one from the Netherlands or Denmark[146]. On the other hand, the harmonisation accompanying liberalisation also involved an increase in costs. The harmonisation of excise duties on diesel fuel was at least partly responsible for the increase of the share of taxes in total costs that ranged from 6.8 per cent in Germany to 11.7 per cent in Spain.

### *Main Issues*

Liberalisation did not generally involve any major reorganisation of the transport sector in the EU. Today, the picture of liberalisation remains somewhat unclear. The European market for transport services is now completely open except for rail transport. Yet the conditions of real competition are not yet fully met, and all the benefits of a liberalised market have not been realised. That the liberalisation effort is relatively recent and in some areas still in the course of implementation explains this to some extent. Moreover, the pace of liberalisation in the various transport activities has not been uniform, and certain barriers to competition still exist.

To implement third-party access to the network, the creation of a single market for *rail transport* requires some technical harmonisation. Because rail transport was long considered a strategic element of economic development, technical standards and organisational requirements became subject to national criteria. As a consequence, many differences still exist among member states, in railway spacing (Spain, Portugal, Finland and Ireland do not share the common standard), control and signalling, electrification systems, lack of interconnection of data processing systems and environmental requirements (particularly noise-level standards).

In *road transport*, national rules on fuel excise duties and annual tax rates for vehicles are not fully harmonised. This biases competition among member states. In *maritime transport*, the main difficulty lies in access to ports and their ancillary services. This market is only partially liberalised and many port operators keep close links with the port authorities and benefit from advantageous conditions for their operations. Vertical integration from port to transport services is frequent. This sometimes causes discriminatory treatment for the use of port infrastructure, which leads to variations in the quality and tariffs of the services rendered. A similar assessment can also be made for airport services.

In *air transport*, the most significant barrier to the full realisation of the single market remains the scarcity of available slots. This accounts for the lack of competition on direct routes. The traditional IATA system for slot allocation, recognised in the EU under Regulation 3976/87/EEC, rests on the recognition of so-called "grandfather rights". It allows a carrier to keep a slot as if it was used during the previous season. Because most European airports are now near their maximum capacity, and the airline companies use these slots more and more as assets, the possibilities for slot redistribution are rare. Frequent Flyer Programmes (FFP) present another major difficulty in air transport. They benefit large companies almost exclusively, because they can offer significant networks of destinations, giving the traveller the greatest scope to accumulate and use FFP points. Small companies offering fewer destinations cannot take advantage of similar systems to lock in customers. As a result, only large companies can attract a greater number of travellers and maintain higher tariffs. In fact, the absence of any spectacular tariff reduction in the EU since liberalisation reveals that competition in the European market is not as complete as it could be.

The absence of a common external policy for the air transport sector also causes certain problems. Extra-EU connections are concluded between states and are based on the nationality of the companies involved. European airlines cannot establish connections with third countries from any departure point in the EU, but only from their own national territories, and thus they cannot compete on the same footing as US companies. The bilateral agreements enable member states to protect the external markets (extra-EU) of their national carriers. Generally, states allocate traffic capacity between the designated companies (of the signatory countries), control tariffs and prevent any real competition from other carriers. These conditions act as a constraint on intra-EU traffic, because a carrier can have an extra-EU connection only from its national territory. This does not offer the same conditions for all European companies and limits competition within the EU market. The nationality requirement also reduces the incentive for M&As, restructuring and the establishment of European companies. Such companies, even if they result from intra-European mergers, would not be able to enjoy connections towards third countries and would lose their traffic rights there.

Differences in realisation of the single market have also resulted in the faster development of certain modes of transport. Road transport accounts for about 45 per cent of European freight and continues to grow, while rail transport accounts for less than 8 per cent and has been losing market share for a long time. In the absence of any significant action to exploit the relative advantage of each mode of transport, this may exacerbate the negative externalities of road transport, which tends to generate such problems as reduced road safety, congestion of networks and pollution.

In September 2001, the Commission's White paper *European Transport Policy: Time to Decide* (COM/2001/0730) put forward several measures within the overall framework of the sustainable development strategy adopted by the European Council at Gothenburg in June 2001. In an effort to re-balance various modes of transport by 2010, this paper aims to control the growth of road and air transport, revitalise rail and promote maritime and inland waterways. It also seeks to increase the integration of various means of transport for freight by increasing the degree of "intermodality" — whereby at least two different modes of transport are integrated to complete a door-to-door service. EU integration and EU enlargement in coming years will make it a priority to establish a true common transport policy.

Box 5. **Transport Services in Europe: Summary**

| | **Main Points of Discussion** |
|---|---|
| A. *Key policy initiatives for liberalisation at the EU level* | 1. Air transport<br>• The first package to liberalise air transport came in 1987 with two directives on scheduled service fares and seat capacity allocation among scheduled carriers between member states.<br>• The second package in 1990 contained three regulations.<br>• The third and last package (from 1992 onwards) to establish full liberalisation in the EU reacted to the "open sky" agreements between the United States and some member states. It established Community operators; total freedom to carry cabotage (March 1997); USOs and financial compensation; and freedom to set tariffs (January 1993).<br>2. Road transport<br>• Progressive liberalisation from a system of bilateral quotas and tariff controls to a community-wide system of regulations based on mutual recognition of diplomas and qualifications and harmonisation of the conditions of market access. Beginning in 1992, community licenses have been issued.<br>• Full liberalisation of goods transport was reached in July 1998. Cabotage operations are partly liberalised for passenger transport.<br>3. Rail transport<br>• The 1991 directive created necessary conditions for competition and initiated the liberalisation process by allowing access to railway infrastructure under certain conditions. It stipulated as essential principles: the management of railway companies without state aid; separate accounting for transport operations and infrastructure management; railway companies' debt reduction; and access to railway infrastructure for international freight and passenger operations.<br>• The 1995 directives introduced the common criteria for licensing companies in the EU (harmonisation) and improved market access conditions by stipulating the rules for capacity allocation of railway infrastructure and market-based, non-discriminatory and fair tariff systems.<br>• The "Rail Infrastructure Package", adopted in 2001, laid down a clear timetable for progressive liberalisation until 2010, when free access to the entire European network is assured for passenger transport (2008 for freight services). A single community license system was also introduced. |

Box 5 (contd.)

| | |
|---|---|
| *B. Assessing the impact of liberalisation* | 1. The conditions of real competition are not yet fully met. There is potential to realise greater benefits from further liberalisation.<br>2. The EU air transport market is more competitive today than in 1993, with greater market entry, better connections and the availability of discount air fares.<br>3. National flag carriers still dominate in maritime transport.<br>4. As for road freight transport, the benefits of greater competition tend to be cancelled out by a higher cost of harmonisation of excise duties on diesel fuel. |
| *C. Current state of play* | 1. The degree and scope of liberalisation vary among various transport activities; e.g. market opening is far less advanced in rail transport than in other transport activities.<br>2. The separation of transport services and infrastructure management has not been realised everywhere.<br>3. Improving implementation and regulation:<br>• The scarcity of available slots, the Frequent Flyer Programmes and the lack of a common external air transport policy all pose major difficulties for European companies, notably smaller ones.<br>• In railway transport, technical standards and organisational and system requirements hamper real competition.<br>• In road transport, fuel duties and vehicle taxes require harmonisation.<br>• Greater use of road freight transport in place of railway services generates such problems as road safety, network congestion and pollution.<br>5. Greater competition is needed in infrastructure services, such as airports and ports.<br>6. The development of inter-modality among various transport services poses a major challenge. |

## Section III. Experiences from Asia: Three Case Studies

This section discusses recent developments in telecommunications, financial services and energy services in three ASEAN countries (Indonesia, Malaysia, Thailand), the Republic of Korea (hereafter, Korea) and the People's Republic of China (hereafter, China), with particular emphasis on their schedules of liberalisation under the GATS. It also presents a brief review of existing quantitative assessments with respect to the first two sectors. For financial services, it focuses on banking and insurance.

### Telecommunications Services

#### *Indonesia*

With a wide territory comprising 13 600 islands and a large population of about 200 million, Indonesia's telecommunications market is one of the world's largest (behind only China and India in Asia) in terms of potential for further development. In 1996, it had about 4 million lines in service with the mainline penetration rate at about 2.1 per 100 inhabitants. The sector experienced rapid growth, however, accompanied by an annual increase of 28 per cent in the number of lines installed between 1992 and 1996.

Indonesia's telecommunications policy falls under the authority of the Ministry of Tourism, Posts and Telecommunications (MTPT). MTPT's powers are broad. It not only regulates competition in the industry but also grants new licenses, sets and controls tariffs for all services and regulates technical requirements. The Directorate General of Posts and Telecommunications (DGPT) is responsible for the implementation, frequency management and standardisation of the telecommunications network.

The development of the telecommunications infrastructure and provision of services were largely government-funded and run by state-owned monopolies until 1989 (PT Telkom for basic local and long-distance telecommunications and PT Indosat for international services). A new Telecommunications Law enacted in 1989 provided for partial deregulation and limited participation of private firms in the sector. It drew a clear distinction between basic and non-basic services. In the basic segment, private firms are allowed to supply services as long as they co-operate with PT Telkom and PT Indosat by forming joint ventures, joint operating schemes or management contracts.

Thus, no entity may provide basic services in Indonesia without some sort of involvement of either of the two state-owned companies. This does not apply to other services such as mobile telephony, data transmission, paging, internet services and satellite systems.

Meeting USOs is a major policy objective. All service providers except PT Indosat must reserve a share of their investment for developing infrastructure and services for unserved or underserved areas[147]. This policy is also reflected in the tariff policy of the MTPT, which undertakes significant cross-subsidisation between customers in less-developed rural areas and those in the more affluent, urban areas. MTPT has granted a duopoly to PT Indosat and PT Satelindo for the exclusive provision of international telecommunications services until the end of December 2004. The domestic telephone market was opened to new operators in 1995. MTPT provided licenses to five international consortia (working with PT Telkom) to expand network facilities and supply telephone services in specified areas outside Jakarta and Surabaya[148]. A second operator for basic international telecommunications services, PT Satelindo, a joint-venture company between PT Telkom, PT Indosat, Deutsche Telekom and Indonesian private partners, received a license in 1993. In the mobile phone market, licenses were issued to seven operators with which PT Telkom, PT Indosat, private Indonesian investors and well-established foreign telecommunications operators are associated in a joint venture. Nearly 30 licenses also went to internet service providers (ISPs). Paging services and data communications and satellite systems markets have also been opened to competition.

These deregulation measures find reflection in Indonesia's commitments under the WTO Agreement on Basic Telecommunications. Indonesia bound its existing telecommunications regime and also committed itself to review its current policy. It has agreed to consider the entry of new suppliers by 2005 for international telecommunications services, by 2006 for long-distance services, and by 2011 for local services. As of 1998, foreign equity participation in local companies in most segments of the telecommunications market was limited to 35 per cent. As Abrenica and Warren (1999) note, the aim of this partial turnaround in the closed market policy was a bid to attract foreign investment in telecommunications infrastructure and raise the country's teledensity, which stood at 2.47 in 1997 (Abrenica and Warren, 1999, pp. 8-9). With respect to market access, there are no limitations on cross-border supply and consumption abroad of local and long-distance telephone services. For commercial presence, Indonesia requires that foreign presence take the form of joint ventures, joint operation schemes or management contracts (joint ventures only for cellular telephony).

### *Malaysia*

The telecommunications sector in Malaysia has grown rapidly since 1997. The number of resident and business telephone lines increased from 3.8 to 4.4 million between 1996 and 1999, with a penetration rate (number of telephones per 100 persons) of over 20 per cent in 1999. At the end of 2000 cellular phone subscribers in the country numbered about 5.1 million.

The Malaysian government has an ambitious and well-articulated goal of ensuring the convergence of telecommunications, broadcasting, and information technology (IT). To fulfil this objective, it passed a new Communications and Multimedia Act (CMA) in 1998, and established the Communications and Multimedia Commission (CMC) in the following year. The Ministry of Energy, Communications and Multimedia is responsible for the formulation of policies as well as long-term planning of the telecommunications sector, while the CMC is responsible for the supervision of the sector to encourage competition and ensure orderly and efficient development. The licensing regime, under the authority of the CMA, is based on network and application services rather than telecommunications and broadcasting. The Minister for Energy, Communications and Multimedia has discretion in granting licenses, determining policies and issuing regulations. The CMC advises the Minister and enforces policies and regulations. In the effort to make the country a major global centre for communications, multimedia information and other knowledge-based services, a Multimedia Super Corridor has been established. The Corridor is 50 kilometres long and 15 kilometres wide stretching from Kuala Lumpur city centre in the north to the Kuala Lumpur International Airport at Sepang in the south. As of June 2001, there were six network facility providers with equity in four telecommunications companies partly held by foreign investors. The main provider is Telkom Malaysia Berhad with holdings of about 95 per cent of the fixed-line market. It has a *de facto* monopoly for providing the backbone infrastructure in the Multimedia Super Corridor.

In the cellular mobile communications sector, five companies with eight licensed cellular networks provided services as of June 2000, with the largest company attracting nearly a third of total subscribers. The number of ISPs has increased since 1997 from two to seven (the five new licenses were issued in 1998). The two companies that had licenses earlier are the only ISPs in Malaysia offering nation-wide coverage, however. No new licenses have been issued for basic and mobile telephony services since 1997, partly because the authorities regard the current number of providers as adequate. Under the CMA, individual licenses are granted to any entity other than a foreign company, an individual, a sole proprietorship or a partnership. The class license is granted to any persons or entities other than foreign individuals or companies. An individual license is required for fixed-line and mobile service providers. ISP services and content providers have been liberalised and now require only a class license.

Foreign equity participation of up to 30 per cent is generally allowed in the network facilities provider business, as stated in Malaysia's GATS Schedule; higher participation is allowed only on a case-by-case basis. "Equal Access" to fixed-line services came into effect in January 1999. Under this scheme, subscribers have the right to choose any network to route their long-distance and international calls. Telkom Malaysia has thus far been the sole provider of universal services in Malaysia. Prior to 1999, it was subject to the universal service requirement without receiving any contribution from other licensed network operators, but thereafter all network operators (including Telkom Malaysia) have been required to contribute to the cost of providing universal service.

There have been no discernible amendments to Malaysia's prevailing GATS Schedule of commitments in telecommunications services. The government guarantees market access and national treatment for specific basic telecommunications services involving up to one-third equity of existing public telecommunications operators. Malaysia has not fully adopted the Telecommunications Reference Paper, nor has it made any commitment to the future liberalisation of the market[149]. Sector-specific commitments incorporated in Malaysia's GATS Schedule cover value-added services that are usually provided from channels or lines obtained from licensed network operators. Market access through commercial presence is assured for data and transmission services, mobile data services and telex and telegraph services. Commercial presence is realised through a locally incorporated joint venture or partial acquisition of an existing licensed value-added service operator.

***Thailand***

The Telephone Organisation of Thailand (TOT) is by law Thailand's sole supplier of domestic telephone services and provides services to neighbouring countries. Its monopoly counterpart in most international services, telegraph, telex, and packet-switching services has been the Communications Authority of Thailand (CAT). The two monopolies are therefore in competition for some services. Some of the services in this sector that have been partly privatised and are now provided by private operators include cellular phones (four operators), domestic Very Small Aperture Terminals or VSAT (five operators) and paging (six operators). A total of 15 operators have thus far received concessions. The authorities have indicated that these concessions provide for revenue-sharing arrangements negotiated on a case-by-case basis with concessionaires. Under current government plans, these concessions will be converted into joint ventures. There are 15 ISPs in Thailand operating under joint ventures and two joint ventures operating domestic high-speed leased circuit services. The CAT and the TOT both have the authority to establish prices and set the level of tariffs, access charges and accounting rates, although for basic telecommunication services the prices charged by CAT and TOT must be approved by the Thai Cabinet. Private operators must submit their prices to their licensors for approval.

No commitments were made in Thailand's 1994 GATS Schedule for activities like voice telephone services, telex and telegraph services and facsimile services, indicating the existence of a monopoly service provider. Thailand participated in the 1997 WTO negotiations on basic telecommunications services and bound both cross-border supply and consumption abroad of basic telecommunications services, subject to licensing and other requirements in its Schedule on Basic Telecommunications of April 1997. Among these requirements, service suppliers were required to be registered locally and foreign equity and shareholder participation were not allowed to exceed 20 per cent. Thailand also undertook to introduce by 2006 commitments regarding commercial presence in public local, long-distance, and international voice telephone services (as well as telex, telegraph and fax) on the basis of proposed new communications legislation.

In 1994, Thailand's GATS Schedule covered database access, on-line information processing services and five other services[150]. Different limitations have been scheduled for these various value-added services. Thus, cross-border supply was bound within the limits of the public monopoly described above and subject to radio frequency availability. Restrictions on foreign equity participation have ranged from 40 per cent to 49 per cent, depending on the activity. No commitments were made regarding the supply of a number of value-added services in the telecommunication sector, viz. e-mail, voice mail, electronic data interchange or enhanced facsimile. There was no additional commitment as a result of the 1997 WTO negotiations regarding value-added telecommunications services. Foreign telecommunications suppliers are not currently allowed to establish companies in Thailand. They may own up to 40 per cent of the equity of registered Thai companies supplying basic telecommunications services for which concessions have been granted. Hence, current regulations would appear to be more liberal than those reflected in Thailand's WTO commitments.

***Korea***

The telecommunications sector in Korea has grown steadily, fuelled by rapid expansion in the number of cellular phones and the demand for data transmission services. The sector represents 5 per cent of Korean GDP. Foreign investors, mainly major telecommunications service providers from developed countries, have focused primarily on the flourishing mobile service market in Korea.

Korea has taken noteworthy steps forward in the deregulation of the telecommunications service market since 1990. Apart from Korea Telecom (KT), state companies from other sectors remain involved in telecommunications, while certain *chaebol* groups such as Hyundai, Samsung and LG are telecommunications equipment manufacturers and multiple service suppliers. A restriction imposed in 1996 limiting the LG Group's stock ownership of Dacom to 5 per cent was revoked in May 1999. This paved the way for further *chaebol* participation in basic telecommunications services. State participation in KT has declined gradually as a consequence of privatisation. Foreign investors have been allowed to trade in its shares on the over-the-counter (OTC) market since March 1999. Like other state firms, KT has been involved in overseas investments or joint venture projects (e.g. in Japan, Viet Nam and the Russian Federation). Restrictions on foreign suppliers of telecommunications equipment to Korea's basic telecommunications operators have also been removed. In order to attract more foreign investment and to enhance the global competitiveness of the telecommunications sector, resale of internet phone services (termed the special telecommunications service — STS) has been authorised.

Under the GATS commitments in basic telecommunications services in 1997, Korea undertook to open 12 additional sub-sectors to foreign participation and began implementing these undertakings two years ahead of schedule. According to Kim and Kim (2001), the main achievements comprised a wide range of binding commitments on market access and a package of pro-competitive regulatory principles, stipulated in

the so-called ‘Reference Paper’. According to these commitments, foreign ownership was to be allowed up to 33 per cent in facility-based services including wired-line services by the end of 2000, to be raised to 49 per cent by 1 January 2001. Individual shareholdings were limited to 10 per cent for wired-line services and 33 per cent for wireless. Foreign ownership in KT was limited to 20 per cent by the end of 2000, to be raised to 33 per cent on 1 January 2001, with individual shareholdings limited to 3 per cent. In telephone services on a resale basis, so-called “voice resale”, foreign ownership of up to 49 per cent was allowed from the beginning of 1999, and this was to be raised to 100 per cent from January 2001. Meanwhile, Korea undertook additional and autonomous liberalisation in 1998-99 in order to cope with the financial crisis of late 1997. The limit on foreign ownership of KT was expanded from 20 per cent to 33 per cent on 17 September 1998. The 33 per cent (10 per cent for wired-line services) limitation on individual shareholdings in a facility-based service supplier other than KT was scrapped on 17 September 1998. At the same time, foreign ownership of a supplier of voice resale services was permitted up to 49 per cent. In addition, the ceiling on foreign ownership of a facility-based service supplier other than KT was raised from 33 per cent to 49 per cent on 1 July 1999, also ahead of its original schedule (*ibid.*, p. 27).

### *China*

Prior to China’s accession to the WTO, foreign investment in any form of telecommunications was restricted. Following accession, foreign participation in the country’s wire-line telecommunications services has been permitted. The foreign equity limit in this sector will increase from 25 per cent to 49 per cent within the next six years, and remaining geographical restrictions on telecommunications services will simultaneously be phased out. Concurrently, a transparent licensing mechanism and effective legal and administrative regulations will be put in place as part of the process of liberalising telecommunications services. The government has also agreed to eliminate tariffs on IT products and internet-related equipment by 2005, to stimulate the demand for and usage of telecommunications services in the country. Box 6 on the following page details the specific commitments undertaken by China in each of the sub-sectors within the telecommunications service sector.

Mattoo (2001*a*) notes that China has accepted the regulatory principles specified in the Telecommunications Reference Paper. It has committed to instituting an independent regulator for basic telecommunications services to ensure that the incumbent supplier does not undermine market access by charging prohibitive rates for interconnection to its established networks.

Box 6. **Summary of China's Specific Commitments in Telecommunications**

*Before WTO accession*, China allowed no foreign investment (ownership and/or management) in any form.

*Post-WTO accession,* China has made several specific commitments. It has undertaken the obligations in the WTO reference paper on pro-competitive regulatory principles and has committed to allow market access in this sector as follows:

*Value-added Services (internet and paging services):* Upon accession, allow minority-owned (up to 30 per cent) JVs in and between Shanghai, Guangzhou and Beijing. These JVs could be set up in Chengdu, Chongqing, Dalian, Fuzhou, Hangzhou, Nanjing, Ningbo, Qingdao, Shenyang, Shenzhen, Xiamen, Xian, Taiyuan and Wuhan (referred to as "other cities") within one year after accession, with foreign equity ownership in JVs up to 49 per cent. Two years after accession, there would be no such geographic restriction, with equity ownership in JVs up to 50 per cent.

*Mobile Voice and Data Services:* Upon accession, allow minority-owned (up to 25 per cent) JVs in and between Shanghai, Guangzhou and Beijing. These JVs could be set up in "other cities" within one year after accession, with foreign equity ownership in JVs up to 35 per cent. After three years this limit would be increased to 49 per cent. Five years after WTO accession, there would be no geographic restriction on operations of foreign service providers.

*Domestic and International Calling Services*: Three years after WTO accession, allow minority-owned (up to 25 per cent) JVs in and between Shanghai, Guangzhou and Beijing. These JVs could be set up in "other cities" within five years after accession, with foreign equity ownership in JVs up to 35 per cent. Six years after accession, there would be no such geographic restriction, with equity ownership in JVs up to 49 per cent.

*Satellite services:* China has attached and signed "Notes for Scheduling Basic Telecommunications Services". Thus, any basic services may be provided through any means of technology, including satellites.

***Summary***

Tables 13 and 14 on the following two pages summarise the state of *de facto* liberalisation as well as specific GATS commitments of the five Asian economies in telecommunications services. It is apparent that Korea is the only country to have committed to liberalise almost all the sub-sectors (with the most commitments in GATS among the economies under consideration). China has made commitments in all but two basic telecommunications services viz. telex and telegraphic services, although it remains to be seen whether it does in fact liberalise these services within the agreed time frame (see Box 6). Malaysia has also made commitments in all but

two value-added services, namely electronic data interchange (EDI) and on-line information and/or data processing services. On the other hand, Thailand has offered the fewest specific sub-sector commitments for liberalisation, in only two sectors of value-added telecom services. Indonesia, too, has been rather cautious in liberalising value-added services compared with basic services. This is partly because the state-owned enterprises PT Telkom (sole local and long-distance service carrier), PT Indosat and PT Satelindo (exclusive providers of international services) are among the few firms that remain financially viable in the aftermath of the 1997-98 economic crisis (Abrenica and Warren, 1999, p. 8).

Regulatory functions in China, Indonesia, Korea and Thailand continue to be exercised by the sector ministry or other government bodies. The regulator remains responsible for the arbitration of disputes[151]. Many of the economies in Asia maintain a wide range of restrictions on foreign equity ownership. Fink, Mattoo and Rathindran (2001) conclude that while the traditional public monopoly is becoming a rarity, most governments seem reluctant to forego discretionary policy-making and delegate choices completely to the market. While privatisation has been accompanied by the introduction of some measure of competition, governments have been reluctant to allow unrestricted entry, and in most cases restrict the extent of private and foreign ownership, at least in the main incumbent. There is high variability in the pattern of regulation in terms of both the degree of autonomy and the domain of the regulator (Fink, Mattoo and Rathindran, 2001).

The rapid growth of mobile networks has come chiefly from the introduction of digital cellular technologies along with reforms to open mobile service provision to more operators. Korea now has more mobile than fixed-line telephone subscribers. Governments appear more willing to open this segment of telecommunications because there is less political need to protect incumbent operators with state ownership (Fink, Mattoo and Rathindran, 2001). The mobile markets in the region are expected to receive a further impetus from the introduction of third generation (3G) mobile technology launched initially in Japan.

In short, there has been a clear preference for a policy of "managed competition" in many Asian countries including the ones under consideration. Fink, Mattoo and Rathindran (2001) correctly observe that there are relatively larger welfare gains to realise from an increase in competition than from a change of ownership. Convincing rationales to prevent market competition are hard to come by. They may include technical limitations to competition (the scarcity of radio spectrum required for mobile telecommunications services is a case in point) or the existence of significant economies of scale (due, for instance, to substantial fixed costs of networks). In many cases, governments tend to justify a gradual introduction of competition for "infant industry" reasons as well as a means to assist in the "orderly exit" of incumbents.

Table 13. **Actual Policies and WTO Commitments in Telecommunications Services in Selected Asian Economies**

| Country | | Local Services | Long Distance | International | Mobile | Maximum FDI | Regulation | Pre-commitment |
|---|---|---|---|---|---|---|---|---|
| China | *Actual policy (1999)* | Monopoly | Duopoly | Monopoly, resale and call-back not permitted | Duopoly | 0% | No separate regulator | |
| | *GATS* | Geographically phased-in competition, 2001-2006 | Geographically phased-in competition, 2001-2006 | Geographically phased-in competition, 2001-2006 | Geographically phased-in competition, 2001-2005 | 25% upon accession, 49% after 5-6 years | Future implementation of Regulatory Reference Paper | Phased-in liberalisation of FDI, adoption of regulatory principles |
| Korea | *Actual policy (early 2000)* | Monopoly | Duopoly | Competition (3 licenses), resale and call-back permitted | Competition (5 licenses) | 49% for facilities-based operators, 20% for KT | No separate regulator | |
| | *GATS* | Competition | Competition | Competition, resale and call-back permitted | Competition | 33% for facilities-based operators, 49% for resellers, 20% for KT | Adoption of regulatory reference paper | In 2001, foreign equity limit will rise to 49% for facilities-based operators, 100% for resellers and 33% for KT |
| Malaysia | *Actual policy (early 2000)* | Competition | Competition | Competition, resale and call-back not permitted | Competition (8 licenses) | 49% | Separate regulator established in 1987, Communications and Multimedia Commission formed in 1999 | |
| | *GATS* | Competition, but entry only through acquisition | Competition, but entry only through acquisition | Competition, but entry only through acquisition | Competition, but entry only through acquisition | 30% | Partial adoption of regulatory principles | |
| Thailand | *Actual policy (1999)* | Monopoly | Monopoly | Monopoly, resale and call-back not permitted | Competition (5 licenses) | 20% | No separate regulator | |
| | *GATS* | Unbound | Unbound | Unbound | Unbound | 20% | Unbound | Bind revised policy and regulatory principles in WTO commitment by 2006, conditional upon legislative approval |

*Note:* The WTO commitments refer to market access and additional commitments for the respective market segments. Only a few countries imposed restrictions on national treatment

*Source:* Fink, Mattoo and Rathindran (2001)

Table 14. **Summary of Specific GATS Commitments in Telecommunications Services**

| | a | b | c | d | e | f | g | h | i | j | k | l | m | n | 01 | 02 | 03 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| China | X | X | X | | | X | X | X | X | X | X | X | X | X | X | X | X |
| Indonesia | X | X | X | X | X | | | X | X | | | | | X | X | X | X |
| Korea | X | X | X | X | X | X | X | X | X | X | X | X | X | X | X | X | |
| Malaysia | X | X | X | X | X | X | X | X | X | X | | X | X | | X | X | X |
| Thailand | X | | | X | X | X | X | | | X | | | | X | | | X |

**Key:**

*a)* Voice Telephone Services
*b)* Packet-Switched Data Transmission Services
*c)* Circuit-Switched Data Transmission Services
*d)* Telex Services
*e)* Telegraph Services
*f)* Facsimile Services
*g)* Private Leased Circuit Services
*h)* Electronic Mail
*i)* Voice Mail
*j)* On-line Information and Data Base Retrieval
*k)* Electronic Data Interchange (EDI)
*l)* Enhanced/Value-Added Facsimile Services
*m)* Code and Protocol Conversion
*n)* On-line Information and/or data processing
*01)* Terrestrial-based mobile
*02)* Satellite-based mobile
*03)* Other.

*Source:* WTO

## Financial Services

### *Indonesia*

*Banking*: The Ministry of Finance has responsibility for the general policy framework governing banks, including the rules and regulations on the conditions of establishment. It carries out international negotiations on market access jointly with Bank Indonesia, which is responsible for the daily supervision of banks and prudential control. While the Ministry of Finance has complete jurisdiction over the licensing of banks (or withdrawal of licenses), the decisions are subject to letters of recommendation of Bank Indonesia.

The banking sector in Indonesia began deregulation in 1988. Foreign banks were allowed to operate in joint ventures with minimum Indonesian equity of 15 per cent or through acquisition in the stock market of a maximum equity share of 49 per cent of existing listed local banks. These joint ventures received national treatment in the sense that they could engage in the same commercial operations as locally owned banks. Nonetheless, restrictions continue to be imposed on the number and location of branches, initially set at one per large city, as well as on the presence of natural persons (these limitations were reflected in Indonesia's 1994 and 1995 GATS Schedules). The banking sector in Indonesia witnessed rapid expansion in the early 1990s; the number of banks approximately doubled, while branches tripled. In the early 1990s, there were concerns about the soundness and safety of the banking system, with an increasing share of non-performing loans in total lending of state-owned banks. The 1997-98 regional financial crisis hit Indonesia particularly hard, resulting in the virtual decimation of the banking sector. The emphasis has since been on its restructuring.

Indonesia improved its GATS commitments under the WTO Agreement on Financial Services (the Fifth Protocol to the GATS) concluded in December 1997 and undertook further supplementary commitments in the context of the IMF programme in January 1998. These new WTO and IMF commitments include:

— Enhanced foreign participation in existing joint-venture banks and an increase of one in the number of branches operated by foreign-owned banks and joint-venture banks in Indonesia's main cities[152];

— Elimination of the economic needs test hitherto applied to the presence of natural persons and removal of limitations on national treatment pertaining to capital requirements of foreign joint ventures;

— Removal of restrictions on foreign ownership in listed banks by June 1998 and permission for foreign investors to increase (up to 100 per cent) their ownership of listed local banks; and

— Removal of restrictions on branching, to allow foreign banks and joint-venture banks to operate nation-wide, with unlimited numbers of offices and branches.

*Insurance*: In mid-1997 Indonesia had 103 general insurance companies, including 18 joint ventures with foreign participation, and 58 life insurance companies, including 17 joint ventures. The Ministry of Finance has responsibility for the general policy framework, supervision, regulation and licensing of new insurance companies. All insurance products must be supplied through a locally incorporated insurance company that may be either Indonesian or foreign owned, except for products not available in the Indonesian market. Foreign commercial presence in the insurance service sector can take place via a joint venture with an Indonesian firm or through participation in the capital of a listed company. Prior to the Fifth Protocol to the GATS, foreign ownership was restricted to 80 per cent in joint ventures and to 40 per cent in listed companies, and restrictions on intra-corporate movement of personnel and discriminatory capital requirements were in place. Under the Fifth Protocol, Indonesia has committed to the removal of ownership limits on foreign insurance companies and the binding of up to 100 per cent foreign ownership in domestic companies. It has also committed to promote greater flexibility in the movement of intra-corporate personnel for insurance companies and to remove discriminatory capital requirements.

***Malaysia***

Financial services (including real estate and business services) constitute 12-13 per cent of Malaysia's GDP. Although banking has remained the largest sub-sector, non-bank intermediaries have increased their presence. All applications to provide financial services require the in-principle approval of the country's central bank, Bank Negara Malaysia (BNM). There are significant restrictions on market access pertaining to commercial presence and hence foreign equity holdings, depending upon the specific

activity involved. Financial companies involved in insurance, fund management, and securities brokerage are allowed up to 51 per cent foreign equity with at least 30 per cent equity from Bumiputras (indigenous Malays). Foreign ownership of 100 per cent is permitted for companies involved in asset management, provided that they manage only foreign investors' funds; otherwise the foreign equity ceiling is only 70 per cent. Similar restrictions apply to companies offering investment services to firms other than those within their groups.

*Banking*: In June 2001 Malaysia had 27 licensed commercial banks (including two Islamic banks), 12 finance companies, and ten investment banks[153]. The Banking and Financial Institutions Act of 1989 governs the operation of banking institutions, while the Islamic Banking Act of 1983 governs Islamic banks. All foreign banks must be locally incorporated to operate in Malaysia. Their parent banks may hold 100 per cent interest in their Malaysian subsidiaries, except for companies involved in insurance, fund management and securities brokerage. Foreign banks can extend loans only in partnership with domestic banks. Of the 27 commercial banks, 14 were foreign owned and controlled about a quarter of total assets, gross loans and deposits in commercial banking. Foreign banks may not establish new branches, including off-site ATMs.

*Insurance*: The insurance sector comprises life and general insurance, insurance brokers, adjusters, and registered agents. According to the latest available data, out of 63 insurers, 23 were foreign owned. Foreign shares accounted for 72 per cent and 36 per cent of total life and general premiums, respectively. In December 2000 there were 83 offshore insurance and insurance-related companies in Labuan. The Insurance Act of 1996 regulates the insurance industry, and the Offshore Insurance Act of 1990 covers offshore insurance. As with banking, the BNM has charge of overall insurance supervision. The Labuan Offshore Financial Services Authority supervises offshore insurance activities.

Entry of foreign insurers into the Malaysian insurance market is currently allowed through investment in existing insurance companies, subject to an aggregate foreign shareholding limit of 30 per cent. For existing joint ventures in the insurance business, foreign shareholders that were the original owners of the companies may own up to 51 per cent of the total shares. For the insurance sector as a whole, foreign equity ownership of up to 51 per cent is permitted with at least 30 per cent of Bumiputra-held equity. As of October 2000, seven new non-life reinsurance licenses and one life reinsurance license had been issued to foreign reinsurers since 1995. In July 1999, BNM invited applications for six professional life reinsurance licenses offered under Malaysia's GATS Schedule. Apart from these regulations, the industry itself practises self-regulation through market agreements, rules and codes issued by the four mandatory associations representing general insurers, life insurers, insurance brokers, and loss adjusters.

### *Thailand*

*Banking*: Thailand's banking sector, adversely affected by the financial crisis in 1997, has since undergone a period of intense consolidation (Rajan, 2001 and Bird and Rajan, 2002). The number of banks is expected to decrease from 15 to 13 by the end of the consolidation process.

For cross-border supply and consumption abroad, there have been no changes in Thailand's market-access commitments in the financial sector, save for insurance. These commitments remain unbound with the possible exception of financial advisory services and financial data processing. For commercial presence, no limitations are placed on representative offices of banks. A total of 21 foreign banks operated fully licensed branches in Thailand in mid-1999, up from 14 in 1995, while 15 foreign bank branches operated as offshore International Banking Facilities (IBFs) under specified terms and conditions. Foreign bank branching is subject to certain operational restrictions. In principle foreign banks can operate up to three branches, but in practice none of them has yet received approval to open more than one branch. According to the authorities, there has been no demand for licenses to open additional branches, notably as four local banks have been put up for sale. A limited number of foreign personnel are allowed per foreign bank office, under a specific set of conditions. Locally incorporated banks in Thailand enjoy a significant advantage over their foreign counterparts, as they are not limited in the number of branches.

Following legislative amendments in 1997, foreign investors may now hold up to 100 per cent of shares in commercial banks, finance companies and *credit foncier* companies for a period of ten years and thereby operate locally incorporated banks. After ten years, they will not be obliged to divest their holdings but may not purchase additional shares until the proportion of total foreign shareholding falls under 49 per cent. Foreign banks that purchase majority shares in local banks are allowed to continue operating them under the rules pertaining to locally incorporated banks. The amendments of 1997 also maintain the requirement that the maximum foreign equity participation should be limited to a quarter of paid-up registered capital, that the combined shareholding of an individual and related persons should not exceed 5 per cent of a bank's paid-up registered capital, and that at least three-fourths of the directors should have Thai nationality. The Minister of Finance has discretion to relax any of these conditions for a particular bank, if it is deemed suitable. A similar decree has also been issued concerning finance companies and *credit foncier* companies.

*Insurance*: Thailand has undertaken a three-stage liberalisation of the insurance industry since 1997. In the first stage, it allowed 25 per cent foreign equity participation in domestic insurance companies and granted approval for 25 new insurance licenses, of which 12 were for life insurance businesses and 13 for non-life businesses. In the second stage, the permitted foreign equity participation increased to 49 per cent of registered share capital. The third stage permits foreign equity beyond the 49 per cent limit after appropriate legal institutions are in place and have been in effect for five years.

Foreign companies have played a significant role in the Thai insurance market, accounting for nearly half of total direct life insurance premiums (mid-2001). Foreign insurance companies may sell life insurance policies to Thai residents, reflecting this sector's high degree of liberalisation. There are limitations on national treatment for life insurance services, however, with life insurance premiums being tax deductible up to 10 000 baht only for holders of policies issued by locally licensed companies, which may be either domestically or foreign owned. Cross-border supply of non-life insurance services has remained unbound, except for international marine, aviation, and transit, together with all classes of reinsurance. Market access conditions for intermediaries and suppliers of auxiliary services have not changed. For instance, a branch of a foreign insurance company cannot conduct business as a broker or insurance agent, and foreign commercial presence remains limited to 25 per cent of equity.

### Korea

*Banking*: Korea has significantly reformed its financial service sector to ensure that it operates largely on a commercial basis, not subject to industrial policy or other non-commercial considerations. As with all other sectors, but especially in this case liberalisation was prompted by Korea's membership in the OECD, the 1997-98 regional financial crisis and the ensuing IMF programme, which led to the ongoing transition of the economy to a market-driven system. Full-scale liberalisation in Korea began in 1993, following the establishment of the "Three-Phase Programme for Financial Self-Regulation and Market Liberalisation", which encompassed interest-rate deregulation and financial market liberalisation. The Korean authorities have under consideration the possibility of allowing banks, brokerage firms and insurance companies to enter into each other's non-core businesses. Foreign banks in Korea have freedom to establish subsidiaries, and foreign financial institutions have been allowed to participate in non-hostile mergers and acquisitions since 1998.

*Insurance*: Korea is (1998 data) the second largest insurance market in Asia (after Japan), and the seventh largest life insurance market in the world in terms of premium income. Yet the insurance market has been concentrated within the top five insurance companies, which take almost 75 per cent of the life insurance business and 65 per cent of the non-life business. The financial crisis forced the restructuring of the insurance industry as well. As part of this restructuring, licenses of four life insurance companies were revoked, two existing surety and fidelity insurance companies were merged on the grounds of insolvency, and 16 life and non-life companies were put under Financial Supervisory Commission (FSC) supervised workout programmes to rebuild their solvency margins though recapitalisation, staff reductions and other managerial adjustments.

In the light of OECD membership and GATS financial commitments, Korea has gradually provided increased access to its life and non-life insurance markets, allowing entry of six foreign life insurance firms (4 subsidiaries, 2 branches) and three non-life insurers. The "economic needs" test for granting establishment licenses has been

eliminated. Insurance appraisal and activities ancillary to the management of insurance and pension funds were liberalised in April 1998, with the insurance brokerage market opened to foreign firms. Restrictions affecting partnership of foreign and local insurers and hiring foreign insurance professionals have been removed.

Under its 1999 Schedule of Specific Commitments, Korea allowed wholly owned or majority-owned subsidiaries of foreign financial institutions to operate banking, securities, securities investment trust and advisory businesses (previously only branches or joint ventures were covered). It also authorised commercial presence of foreign insurance brokerage companies (in addition to agencies previously permitted), as well as foreign claim settlement and actuarial companies. Further, it removed the requirement that a bank rank among the world's top 500 in asset size to qualify to open a branch in Korea, and it scrapped a requirement that securities investment trust companies open representative offices for at least one year before authorisation to open branches. Korea also undertook as of 31 August 1997 commitments for specific horizontal (i.e. cross-sectoral) undertakings related to limitations on market access and national treatment. These liberalisation efforts have borne fruit, with FDI in financial services increasing sharply from $480 million in 1996-97 to $2.3 billion in 1998-99 (Kim and Kim, 2001).

### *China*

*Banking Services*: China has agreed that two years after accession to the WTO, foreign banks would be able to conduct renminbi business with Chinese enterprises in Shanghai, Shenzhen, Tianjin and Dalian, and within five years of accession, all geographical restrictions would be removed. Box 7 details the specific commitments undertaken by China in each of the sub-sectors of financial services.

*Insurance*: Prior to China's accession to the WTO, no more than 20 foreign insurers were allowed to provide insurance services, but only in Shanghai and Guangzhou. Two years after accession, foreign insurers and insurance brokers will be able to form joint ventures with up to 50 per cent foreign equity in a number of cities including Beijing, Shanghai and Guangzhou, with other geographical restrictions phased out in three years. Thus, they are expected to position themselves as major players in reinsurance, insurance agency and brokerage when these Chinese commitments are fulfilled.

Reviewing the financial service commitments by a number of developing and transition economies, Mattoo (1999, p. 23) reached the following conclusion, which applies equally to the five Asian economies under consideration here, including China:

> "In broad terms, governments have adopted three different approaches to the financial services negotiations, assuming that they participated at all. These are: *i)* to bind the *status quo*, which may have been arrived at after liberalisation, either unilateral or in the context of the negotiations; *ii)* to make binding commitments that represent less than the *status quo* in policy terms; and *iii)* to promise future liberalisation, which may or may not

have been planned prior to the negotiations. These categories are not necessarily mutually exclusive when the set of a country's commitments is taken as a whole, nor is it always easy to determine the precise category in which a policy position should fall. The distinctions are useful, however, in thinking about the relationship between WTO negotiations and domestic liberalisation processes."

### *Summary*

Table 15 summarises specific GATS commitments by the Asian economies in financial services. As did many other countries, the Asian economies bound their multilateral obligations at less than the *status qu*o. For instance, notwithstanding Korea's recent aggressive steps towards liberalisation, its GATS commitments on foreign portfolio investment do not equal those made at the OECD. For the other countries, not bound by the OECD, binding below *status quo* reflects governments' dual objectives. They try to encourage foreign investment in their financial sectors, but simultaneously want to avoid a repeat of the turmoil and instability following the premature and ill-sequenced liberalisation prior to the regional crisis of 1997-98, not to mention providing some degree of protection to incumbent national suppliers from immediate competition. Nevertheless, all these economies, especially Korea and Thailand, have continued to take important steps towards the *de facto* relaxation of foreign equity limitations. There is a clear policy preference for promoting foreign equity investments over the promotion of market competition. There also appears to be a relatively greater willingness to undertake more liberal commitments in banking than in insurance (Mattoo, 2001*b*). In the insurance sector, entry limitations are accompanied by restrictions on foreign equity in Indonesia, Malaysia and Thailand. Korea enforces equity limitations but only without restricting foreign equity in new direct investment (it uses restrictions on foreign acquisition of stocks listed on the Korean stock exchange).

Table 15. **Summary of Specific GATS Commitments in Financial Services**

| Country | Insurance | | | | Banking | | | |
|---|---|---|---|---|---|---|---|---|
| | Life | Non-life | Reinsurance | Intermediation | Deposits | Lending | Forex Trading | Derivatives Trading |
| China | X | X | X | X | X | X | X | |
| Indonesia | X | X | X | X | X | X | X | |
| Korea | X | X | X | X | X | X | X | |
| Malaysia | X | X | X | X | X | X | X | X |
| Thailand | X | X | | X | X | X | X | |

| | Securities | | Other | |
|---|---|---|---|---|
| | Trading in Securities | Underwriting | Asset Management | Financial Information |
| China | X | X | X | X |
| Indonesia | X | X | X | |
| Korea | X | X | X | |
| Malaysia | X | X | X | |
| Thailand | X | X | X | X |

*Source:* WTO

Box 7. **Summary of China's Specific Commitments in Financial Services**

| Pre-WTO Accession | Post-WTO Accession (Specific commitments) |
|---|---|
| | **Banking Services** |
| Although wholly foreign-owned banks and joint ventures were allowed, they could open only one branch in each of all major cities. Domestic banks were effectively shielded from foreign competition. | All geographic and client restrictions will be removed within 5 years of accession. By that time, any existing non-prudential measures restricting ownership, operation and juridical form of foreign banks, including internal branching and licenses, will be eliminated. Financial leasing will be allowed for foreign banks when it is permitted for domestic banks.<br>Non-bank financial institutions will provide credit facilities for financing motor vehicles. To establish a subsidiary in China, a foreign bank would need to have total assets of over $10 billion; to establish a branch it would need to have total assets of over $20 billion. |
| *Foreign currency business*: Foreign banks could transact in foreign currencies only with foreign firms and individuals. | All geographical and client-related restrictions on foreign currency business were removed upon accession. |
| RMB *business*: 32 foreign banks licensed to conduct limited RMB business in Shanghai and Shenzhen with foreign firms and individuals. Those in Shanghai also allowed to serve clients in Jiangsu and Zhejiang, while those in Shenzhen also allowed to serve Guangdong, Guangxi and Hunan. | Foreign banks allowed to transact in Renminbi (RMB) in Shanghai, Shenzhen, Dalian and Tianjin upon China's accession to WTO. They will be allowed to expand their business to Guangzhou, Zhuhai, Qingdao, Nanjing and Wuhan within 1 year, and to Jinan, Fuzhou, Chengdu and Chongqing within 2 years, and further to Kunming, Beijing and Xiamen within 3 years and to Shantou, Ningbo, Shenyang and Xian within 4 years, with all geographic restrictions to be removed within 5 years after WTO accession.<br>Foreign banks are allowed to conduct RMB business with local firms within 2 years after accession, and with local individuals within 5 years after accession. Further, those licensed for operation in one region may service clients in other regions opened for such business. The eligibility to obtain a license is that a foreign bank needs to have at least 3 years business operation in China, and be earning profits since the past 2 years. |
| | **Insurance Services** |
| Fewer than 20 foreign insurers were allowed to operate and only in Shanghai and Guangzhou, although AIG had branches in Shenzhen and Foshan. Not more than one branch was allowed in each city. There were also restrictions on the scope of their business. | Licenses for foreign insurance providers will be based on prudential criteria. Foreign insurers qualify for licenses if they have more than 30 years of experience in a WTO member country, have had a representative office established in China for 2 consecutive years and hold global assets of over $5 billion. For insurance brokerage, asset requirements are set at $500 million upon accession, which is to be gradually reduced to $200 million within 4 years.<br>Upon accession, foreign insurers and insurance brokers may operate in Shanghai, Guangzhou, Dalian, Shenzhen and Foshan. Within 2 years these areas of operation will expand to Beijing, Chengdu, Chongqing, Fuzhou, Suzhou, Xiamen, Ningbo, Shenyang, Wuhan and Tianjin, and all geographic restrictions will be eliminated within 3 years. |

Box 7 (contd.)

| | |
|---|---|
| *Non-life insurance*: Foreign non-life insurers could establish branches, but clients were restricted to organisations involving foreign investment. They also could not underwrite vehicle insurance. | JVs with up to 51 per cent foreign ownership were allowed upon accession, with wholly owned subsidiaries to be allowed within 2 years. Foreign insurers may provide master policies and/or large-scale commercial risk insurance with no geographic restriction. They may also engage in insurance of enterprises abroad, property insurance, related liability insurance and credit insurance of foreign-invested companies consistent with the geographical restrictions outlined above. They will be allowed to provide a full range of non-life insurance services to both foreign and local clients within 2 years of accession. |
| *Life insurance*: Since 1997, JVs have been approved for life insurers, but foreign life insurers have been restricted to writing individual life products. | China will allow JVs with 50 per cent foreign ownership. Consistent with the geographical restrictions, foreign insurers can provide individual insurance to foreign and Chinese citizens and provide health, group and pension/annuity products in 3 years' time. |
| *Reinsurance*: Foreign reinsurers could not write local currency business and property/casualty insurers were obliged to have 20 per cent of their business reinsured by China Reinsurance Company. | Upon accession, foreign insurers may provide reinsurance for life and non-life insurance through branches, JVs or wholly foreign-owned subsidiaries without geographic or quantitative restrictions. The 20 per cent obligatory reinsurance cession to China Reinsurance Company will be phased out within 4 years of accession. |

## Energy Services

### *Indonesia*

The world's largest LNG exporter, Indonesia is the only one of the five Asian countries that is a member of OPEC. It is a significant player in world energy markets. During the first ten months of 2001, its crude oil production averaged about 1.2 million barrels per day (b/d), the lowest in the last decade due in part to ageing oil fields. Indonesia has stepped up efforts to sign new oil exploration contracts to boost domestic production. Because most of the producing fields lie in the central and western regions of the country, new exploration has focussed on the frontier regions, particularly in the eastern areas of the country. Both the government and private companies operating in existing oil fields are investing in projects to increase recovery rates and prolong field lives. One such company, Caltex, has undertaken a steam injection project at the Duri field on Sumatra. Although three major new oil projects involving multinational companies (Unocal, Conoco and Exxon Mobil) are expected to begin production before 2004, overall oil output in Indonesia is unlikely to rise markedly due to the continued ageing of existing mature fields. Indonesia could become a net oil importer in the near future.

The country also has very rich coal deposits, 5.75 billion tons of recoverable reserves at end of 2001. Sumatra contains roughly two-thirds of the total. The coal market is primarily export-oriented, with about 83 per cent of its coal production exported. The major export markets are Japan, Korea and Chinese Taipei. To increase coal production, Indonesia has allowed private mining. The Clough Group and Broken Hill Proprietary (BHP) of Australia have been two major private mining companies engaged in improving mining efficiency and expanding coal output.

Indonesia has an installed electrical generating capacity of about 21.4 gigawatts, with 84 per cent of that coming from thermal (oil, gas, and coal) sources. The state utility Perusahaan Listrik Negara (PLN) is responsible for transmission, generation and distribution of electric power. Besides the PLN, some regional electricity co-operatives (RECs) generate electricity in more remote locations. Although Indonesia had plans to expand power generation and open up the market to Independent Power Producers (IPPs) before the 1997-98 crisis, financial constraints on PLN have somewhat slowed the privatisation drive in this area. PLN has had to cancel many IPP contracts under which work had already begun. As a result of the crisis, many foreign investors involved in IPPs in Indonesia abandoned partially built projects. Even though the financial health of the state utility is gradually improving, privatisation of this market segment is deemed essential to meet future demand for power, and IPPs thus need to be encouraged by creating a more investor-friendly environment.

Although Indonesia is a very important player in the world energy market, it has not yet made any specific GATS commitments to liberalise energy services. It has nevertheless allowed foreign investment in oil exploration, natural gas production, coal mining and electricity generation.

***Malaysia***

Malaysia is also a significant player in the world energy market. Petronas, the state oil and gas company, has embarked on a series of overseas production projects in a number of other developing countries in Asia, the Middle East and Africa. In 2000, the major export destinations included Japan, Thailand, Korea and Singapore. Natural gas production has also increased steadily; Malaysia accounted for approximately 17 per cent of total world LNG exports in 1999. Exports of LNG go mostly to the higher-income East Asian economies of Japan, Korea and Chinese Taipei.

One of the important areas of co-operation for gas exploration and development is the Malaysia-Thailand Joint Development Area (JDA), located in the lower part of the Gulf of Thailand and governed by the Malaysia-Thailand Joint Authority (MTJA). Malaysia has proceeded with a planned expansion of the Bintulu LNG complex in Sarawak, expected to be the largest LNG liquefaction centre in the world. In addition to LNG, Malaysia exports about 150 million cubic feet of gas per day to Singapore through pipelines. It may also become an importer of Indonesian gas; Petronas signed an agreement in April 2001 with Indonesia's state oil and gas company, Pertamina, for the import of gas from Conoco's West Natuna offshore field in Indonesian waters.

In view of an anticipated rise in domestic electricity demand by more than 8 per cent annually over 2001-05, the Malaysian government is considering the introduction of reforms to make the power sector more competitive and to bring down costs. Three state-owned utilities dominate power generation and distribution (May 2001 data). The government allowed IPPs into the market in 1994 and licensed 15 of them. Tenaga Nasional Berhad, the main state-owned electric utility, divested some of its power generation units in 1999. These developments suggest that Malaysia is moving towards establishing a competitive power market, with reforms still at an early stage. The exact process and timeframe of deregulation of state utilities and transition to a competitive market have not been decided, however.

Malaysia is the only Southeast Asian country under consideration here that has made a GATS commitment in energy-related services, namely for management and consulting services covering advisory, guidance and operational assistance as well as services concerning the management of the transmission of non-conventional energy. It has allowed entry under Mode 3, with the restriction that commercial presence can be undertaken only though a locally incorporated joint venture corporation with shareholdings of Malaysian individuals, Malaysian controlled corporations and/or Bumiputras of at least 30 per cent.

***Thailand***

Thailand's energy sector has also undergone restructuring in recent years. The electric utility and petroleum industries, formerly strictly state-controlled monopolies, are currently being restructured and deregulated. The state-owned Petroleum Authority of Thailand (PTT) dominates the oil industry in the country. The government plans to privatise PTT's holdings, which was agreed as a part of the package of economic reforms in 1998 with the IMF. A new national energy policy to promote the use of natural gas was approved in 1999. It encouraged IPPs to design their power plants to burn natural gas rather than coal or other mineral fuels. In May 1997, PTT signed a memorandum of understanding (MOU) with Indonesia's Pertamina to purchase natural gas from Indonesia's Natuna gas field by 2007. This deal had provisions for a 1 000-mile undersea pipeline to transport the gas from Natuna to Thailand via Malaysian waters. Among other projects related to interconnection networks for energy supply, a 416-mile Thai-Myanmar natural gas pipeline, running from Myanmar's Yadana gas field in the Andaman Sea to an Electricity Generating Authority of Thailand (EGAT) power plant in Ratchaburi province, was completed in mid-1999. EGAT, the main state-run public electric utility, plans to lower its generating capacity. It also owns and operates Thailand's electricity transmission grid, but two state-controlled companies are involved in electricity distribution, the Metropolitan Electricity Authority (MEA) and the Provincial Electricity Authority (PEA). Thus, transmission and distribution of electricity remain completely subject to state monopoly. Thailand has made no specific commitments in any of the sub-sectors of energy services under GATS. Although it has taken some bilateral initiatives in energy trade with Myanmar, Indonesia, Malaysia and Oman, most of them are related more to energy products in general than to services.

### *Korea*

Korea, the fourth largest oil importer and the second largest importer of LNG, is yet another major Asian player in the world energy market. It currently imports LNG mostly from Indonesia and Malaysia, and in smaller volumes from Brunei, Qatar and Oman. Kogas, the state natural gas utility, plans to expand by installing increased capacity at its existing LNG receiving terminals. Some foreign companies like Mitsubishi and Enron are also involved in such projects. The government has already proceeded with the privatisation of Kogas.

Korea depends entirely on imports for crude oil, which accounts for more than half of total energy consumption. To secure and diversify the oil supply, it has developed a strategic petroleum reserve managed by the state-owned Korea National Oil Corporation (KNOC). As a long-term strategy, KNOC is pursuing equity stakes in oil and gas exploration in 19 overseas exploration and production projects in 12 countries around the world. The Korean oil refining industry was also adversely hit by the financial crisis in 1997-98. This provided the impetus for the government to deregulate the industry aggressively to enhance efficiency and attract foreign investors. It led to a number of corporate consolidations and sell offs.

Most of Korea's coal supplies (which meet about a fifth of its overall energy requirements) are met with imports from Australia, the United States and China, because domestic coal resources are of low quality. The state power utility, Korean Electric Power Corporation (KEPCO), has invested in several Australian coalmine projects. The Korean government is keen on privatising the energy sector and terminating the monopoly of several large state-owned enterprises (SOEs), including KEPCO. As part of these efforts, it broke KEPCO into six separate companies in April 2001. Five of them operate thermal and hydroelectric facilities and are roughly equal in installed generating capacity; the sixth includes all of KEPCO's nuclear plants, kept together in one corporation and expected to remain under government ownership for the time being. Plans envisioned the sale of the five non-nuclear generation companies in early 2002. Despite steps towards domestic product market liberalisation, Korea has not made any specific commitments in energy services under GATS.

### *China*

The world's most populous country, China is the second largest consumer of energy in the world after the United States. It made concessions viewed as relatively modest in the energy sector as part of its WTO accession package. Aside from tariff reductions on energy-sector capital goods, there has been limited progress in the liberalisation of the petroleum sector. China has been a net oil importer since 1993, although it does export a modest amount of crude oil, mainly to Japan. With the rapid growth of the economy and rising demand for energy products, major structural changes have occurred in China's oil and gas industry. Restructuring and deregulation measures are intended to help firms operate under competitive pressures in the wake of China's entry into the WTO.

In December 2000, China announced regulatory changes to remove some barriers to commercial presence in the Chinese oil and gas industry. It gave priority to stabilising production in the eastern regions at current levels while increasing production in new fields in the west and developing networks to transport oil and gas from west to east. Chinese firms have also acquired interests in exploration and production abroad in diverse areas, such as Kazakhstan, Venezuela, Sudan, Iraq, Iran and Peru.

Traditionally natural gas has not been a very important energy source for China, but, given significant domestic reserves and environmental concerns, it has expanded and is encouraged. Natural gas consumption in China is expected to more than triple by 2010. The largest reserves are located in western regions and require significant investment in pipeline infrastructure to transport the gas to eastern cities.

Coal, the major fuel, satisfies nearly two-thirds of China's primary energy consumption. China is the largest consumer and producer of coal in the world, with exports destined predominantly for Korea and Japan. It has had an oversupply problem in recent years, particularly in the late 1990s, leading the government to undertake reforms in the coal industry. China has also encouraged foreign investment in the coal sector, especially to modernise large-scale mines and develop new ones. The China National Coal Import and Export Corporation is the primary Chinese partner for foreign investors. Foreign investment is restricted to projects either introducing new technologies or providing environmental benefit, through coal liquefaction, coal-bed methane production and slurry pipeline transportation. China also expects to expand its coal export network by supplying countries in short supply, including the Russian Federation (the Far East), India and possibly Germany.

With China's accession to the WTO, steps ought to be taken in the near future to liberalise energy transmission and distribution services. China, like most other countries under consideration in this report, has concentrated so far on liberalising and deregulating its energy products' market and building cross-border energy supply networks.

### *Future Directions*

The foregoing highlights some noteworthy steps undertaken by the five Asian countries towards introducing market competition and privatisation of energy products. Most of them have permitted private foreign participation in areas such coal mining, production and exploration of oil and natural gas fields and production of electric power. At a domestic level, Korea has taken the lead, having deregulated its oil refining industry and "conceived the most comprehensive energy reform strategy in the region, with one of the most progressive and committed electricity deregulation programs in Asia" (Jaffe and Barnes, 2000, p. 12). China too has begun to take ambitious steps towards opening the power generation sector with a view to attracting FDI[154]. Nonetheless, much scope remains for further deregulation as well as regional and indeed multilateral integration of energy markets. Distribution and transmission of energy products (energy services) remain largely state controlled in these economies,

and there are no commitments yet to open these services to multilateral trade liberalisation. Nevertheless, some notable steps towards regional co-operation have been taken through ASEAN and APEC programmes, particularly in interconnectivity.

Uninterrupted transmission, low-cost availability of energy resources and interconnection are instrumental to further internationalisation and integration of production and trade. Thus, a strong case can be made for domestic deregulation and regulatory reforms as well as a systematic acceleration of energy trade and integration through multilateral negotiations. As in other sectors, a well-sequenced liberalisation of the energy sector would also facilitate technological innovation and diffusion[155].

Probably more than for other services, specific multilateral commitments to promote trade in energy services require agreement on precise definitions of energy services, which currently remain rather vague and fragmented (Zarrilli, 2001)[156]. The many sub-sectors within energy services range from exploration of energy resources to generation, transmission, distribution, marketing, trading and final consumption. Some suggest the need to distinguish between "core" versus "non-core" sub-sectors (METI, 2001). According to this view, the initial focus of international negotiations and trade liberalisation should be on the "core" energy services of wholesale trade, transportation (encompassing the transmission and distribution of electricity, pipeline transportation and transmission of heat) and retail trade. Non-core sectors, like energy-related engineering and construction services, could be left for later or considered separately[157].

## A Quantitative Assessment for Telecommunications and Financial Services

The preceding treatments of telecommunications and financial services presented brief reviews of major steps taken in recent years by the five Asian economies to liberalise their telecommunications and financial sectors. This discussion makes a quantitative assessment based on existing empirical studies[158].

### *Extent and Direct Costs of Service Trade Restrictions*

Restrictions on trade in services are measured by using a trade restrictiveness index developed by Warren and Findlay (2000) and further elaborated by Findlay and McGuire (2001). Broadly, the index is a frequency measure that estimates the restrictiveness of an economy's trading regime for services based on the number and severity of restrictions. As a first step, restrictions are classified in two ways:

— First, according to whether they apply to actual e*stablishment or right to entry* (commercial presence), on the one hand, or to *ongoing operations*. i.e. continued day-to-day operations of a service supplier after it has entered the market, on the other[159]; and

— Second, according to whether the restrictions are imposed on domestic and foreign service suppliers equally ("non-discrimination") or whether they are "discriminatory", i.e. restrictions imposed either only on foreign or only on domestic service suppliers.

A “trade restrictiveness” index score is computed for each economy based on a methodology of scores and weights. The more prohibitive the restriction, the higher the score. Some degree of subjectivity must be used in assigning scores. The restriction categories are then weighted once again on the basis of a judgement about their relative economic cost. For instance, restrictions on FDI get a higher weight than those on the temporary movement of people. The weights are ascribed so that the total restrictiveness index score ranges from zero (“least restrictive”) to one (“most restrictive”). Separate index scores are computed for domestic and foreign service suppliers. The difference between them may be interpreted as an indicative measure of the extent of discrimination against foreigners.

Table 16 provides two examples of trade restrictiveness index calculated for telecommunications and banking services in selected Asian economies. In the case of telecommunications services it is suggested that Thailand is most restricted among these Asian economies, with significant limitations on FDI, while Malaysia is moderately restricted in terms of some limitations on FDI in telecommunications service providers. Indonesia and Korea are ranked between the two. For banking services, the results indicate Malaysia and Indonesia as among the most restricted markets in East Asia with limits on new foreign bank entry, strict limits on foreign equity participation and restrictions on banks from expanding their existing operations (Findlay and McGuire, 2001). Having recently relaxed a number of restrictions, both Korea and Thailand are moderately restricted with at least one significant restriction that limits foreign access to their markets.

Table 16. **Trade Restrictiveness Indices for Telecommunications and Banking Services in Selected Asian Economies**[a,b]

| A. Telecommunications | | | | | | |
|---|---|---|---|---|---|---|
| Economy | Domestic | | | Foreign | | |
| | Establishment | Ongoing operations | Total | Establishment | Ongoing operations | Total |
| Hong Kong, China | 0.11 | 0.10 | 0.21 | 0.11 | 0.10 | 0.21 |
| **Indonesia** | **0.14** | **0.20** | **0.34** | **0.27** | **0.40** | **0.67** |
| **Korea** | **0.15** | **0.20** | **0.35** | **0.28** | **0.40** | **0.68** |
| **Malaysia** | **0.04** | **0.20** | **0.24** | **0.18** | **0.40** | **0.58** |
| Philippines | 0.00 | 0.13 | 0.13 | 0.12 | 0.33 | 0.45 |
| Singapore | 0.21 | 0.13 | 0.34 | 0.31 | 0.13 | 0.44 |
| **Thailand** | **0.23** | **0.20** | **0.43** | **0.39** | **0.40** | **0.79** |
| B. Banking | | | | | | |
| Economy | Domestic | | | Foreign | | |
| | Establishment | Ongoing operations | Total | Establishment | Ongoing operations | Total |
| Hong Kong, China | 0.00 | 0.04 | 0.04 | 0.03 | 0.07 | 0.09 |
| **Indonesia** | **0.00** | **0.07** | **0.07** | **0.37** | **0.18** | **0.55** |
| **Korea** | **0.00** | **0.19** | **0.19** | **0.21** | **0.22** | **0.43** |
| **Malaysia** | **0.19** | **0.08** | **0.27** | **0.38** | **0.26** | **0.65** |
| Philippines | 0.10 | 0.05 | 0.14 | 0.37 | 0.16 | 0.53 |
| Singapore | 0.00 | 0.11 | 0.11 | 0.13 | 0.25 | 0.37 |
| **Thailand** | **0.00** | **0.00** | **0.00** | **0.24** | **0.15** | **0.39** |

*Notes:* *a)* Figures may not add up to total due to rounding off error.
*b)* The restrictiveness index scores range from 0 to 1. The higher the score, the greater are the restrictions for an economy.

*Source:* Adapted from Findlay and McGuire (2001).

The estimated price/cost effects of maintaining trade restrictions in the same service sectors are presented in Table 17. As can be seen, there is a direct relationship between the price/cost of services and the degree of protection of the particular sector. For instance, the price effect measures on foreign telecommunications service suppliers are well over 100 per cent in Indonesia. The price effect measures for Korea and Malaysia are moderate. This table suggests, therefore, that countries with the most restrictive regimes would reap the largest efficiency gains from liberalisation[160].

Table 17. **Price Effect Measures for Telecommunications and Banking Services in Selected Asian Economies**
(Percentage)[a]

| A. Telecommunications | | | | | | |
|---|---|---|---|---|---|---|
| Economy | Domestic | | | Foreign | | |
| | Establishment | Ongoing operations | Total | Establishment | Ongoing operations | Total |
| Hong Kong, China | 0.00 | 2.65 | 2.65 | 1.97 | 4.94 | 6.91 |
| **Indonesia** | **0.00** | **5.35** | **5.35** | **32.91** | **16.42** | **49.33** |
| **Korea** | **0.00** | **14.93** | **14.93** | **18.15** | **18.58** | **36.73** |
| **Malaysia** | **15.38** | **6.73** | **22.11** | **35.92** | **24.69** | **60.61** |
| Philippines | 7.32 | 3.66 | 10.99 | 33.28 | 14.08 | 47.36 |
| Singapore | 0.00 | 8.15 | 8.15 | 10.69 | 20.76 | 31.45 |
| **Thailand** | **0.00** | **0.00** | **0.00** | **20.56** | **12.50** | **33.06** |
| B. Banking | | | | | | |
| Economy | Domestic | | | Foreign | | |
| | Establishment | Ongoing operations | Total | Establishment | Ongoing operations | Total |
| Hong Kong, China | 0.00 | 2.65 | 2.65 | 1.97 | 4.94 | 6.91 |
| **Indonesia** | **0.00** | **5.35** | **5.35** | **32.91** | **16.42** | **49.33** |
| **Korea** | **0.00** | **14.93** | **14.93** | **18.15** | **18.58** | **36.73** |
| **Malaysia** | **15.38** | **6.73** | **22.11** | **35.92** | **24.69** | **60.61** |
| Philippines | 7.32 | 3.66 | 10.99 | 33.28 | 14.08 | 47.36 |
| Singapore | 0.00 | 8.15 | 8.15 | 10.69 | 20.76 | 31.45 |
| **Thailand** | **0.00** | **0.00** | **0.00** | **20.56** | **12.50** | **33.06** |

*Note:* *a.)* Figures may not add up to total due to rounding off error.
*Source:* See Table 16.

### *Economy-wide Impact of Reduction in Remaining Service Trade Restrictions*

This final presentation considers the results from a multi-sector, multi-regional computable general equilibrium model of world trade and investment. The model covers 19 regions (spanning Asia, North and South America and the European Union) and three sectors (agriculture, manufacturing and services). The theoretical structure of the model encompasses both FDI and portfolio investment. It is closely based on the well-known Global Trade Analysis Project (GTAP) model (Hertel, 1997) with the inclusion of FDI (FTAP) and other modifications to the structure to account for services liberalisation[161]. Incorporating FDI allows for an examination of the comprehensive

removal of restrictions on all modes of service supply, including restrictions on services delivered through FDI. In effect, the price/cost effects of trade protectionism noted above are modelled as tax equivalents in FTAP to capture the direct effects of current services trade restrictions. Following the discussion on types of restrictions, restrictions on *establishment* are modelled as taxes on capital, while those on *ongoing operations* are modelled as taxes on the output of FDI firms and the exports of firms supplying through other modes of delivery. Tax rates applied to domestic and foreign-owned industries also vary.

Using the FTAP model, Dee and Hanslow (2000) reach the following set of conclusions with regard to projected gains in real income about a decade after complete liberalisation has taken place (accounting for transitory adjustment effects). Note that the results are static, showing only the direct impact of trade liberalisation (and not the ensuing impact of savings, investment and therefore growth). First, the world as a whole is projected to be better off by around $260 billion annually as a result of eliminating all post-Uruguay Round trade restrictions[162]. Second, about half of these projected gains accrue from liberalising services trade, $80 billion from liberalisation of manufactures and the rest from agricultural liberalisation.

These results broadly agree with those of other general equilibrium models more sophisticated than the FTAP model (Findlay and McGuire, 2001). For instance, a model by Robinson *et al.* (1999) estimates that the welfare gains from a 50 per cent reduction in service-sector protection are as much as five times those from non-service trade liberalisation. All these general equilibrium results themselves may understate the gains from services liberalisation because not all the modes by which services are supplied are necessarily taken into account (e.g. temporary movement of individual service suppliers is excluded). Dee and Hanslow (2000) conclude that the greatest global benefits of partial services trade liberalisation derive from the liberalisation of *non-discriminatory* or *market access* restrictions. In addition, the removal of all restrictions on *establishment* would yield a larger total benefit than removing all restrictions on ongoing operations.

Verikios and Zhang (2001) also use the FTAP model but focus specifically on the impact of liberalisation of financial and telecommunications services and make use of more recent estimates of trade barriers (i.e. post Uruguay Round). They project the total gain in world income from liberalisation of just these two sectors to be about $48 billion. In the case of telecommunications services, Table 18 reports the simulation results of complete liberalisation in five Asian countries. The world as a whole is projected to gain by about $24 billion (a 0.1 per cent rise in world real GNP). While the results further indicate that countries with higher initial barriers should benefit more from liberalisation, the results for such middle-income countries as Malaysia and Thailand are surprising and warrant closer examination.

Table 18. **Sources of Change in Real GNP of Complete Liberalisation in Telecommunications Services**

($ million)

| Country/ Region | Allocative Efficiency | Terms of Trade | Net Capital Endowment | Product Variety | Net FDI Income | Row Sum | Per cent of Real GNP |
|---|---|---|---|---|---|---|---|
| Korea | 36 | -5 | -13 | 1 | 16 | 35 | 0.01 |
| Indonesia | 1 152 | -434 | 1 303 | 401 | -1 151 | 1 258 | 0.70 |
| Malaysia | 17 | -30 | - | -5 | -3 | -22 | -0.03 |
| Thailand | 37 | -562 | 60 | 17 | -55 | -502 | -0.35 |
| China | 5 575 | -1 301 | 354 | 1 037 | -343 | 5321 | 0.81 |
| **World** | **20 600** | **-34** | **833** | **2 938** | **-** | **24 313** | **0.10** |

*Notes:* The terms of trade effects on GNP do not sum exactly to zero due to numerical inaccuracy in solving the model.
*Source:* Adopted from Verikios and Zhang (2001).

The FTAP model allows one to distinguish between five sources of gains from liberalisation. The following reproduces the illuminating discussion of these sources by Verikios and Zhang (2001). The percentage change in real GNP for each country can be decomposed into five effects:

— the allocative efficiency effect, which measures the contribution to GNP changes of changes in resource allocation;

— the terms-of-trade effect, which measures the contribution from changes in the relative price of exports and imports for a country. Where export prices rise more quickly than import prices, or fall less quickly than import prices, there is a terms of trade gain for that country;

— the net capital endowment effect refers to the contribution from changes in the rental value of the net capital stock (gross capital minus depreciation) located within a country. Here the capital stock consists of both domestically and foreign-owned capital stock. Therefore, this is a measure of a change in a country's productive capacity;

— the product variety effect refers to the benefits that the increased variety of a particular good or service may provide for consumers. In the model, an increase in the output of a given sector means more firms and more varieties for consumers; and

— the net FDI income effect measures the contribution from changes in three different forms of income: the normal rental income received by the owners of foreign capital from the country in which the capital is invested; the "barrier rents" received by the owners of foreign capital and affiliates in a host country; and the income received or paid on foreign credit or debt by a country.

For the world as a whole, only changes in allocative efficiency, net capital endowment and product variety contribute to changes in real GNP. These three effects can be referred to as "income-generating" factors. Other effects do not change world

GNP. In other words, a gain for one country is a loss for others. They are therefore referred to as “income-redistributing” factors. At the world level, the question of whether a policy change is beneficial depends only on income-generating factors, because income-redistribution factors are cancelled out. At an individual country level, both factors are important (Verikios and Zhang, 2001, pp. 11-12).

Seen from this angle, the projected declines for Malaysia and Thailand after liberalisation result from an adverse movement in the terms of trade and a decline in net FDI incomes, which together outweigh the allocative efficiency gains. For China and Indonesia, the allocative efficiency gains tend to more than compensate the effects of all other factors. Korea would benefit marginally due to a combination of allocative efficiency benefits and a positive net FDI income effect.

As for financial services (which include finance/banking, insurance and business services), Table 19 displays the results of complete liberalisation in the five Asian countries. The world as a whole is projected to gain by about $23 billion (a 0.09 per cent rise in world real GNP). The sources of gains are decomposed into five effects, as with telecommunications. The largest gains come from capital reallocation to the liberalising countries, together with allocative efficiency gains. As before, significant gains arise from greater product variety but fairly large losses appear due to the net FDI income effect. The terms of trade effect is also negative. Overall, Thailand and Indonesia would benefit most from liberalising the financial sector, relative to their GNPs. Somewhat surprisingly, China appears to benefit only marginally, while Malaysia and Korea would benefit moderately. China’s rather modest gains may be due to a sharp adverse movement in the terms of trade effect, which negates the allocative efficiency gains, while the gains from changes in net capital stock are rather modest.

Table 19. **Sources of Change in Real GNP of Complete Liberalisation in Financial Services**
($ million)

| Region | Allocative efficiency | Terms of trade | Net capital endowment | Product variety | Net FDI income | Row sum | Real GNP |
|---|---|---|---|---|---|---|---|
| Korea | 796 | -578 | 1826 | 663 | -1229 | 1468 | 0.36 |
| Indonesia | 753 | -340 | 2245 | 549 | -1943 | 1250 | 0.70 |
| Malaysia | 262 | -112 | 150 | 70 | -144 | 226 | 0.27 |
| Thailand | 703 | -266 | 2311 | 453 | -1797 | 1396 | 0.96 |
| China | 1221 | -1157 | 104 | 322 | -106 | 384 | 0.06 |
| **World** | **6 463** | **-16** | **14 164** | **2 112** | **0** | **22 640** | **0.09** |

*Notes:* The terms of trade effects on GNP do not sum exactly to zero due to numerical inaccuracy in solving the model.
*Source:* See Table 18.

# Notes

1. For Europe, analytical focus is given to services of general interest, defined by the European Commission to cover "market and non-market services which the public authorities class as being of general interest and subject to public service obligations" (COM//2000/580 final, Annex II). This definition conventionally refers to telecommunications, power, postal and transport services.

2. See WTO (2001*a*), Tables III 3 and 4.

3. See COM/2000/800, p. 1. In this communication, the European Commission proposes an innovative approach, dealing with different types of rules that may affect service providers at different stages of the business process (setting up the business, use of inputs, promotional activities, distribution activities, sales activities and after-sales support services). This appears to be a new departure from the traditional, sectoral approach taken by the European Commission in its previous communication, which focused on such strategically important sectors as telecommunications, energy and transport (COM/2000/580 final of 20 September 2000, entitled *Services of General Interest in Europe*).

4. Due to the derogations granted to some member states, the final date for full liberalisation in the EU was in fact set for 31 December 2000 (see the next section for further discussion).

5. Note, however, that if services were priced below their costs (due to subsidy) before liberalisation, then liberalisation would most likely cause prices to *rise*, to reflect the true cost of resources.

6. For further discussion, see OECD Development Centre (2002), Chapter 5.

7. Part II of this report does not cover financial services in Europe. Interested readers should consult a recent report prepared for European Financial Services Round Table, Heinemann and Jopp (2002).

8. See Article 3 (1)(c) of the EC Treaty. The Treaty defines "services" very broadly as the activities that "are normally provided for remuneration, insofar as they are not governed by the provisions relating to freedom of movement for goods, capital and persons" (Article 50). There are, however, some exceptions to this principle in the following areas: *i)* the exclusion of employment in the public service (Article 39 (4)); *ii)* the progressive abolition of restrictions regarding the medical and pharmaceutical professions, which depend on co-ordination of the conditions for their exercise in various member states (Article 47(3)); *iii)* transport services to be governed by the

provisions relating to transport (Article 51(1)); and *iv)* banking and insurance services, whose liberalisation shall be effected in step with the liberalisation of movements of capital (Article 51(2)). Free movement of services is guaranteed by securing the right of establishment and free movement of goods, persons and capital. However, unlike the case of goods in which products coming from a third country are allowed in free circulation, the treaty stipulates only that the Council may extend the freedom to provide services to nationals of a third country who are established within the Community (Article 49).

9. The intricate nexus between the energy industry and environmental protection has further complicated multilateral agreements in this area. Still, a number of international treaties governing the energy industry have come into force. They include the UN Declaration on Permanent Sovereignty over Natural Resources and the 1991 Energy Charter Treaty (which has had a Euro-centric focus until recently).

10. At the 6th ASEAN Summit Meeting in Hanoi in December 1998, the member states adopted their Plan of Action for Energy Co-operation (1999-2004). One of the objectives set by the ASEAN Plan of Action for Energy Co-operation was to seek the early realisation of the Trans-ASEAN energy networks, covering the ASEAN Power Grid and Gas Pipeline Projects. Although good progress has been achieved in technical co-operation with respect to interconnection of power systems, there is further need to deal with legal, regulatory and financial issues related to these projects. Apart from these regional interconnection projects, ASEAN is also engaged in energy co-operation with OECD countries, including the EU-ASEAN Energy Co-operation Programme of the EU-ASEAN Energy Facility (EURASEF).

11. The primary reason for California's power crisis predated deregulation. Robust economic growth considerably raised the state's demand for power, while generation capacity actually declined in the 1990s. Deregulation simply helped to reveal this fundamental problem of demand-supply mismatch (OECD Development Centre, 2002, Box 6.1).

12. The final date for liberalisation was set as 31 December 2000 for the first three, 1 July 1998 for Luxembourg, and 30 November 1998 for Spain.

13. Article 86 of the EC Treaty deals with companies with exclusive and special rights, as well as those entrusted with services of general economic interest and was apparently the article invoked to maintain exclusive rights for telecommunications monopolies.

14. Sweden is the exception.

15. This sector structure explains why for a long time the only co-operation body at the European level was the "European Conference for Post and Telecommunications" (CEPT), created in 1959 as an inter-administrative organisation associating national post and telephone enterprise administrations.

16. For example, GEC/Plessey in Britain and Siemens in Germany. See Eliassen, Mason and Sjovaaj (1999).

17. American Telephone and Telegraph. Regional Bell Operating Companies (or Baby Bells).

18. In particular, US companies. For example, AT&T created joint ventures with European enterprises (Philips and Olivetti).

19. A substantial analysis of the interaction process of policy integration is provided by Dang-Nguyen *et al.* (1993).

20. One can also note the adoption in 1986 of the Special Telecommunications Action of the regional development programme in favour of the least developed regions of the EU.

21. Commission Directive 88/301/EEC, 16 May 1988 (services). Council resolution, 88/C 257/01, 30 June 1988.

22. Council Directive, 90/387/EEC of 28 June 1990.

23. One of the most important successes of the ETSI is certainly the adoption in 1992 of a single standard for the numerical telephone: the "Global System for Mobile Telecommunications" (GSM), nowadays one of the most widely used in the world.

24. In order to stimulate competition, new entrants must be allowed to connect their own clients located beyond their own networks via an interconnection service offered by the historical operator for all the national territory.

25. Council resolution 93/C213/01, 22 July 1993, and European Parliament resolution A3-0113/93, 20 April 1993.

26. Council resolution 94/C213/01, 22 December 1994, and European Parliament resolution A4-0063/95, 11 May 1995.

27. A general authorisation gives the right to offer telecommunications services and/or infrastructures whereas the individual license gives specific rights or obligations to companies operating under general authorisation.

28. Before their implementation, member states have to notify to the Commission and publish any national licensing or declaration procedure.

29. For general authorisations the least constraining mode compatible with the requirements must be adopted. For individual licenses the directive draws up a list of the situations where they are required.

30. The directive, however, lists the types of services that can be offered in the EU either without authorisation or on the basis of general authorisation. Harmonisation aspects of licensing are considered in the licensing directive (97/13/EC).

31. Basically, the specific cost of a USO is the difference between the extra costs supported and the extra benefit obtained by the operator. It is calculated by operators in charge of the USOs, checked by an independent organisation and approved by the NRA. The cost calculations and the conclusions of the monitoring are available to the public.

32. These are public network operators or service providers who control access to consumers via official telephone numbers, provide leased lines to users' premises, have special or exclusive rights to provide international circuits to non-EU countries and/or are permitted to interconnect in accordance with relevant national licensing or authorisation schemes.

33. The main limits are about competition in local access, where progress is insufficiently speedy; high tariffs for terminating calls in mobile networks; tariff and cost accounting principles; and the organisation of the NRAs, particularly regarding their capability to verify accounts and solve disputes rapidly.

34. M&As and strategic alliances can be carried out, for example, to reduce risks, to share costs and to assure a quick presence in foreign markets. All these reasons are motivated by the existence of a competitive situation. Even M&As and strategic alliances whose aim is to reduce competition are the outcome of competitive pressure.

35. For local calls and for retail revenues, incumbent operators control 68 per cent, 70 per cent and 74 per cent of the market in United Kingdom, Germany, and Denmark respectively, but more than 90 per cent in ten other member states.

36. See COM/2001/706, Annex 1. Prices in this paragraph are expressed in PPP and include VAT.

37. The price of a three-minute call was €0.12 in the United States in 2001 and only six in Japan. For a ten-minute call, charges were €0.12 and €0.27 respectively.

38. http://www.europa.eu.int/comm/information_society/policy/framework/index_en.htm.

39. This breakdown differs from the traditional five-stage description and already reflects a result of liberalisation. See Ruff (1994).

40. Storage can be achieved by pumping water in hydroelectric stations, but this is very expensive.

41. See, for instance, Joskow P. (1996), Newbery (2000) and Shuttleworth (2000).

42. Shuttleworth (2000) and Littlechild (2001). Note, however, that not all agree on the extent of regulation that is needed and its optimal cost.

43. See Shuttleworth and McKenzie (2002) for further discussion.

44. The directive was not the first one to address the issue of the IEM: two relatively minor directives on transit of electricity (90/547/EEC) and price transparency (90/377/EEC) were published in 1990.

45. In effect, such an obligation makes this option equivalent to rTPA. For further discussion, see Shuttleworth (2000).

46. An independent dispute settlement system has to be established. Access may be refused if there are capacity constraints, but lack of co-ordination with a neighbouring TSO cannot be considered as a reasonable ground to refuse access.

47. The EU Treaty normally prohibits reciprocity, but the clause is here seen as transitional towards equal treatment.

48. This issue is concerned with the sunk costs that a utility cannot expect to recover during the transition to a deregulated market.

49. European Commission, DG TREN, *Guide to the Electricity Directive*, http://www.europa.eu.int/comm/energy/en/elec_single_market/memor.htm.

50. Communication from the Commission to the Council and the European Parliament, *Completing the Internal Electricity Market*, COM/2001/125 of 13/3/2001. This new initiative took on board some critics stressing the problems behind the implementation of the electricity directive. See Newbery (2002).

51. Interconnection is not a new issue, as cross-border trades in electricity well preceded the design of the IEM. These flows were limited to bilateral transaction agreements between vertically integrated utilities, however. Although the economics and the technical tools were available to establish further integration, the political will was focussed on issues of public services and domestic monopoly. See Smeers (2001).

52. This implies the piling up of several connections and usage fees in transit traffic.

53. Presidency Conclusions, Stockholm European Council, 23-24 March 2001, as quoted in the *Communication from the European Commission to the Council and the European Parliament — Energy Infrastructure*, 2001 (COM/2001/775/final).

54. The French government not long ago signalled ahead of the Barcelona Conference that it would resist pressure to open electricity markets. It has since softened its position. "France Resists EU Heat Over Energy", *The Guardian*, 18/1/2002.

55. With a few exceptions; see Table 1 in SEC(2001)438.

56. France, Germany, some networks in Austria, Scotland-Northern Ireland grids, Greece, and Luxembourg.

57. The power of the French Ministry is limited since it can only reject, but not modify a proposal.

58. "Böge's Beefs: Germany's Competition Watchdog Is Busier than Ever", *The Economist*, 7/2/02. This high level of complaints suggests for some that a regulatory approach might be more efficient than the competition one. See, for example, Shuttleworth (2000).

59. Austria, Belgium, Germany, Italy, Luxembourg, the Netherlands and Spain.

60. Among them are Belgium, Germany, Ireland, the Netherlands, Portugal, Sweden and the United Kingdom.

61. Except Belgium, Denmark, Italy and the Netherlands. See Eurelectric (2001).

62. The liberalisation of the electricity sector is conducted differently in England and Wales on one side and Scotland on the other.

63. OFGEM claimed that this was the result of the implementation of the New Electricity Trading Arrangements (NETA) initiated in March 2001. A recent study shows, however, that this seems rather the result of a change in market structure and not of the implementation of NETA. See: OFGEM press release, "New Electricity Trading Arrangements Go Live", 27 March 2001 and Bower (2002).

64. Whereas big consumers can probably countervail this market power. See Steiner (2001).

65. The level of renegotiation is unknown.

66. See Oxera (2001) and CEER (2001). The Commission in its second benchmarking report (SEC/2002/1038) cites consumer surveys indicating a high level of satisfaction.

67. See Price Waterhouse Coopers (2002). The numbers are significantly up compared to 2000, when Europe as a target zone accounted for 29 per cent of the value of world deals. See also *Financial Times*, “Europeans Fill Vacuum Left by US Companies”, Energy Review Supplement, April 2002.

68. Since the privatisation in 1990/91, numerous mergers and takeovers have taken place in the United Kingdom, particularly in the distribution sector, where most companies have been bought back. Foreign participation is important. Acquisitions have also concentrated the industry in fewer hands; four firms operate two distribution companies (OFGEM, 2001).

69. Smeers (2001) argues that the strict application of the principle of subsidiarity should actually have the opposite result, since the European grid (the overall network of interconnected national grids) should be viewed as one system which needs a common market mechanism in order to operate efficiently.

70. Such as the Florence Regulatory Forum. See Hancher (2000).

71. See COM(2002)14, final: “Where the lack of progress for example for gas and electricity, is harming competition and holding back market integration, the Commission — as it did in the 1990s for telecommunications — will consider adopting legislation to open markets using its powers under the European competition rules”.

72. For a review of the Commission’s approach, summarised here, see Albers (2001).

73. Electricité de France (EDF) is the French public utility, and Energie Baden-Württemberg (EnBW) is the third German electricity utility. VEBA AG and VIAG AG are two German conglomerates both having activities in generation and distribution of electricity and chemicals.

74. Commission press releases: “Commission Gives Green Light to ‘Stranded Costs’ Compensation by Spain, Austria, and the Netherlands”, IP/01/1079 of 25/7/2001, and “The Commission Authorises Greece to Compensate PPC for Liberalisation in the Electricity Sector (Stranded Costs)”, IP/02/1477 of 16/10/2002.

75. Commission press release: “Commission Seeks End to Some Advantages Enjoyed by EdF”, IP/02/1485 of 16/10/2002.

76. In the United Kingdom, market power was estimated to result in excessive pricing of 60 per cent. Incumbent firms were leveraging their market power through capacity restriction. See the empirical studies of the England and Wales market by Green and Newbery (1992) and Patrick and Wolak (1997).

77. See, for instance, Shuttleworth and McKenzie (2002). Recent research shows that the Nord Pool has not been captured by market power like other markets. See Hjalmarsson (2000).

78. Cross-border differences in tariffs are potentially very important. Price differences reach 25-30 €/MWh at the French-Italian and German-Dutch borders. Newbery (2002) notes that even when there are market based wholesale markets, lack of arbitrage results in wide differences in spot market prices; price ratios of 2:1 were observed between the Dutch and the German markets during 30 April-10 August 2001.

79. Some regions like Ireland are spokes at the ends of other spokes. *Communication from the European Commission to the Council and the European Parliament — European Energy Infrastructure*, 2001 (COM/2001/775/final).

80. Four different approaches coexist: first-come, first-served (France-Spain, France-Belgium and Austria-Italy interconnections); pro-rata curtailment (France-Italy); auctions (France-United Kingdom, Denmark-Germany, Spain-Portugal, and Belgium-Germany/Netherlands); linkage of capacity and spot markets (Nord Pool and partially Spain-Portugal). Annex I to the *Communication from the European Commission to the Council and the European Parliament — Energy Infrastructure*, 2001 (COM/2001/775/final).

81. Proposal for a regulation of the European Parliament and of the Council on conditions for access to the network for cross-border exchanges in electricity, Document 501PC0125(02), available at http://europa.eu.int/eur-lex/en/com/dat/2001/en_501PC0125_02.html.

82. This section draws mostly from Biggar (1999).

83. Economies of scale vary. In the United States, where the volume of mail delivered is much larger than in Europe, delivery costs as share of total costs are inferior to those in Europe.

84. In the 1930s, some of these companies started providing their own services, recalling for instance that some companies developed their own internal national telephone systems. This tends to prove that there may be no natural monopoly.

85. Direct mail is advertising mail.

86. Several studies have found that rates of substitution are increasing, especially for business-related services. The frontier between the two activities is more and more blurred, with mail services also using telecommunications to reduce transport costs.

87. The latest example is the diversification of Consignia in the United Kingdom into travel services. "Joint Venture Consolidates Post Office Presence in Travel Services Sector", Consignia Press Release, 23/5/02.

88. Network services were not mentioned in the EC-1992 White paper of 1985 (Pelkmans, 2001).

89. Directive 97/67/EC of the European Parliament and Council of 15 December 1997 on common rules for the development of the internal market of Community postal services and the improvement of quality of services, OJEC L15/14, 21/1/1998.

90. The Notice from the Commission on the application of the competition rules to the postal sector and on the assessment of certain state measures relating to postal services can be found in SEC(97) 2289, 17/12/1997, published in OJEC C39, 6/2/1998.

91. As the weight limits show, the notion of universal service is not restricted to the reserved market; it also addresses part of the market open to competition. National regulators can relax the universal service rules, subject to notification to the Commission. Note also that the directive does not require a universally uniform price.

92. International agreements also distinguish between physical and non-physical re-mail; in the first the mail is "produced", then physically shipped from the country of origin to the country of re-mail, and in the second the mail is physically produced in the country of re-mail.

93. Recitals 10 & 11 in the Commission proposal. The Commission proposed to remove the price-based value-added limit criteria in place (recital 18), which had not proven very effective, and to introduce a new definition. *Proposal for European Parliament and Council Directive amending Directive 97/67/EC with regards to the further opening to competition of Community postal services*, COM(2000)319 final, 30 May 2000.

94. In the proposal for amending the current directive, the Commission wrote: "The postal directive has required only a limited market opening.…It did not create real competition in the letters market, since it opened only 3 per cent on average of the postal revenues of the public operators".

95. On 4 November 2002, "Consignia plc." was changed to "Royal Mail Group plc."

96. In the light of its difficulties, Consignia will receive a relief package from the UK government. *Financial Times*, "Consignia Given Assurance of Government Rescue Package", 27/05/2002.

97. The transformation of Sweden's Posten into a private firm has resulted in its subjection to VAT.

98. A list of the pending infringement and competition issues is available at http://www.freefairpost.com/others/pending.htm.

99. The license fee to fund the universal service obligation and to prevent "cream skimming" can amount to 20 per cent of turnover.

100. For letters under 100g for TPG. Postcom (2001).

101. See Frontier Economics (2002). For a list of examples of efficiency gains, see Annex I of this reference.

102. They cite for example the entry of Citymail on the Swedish market with low-cost no-frills services. See Reay and Rodriguez (2001).

103. Consignia has staunchly opposed the call for liberalisation recently proposed by Postcomm in the United Kingdom, arguing that the stamp price would rise by more than 40 per cent.

104. Although part of the increase is the result of the imposition of VAT.

105. In 1998. See SEC(2001)1961 final, *Communication from the Commission to the European Parliament Pursuant to the Second Subparagraph of Article 251(2) of the EC Treaty Concerning the Common Position of the Council on the Adoption of a European Parliament and Council Directive Amending Directive 97/67 EC with Regards to the Further Opening to Competition of Community Postal Services*, 10/12/2001.

106. 1993 ECR I, 2533. The case was brought as a challenge to the Belgian postal monopoly in value-added services.

107. Access shall be granted on the basis of avoided costs.

108. Decision 2001/176/EC of 21 December 2000 concerning the provision of certain new postal services with a guaranteed day- or time-certain delivery in Italy, Official Journal L 63, 3/3/2001 p. 59-66.

109. From the name of the French trade association of mail preparation firms who brought the complaint in 1998.

110. Overall, since 1985, four decisions of a total of 16 under this article have been taken in the postal sector. See Hocepied (2002).

111. See also Commission press release, "Italy Implements Commission Decision on the Provision of New Postal Services in Italy", 24/11/2001.

112. EC press release, "Commission Closes State Aid Investigation Concerning Poste Italiane with A Positive Decision", 12 March 2002.

113. Cf. Note 97.

114. For a thorough review of the evolution of international agreements on re-mail under the Universal Postal Union (UPU) convention, see Campbell (2001*b*).

115. Following the introduction of new measures by the CEPT re-mail conference.

116. In 1986, the United States formally opened outgoing international mail for re-mail, which led the European countries to replace the UPU provisions under the auspices of the CEPT re-mail conference in 1987. In 1988, the International Express Carriers Conference (IECC) complained to the European Commission about the anti-competitive practices established by the 1987 Re-mail Conference held by European USPs as a response to the American move. IECC challenged the right of postal administrations to set terminal dues discriminating against international mail (i.e. price fixing) and the application of Article 23. This and what follows draw heavily from Campbell (2001*a*).

117. Similar recommendations applied for international mail. See Campbell (2001*a*).

118. This was a deal of only one month earlier, regarding the terminal dues agreement and subsequent to a promise in 1989 not to resort to interception of re-mail destined overseas (this type of re-mail is known as ABC re-mail). Campbell (2001*b*) notices that the promise not to use art. 23.4 was in effect an empty promise, since the operators could in most instances use the provisions regarding non-physical re-mail (arts. 23.1 to 23.3) to the same effect.

119. The CEPT agreement was ruled to be a cartel.

120. Because, according to the Commission, this caused the postal operators to lose money on re-mail, since they charged less in terminal dues than they would do on domestic postage.

121. The Green paper left open this latter topic, seemingly leaving possible the use of these provisions for extra-Community re-mail. Campbell (2001*b*).

122. In September 1999 after two years of negotiation.

123. This is despite Art. 13 of the directive, which states that terminal dues shall be fixed in relation to costs. The current inability to calculate costs would explain the tariff-based approach, but it is very likely that the 80 per cent level is well above the costs of distribution.

124. Special regimes applied for Greece, Spain and Italy during the transition period.

125. See the European Court of Justice judgement in the GZS joined cases, C-147/97 and C-148/97, February 2000.

126. The official reason for the delay is to facilitate the transition towards the final level of terminal dues. Federation of European Direct Marketing Association website: http://www.fedma.org.

127. One of the most notable decisions of the 1999 UPU Congress was the adoption of a two-tier terminal dues system for developed and developing countries. Therefore, the system not only depends on the volume of mail exchanged bilaterally as before but also installs an "export tax" on terminal dues in favour of developing countries.

128. Article I:3c of GATS excludes governmental services that are "any service which is supplied neither on a commercial basis nor in competition with one or more service suppliers". Postal services probably would not fall into that category (Sinclair, 2001).

129. Communication from the European Communities, "GATS 2000: Postal/Courier Services", WTO S/CSS/W/61, 22 March 2001.

130. Transport services with an optimum use of energy consumption and transport time, routes and conditions.

131. European Parliament v. Council, Case 13/83, 1985. The objective of a common transport policy has to be pursued according to Title V (ex Title IV), articles 70 (ex 74) to 80 (ex 84) of the Treaty establishing the European Community, consolidated version.

132. EC/2342/90, EC/2343/90 and EC/2344/90, 24 July 1990.

133. There are eight air traffic freedoms. The first is the right to over-fly one country en route to another; the second is to make a technical stop in another country; the third is to carry passengers and freight (P&F) from the home country to another country; the fourth is to carry P&F to the home country from another country; the fifth is to carry P&F between two countries by an airline of a third country on a route with origin or destination in its home country; the sixth is to carry P&F between two countries by an airline of a third country on two routes connecting in its home country; the seventh is to carry P&F within a country by an airline of another country on a route with origin or destination in its home country; and the eighth is to carry P&F within a foreign country with no connection with the home country.

134. With the Netherlands in 1992, Germany in 1994 and Belgium, Luxembourg and Austria in 1995. These agreements envisaged free access to all the lines, unlimited frequencies and the authorisation to operate without restriction in any point of each signatory state.

135. For the reasons underlying a progressive liberalisation of cabotage (traffic operation within a territory), see Lewis (1992).

136. In the design of the EU regulation access to a given connection must be regarded as city to city and not as airport to airport. Consequently, all the airports making it possible to serve a city are regarded as belonging to the same airport system. See Commission decision 94/291/CE, 19 May 1994.

137. The exclusive right cannot exceed three years and the financial compensation must be based on real costs and foreseen turnover. These USOs now exist on about 130 intra-community routes.

138. The access right for international groupings has allowed at least two initiatives: Thalys and Eurostar.

139. The criteria for licensing take into account reputation, financial position and professional competence.

140. The lines allocated to the TERFN total around 50 000 km and are used for the transportation of approximately three-quarters of the rail freight traffic.

141. International liberalisation has been accompanied by safeguard measures enabling the EU to react in the event of unfair pricing practices in the EU market by third countries, and if third countries restrict access to their markets (Regulation 4058/86/EEC).

142. For example, for services in the Mediterranean and along the coast of Spain, Portugal and France, the exemptions were cruising, until 1 January 1995; carriage of strategic goods (oil, petroleum products and drinking water), until 1 January 1997; and regular passenger transport services, until 1 January 1999.

143. In this system national freight authorities fixed charges and operators took their turns in loading consignments.

144. In the EU, state and other public aids to the railroads accounted for almost €32 billion in 1999.

145. For an analysis of access to Paris airports (France), Milan Airports (Italy) and Karlstad (Sweden), see Jankovec (1999).

146. Average measure for a standard trip of 1000 km. See Coopers and Lybrand (1996).

147. As part of the joint operation scheme, PT Telkom and its partners are required to allocate 20 per cent of their annual investment on installations in unserved or underserved areas regardless of commercial considerations.

148. Each of the five consortia included at least one foreign telecommunications company.

149. The Telecommunications Reference Paper refers to avoiding anti-competitive practices, manners and processes of managing licensing, the terms on interconnectivity, the right to develop a universal service policy and so on. The importance of a supervisory body independent of any supplier of basic telecommunications services is also emphasised. As Abrenica and Warren (1999, p. 4) note, the Reference Paper outlines a set of six broad principles designed to ensure that service providers can compete on equal terms once they have been allowed to enter a particular market. These include:

— Competitive safeguards to be maintained that prevent incumbent suppliers from engaging in anti-competitive conduct towards entrants, such as anti-competitive cross-subsidisation, use of network information, or failure to supply necessary technical or commercial information;

— An interconnection regime to ensure that entrants can connect with the incumbent on non-discriminatory and cost-oriented rates that are transparent, reasonable, having regard to economic feasibility and sufficiently unbundled so that the supplier need not pay for network components or facilities that it does not require for the service to be provided;

— Universal service obligations that are administered in a transparent, non-discriminatory and competitively neutral manner;

— Licensing criteria that are transparent, with reasons for denial made known to the applicant;

— A regulator that is independent of any supplier of basic telecommunications; and

— Procedures for the allocation of scarce resources (e.g. spectrum) that are objective, timely, transparent and non-discriminatory.

150. These are sales and consulting services, videotext, teleconference, and domestic leased circuits.

151. It is commonly recognised that by far the regulator's most challenging task is dealing with interconnection.

152. According to Indonesia's GATS Schedule, branching is also subject to geographical limitation (limited to eight cities or regions in Indonesia).

153. In 1995, 37 commercial banks, 40 finance companies and 12 investment banks were licensed in Malaysia. No new banking licenses have been awarded since 1997, except for offshore banking licenses.

154. For an overview of regulatory reforms of the regional energy sectors, see Masuda (2001).

155. Of course, deregulation *per se* by no means guarantees a stable supply of energy, as the electricity crisis in California has made apparent (Joskow, 2001).

156. Apart from the "core" versus "non-core" demarcation noted by the Japanese government, Zarrilli (2001) has suggested the following classification. "Traditional services" would include exploration, extraction, drilling, derrick building and pipeline construction, while "emerging services" would include gas and electricity transmission and distribution, operation of power pools, energy trading/brokering and energy management.

157. While Japan has argued that negotiations should generally be "resource neutral" in the sense that they should not address energy resources, a controversial area pertains to services relating to nuclear power.

158. Bird and Rajan (2002) provides a useful overview of the recent empirical literature on this topic.

159. Why distinguish between restrictions on *establishment* from *ongoing operation*? According to Findlay and Warren (2000), because "the former can be modelled as restrictions on the actual movement of capital, while the latter can be modelled as restrictions on output" (p. 36).

160. In addition to these cost-increasing effects of import restriction, there are rent-creating effects due to the market imperfections which allow firms to enjoy supra-normal profits.

161. The treatment of FDI in the FTAP model is in turn based on Petri (1997). Dee and Hanslow (2000) and Hanslow *et al.* (1999) offer a detailed discussion of the FTAP model. Descriptions and documentation related to the model are available on the Productivity Commission of Australia's website: http://www.pc.gov.au.

162. China itself is expected to gain from services liberalisation by around $90 billion.

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# Financial Opening under the WTO Agreement in Selected Asian Countries: Progress and Issues

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## Introduction

The General Agreement on Trade in Services (GATS) provides an international regulatory framework for administering global liberalisation of trade in services[1]. Its major component is trade in financial services. The increasing importance of services trade led to the establishment of the GATS as one of the new areas in the Uruguay Round negotiations, although developing countries, in general, initially had reservations. The reservations were based on the perception that services, unlike goods, are exported more from developed economies to developing economies, and that domestic service industries remained at an underdeveloped stage requiring further protection and regulation.

Against this backdrop, the GATS allows remarkable flexibility within which the member governments of the World Trade Organisation (WTO) determine their level of obligations. Four main elements of flexibility underlie the GATS (WTO, 2002): *i)* member governments choose those service sectors or sub-sectors in which they will make commitments, guaranteeing the right of foreign suppliers to provide the service. Each member must have a schedule of commitments, but there is no minimum required coverage — members may cover only a small part of one sector; *ii)* for those services that are committed, the governments may set limitations specifying the level of market access and the degree of national treatment they are prepared to guarantee; *iii)* the governments are able to limit commitments to one or more of the four recognised "modes of supply"[2] through which services are traded, and they may also withdraw and renegotiate commitments; and *iv)* in order to provide more favourable treatment to certain partners, the governments may take exemptions, in principle limited to 10 years, from the most-favoured-nation (MFN) principle[3], which is otherwise applicable to all services, whether scheduled or not. This flexibility in scheduling commitments contributed to the early resolution of the north-south controversy over services trade.

The Fourth WTO Ministerial Conference Declaration in November 2001 in Doha, Qatar, provides the mandate for negotiations on a wide range of subjects and sector issues. Of primary importance is the declaration that sets 1 January 2005 as the date for completing all but two of the negotiations (i.e. the Dispute Settlement Understanding and a multilateral register of geographic indications for wines and spirits by 2003). It is therefore during the period 2002-2004 that a new round of negotiations on financial services should be held and concluded. Services negotiations have been ongoing as mandated since January 2002. WTO countries should submit initial requests for specific commitments by 30 June 2002, and initial offers by 31 March 2003; all services negotiations should conclude by 1 January 2005.

Opening up of financial services has enormous policy implications for a member country. As demonstrated by the Asian crisis, which erupted in 1997, mismanagement of financial opening may lead to disastrous economic consequences. Only prudent financial policies, including implementation of GATS commitments, can result in macroeconomic stability, sustained output growth, and financial sector development. This paper examines six selected countries: People's Republic of China (PRC), Indonesia, Republic of Korea (Korea), Malaysia, Singapore and Thailand. For the PRC, as a new WTO member, successful liberalisation of financial services trade is of great importance. For the five other countries, all crisis-affected, there arises the need to review ongoing financial liberalisation policies and explore future directions.

The first four sections of this paper will examine the following: *i)* relations between financial services liberalisation and capital account liberalisation; *ii)* GATS and/or multilateral commitments made by these countries; *iii)* progress in compliance of the commitments and their impact; and *iv)* implications and issues of financial opening with focus on the banking sector. The last section presents conclusions.

## Relations Between Financial Services Liberalisation and Capital Account Liberalisation

It is desirable to clarify both the difference and linkage between opening up of financial services within the context of the GATS and capital account liberalisation before discussing opening up of financial services. Confusion arises frequently because people do not always distinguish between cross-border capital flows and transactions of financial services. Strictly speaking, the latter does not necessarily entail the first (for example, provision of financial information only by foreign financial organisations), although most financial transactions involve cross-border capital flows (e.g. foreign currency lending by a foreign [resident] bank using money sourced from abroad). If a domestic bank sources foreign currency funds from overseas markets/institutions, this is not opening up of financial services but simply international capital movements related to capital account liberalisation. Table 1 provides an example of differences between domestic financial deregulation, capital account liberalisation, and financial services liberalisation.

Table 1. **Comparison of Domestic Deregulation, Capital Account Liberalisation, and Financial Services Liberalisation**

| | Domestic Funds (I) | International Funds (II) |
|---|---|---|
| Credit provided by domestic supplier (A) | Domestic deregulation: neither financial services trade nor international capital flow | Capital account liberalisation: international capital flow only |
| Credit provided by overseas supplier (B) | Financial services liberalisation | Capital account liberalisation and financial services liberalisation |
| Credit provided by foreign resident supplier (C) | Domestic deregulation and financial services liberalisation | Capital account liberalisation and financial services liberalisation |

The GATS requires only the liberalisation of capital flows as crucial in the financial services provided by foreign financial institutions. Commitments to cross-border trade liberalisation (Mode 1) require the liberalisation of inflows and outflows of capital, which are an essential part of the concerned services, while commitments to commercial presence (Mode 3) require the liberalisation of capital inflows that are related to the supply of the services[4] (Kono and Schuknecht, 2000), which might include capital for foreign financial institutions to establish branches or companies and to facilitate their operations. Capital outflows related to the supply of services under Mode 3 do not have to be liberalised. The GATS does not oblige WTO members fully to liberalise capital flows related to the activities of such local establishments. This means that opening up financial services is consistent with the existence of certain capital account restrictions. This is particularly important for most developing countries where domestic financial markets remain underdeveloped and small, and balance of payments positions are weak.

It should be noted, however, that there is a coherent linkage between the opening up of financial services and liberalisation of the capital account. For example, a high level of capital control will discourage the entry of foreign financial institutions into the country, because of the poor prospects of local currency convertibility and withdrawals/remittances of the concerned capital. This is why opening up of financial services can be implemented successfully only when a prudent, sound policy on capital account liberalisation is in place. An orderly and well-designed sequencing of capital account liberalisation is therefore critical to reaping the benefits of financial services opening in developing countries.

## Overview of Financial Opening under GATS in Selected Asian Countries

### *Definition of Financial Services*

According to definitions provided in the Annex on Financial Services (the Annex) of the GATS, "a financial service is any service of a financial nature offered by a financial service supplier of a Member." The term "financial service supplier" does not include a public entity that provides services in the exercise of government authority. Financial services include the following activities:

*Insurance and Insurance-related Services*

This covers: *i)* direct insurance (including co-insurance), both life and non-life; *ii)* reinsurance and retrocession; *iii)* insurance intermediation, such as brokerage and agency; and *iv)* services auxiliary to insurance, such as consultancy, actuarial, risk assessment, and claim settlement services.

*Banking and Other Financial Services (excluding insurance)*

This covers: deposit taking; lending; leasing; payment and monetary transmission; guarantees and commitments; financial trading (money market instruments, foreign exchange, derivative products, swaps, forward rate agreements, transferable securities, and other negotiable instruments); money brokering; asset management; settlement and clearing services; provision of financial information; and advisory services.

### *Commitments of Individual Countries*

The six countries examined have generally made commitments to all financial areas but differences among the countries exist. Individual country commitments are composed of the horizontal commitments and sector commitments; the first deals with across-the-board agreements, while the latter with sector-specific ones.

In addition to the GATS, the ASEAN Framework Agreement on Services (AFAS)[5] was born out of the Bangkok Summit of the Association of Southeast Asian Nations (ASEAN) in 1995, which provides a basis for ASEAN countries to launch negotiations on seven areas of services: banking, tourism, air transportation, maritime transportation, telecommunications, construction, and professional services. Commitments were made only in such sectors as finance and telecommunications in September 1998. The GATS framework provided the basis for the AFAS negotiations and a positive list approach was adopted in liberalising the service sectors. Slow progress in the AFAS is attributed to weak political will, legal restrictions, and institutional limitations. The PRC joined the WTO as a new member on 11 December 2001 after the WTO approved the accession protocol in November 2001.

*People's Republic of China*

The PRC made substantial commitments in the banking sector during WTO entry negotiations. Its financial markets will be opened on a step-by-step basis. Two years after the PRC's entry into WTO, foreign banks will be allowed to undertake some local currency business with all their customers. Five years after the PRC's entry, foreign banks will be able to fully engage in local currency services and receive national treatment in banking services without restrictions in terms of geography, branching, and scope.

As of the end of 2000, there were 178 foreign banking institutions in the PRC with total assets of $34.6 billion, including $18.8 billion of foreign currency loans that accounted for 22.7 per cent of total foreign currency loans in the PRC. However, because of various restrictions, foreign banks account for only 2 per cent of total banking business in the PRC, a much lower level than in most other developing and transition economies.

Major Horizontal Commitments

*i)* *Commercial presence:* foreign investment[6] in an equity joint venture should be no less than 25 per cent of the registered capital; establishment of branches by foreign enterprises is boundless, unless otherwise indicated in specific sectors.

*ii)* *Presence of natural persons:* senior employees (managers, executives, and specialists) of a corporation are permitted for an initial term of 3 years.

Commitments on Specific Financial Services

*i)* *Insurance and insurance-related services:* two areas are vital — foreign equity participation and geographic coverage. As to the former, foreign non-life insurers will be permitted to establish a branch or a joint venture with 51 per cent foreign ownership that can rise to 100 per cent within 2 years from the PRC's accession to the WTO. Life insurers will be allowed 50 per cent foreign ownership in a joint venture upon accession. Brokerages of insurance/reinsurance will be allowed no more than 50 per cent foreign ownership upon accession, up to 51 per cent within 3 years after accession, and up to 100 per cent within 5 years after accession.

As to geographic coverage, upon accession, foreign life and non-life insurers and insurance brokers will be permitted to provide services in Shanghai, Guangzhou, Dalian, Shenzen and Foshan. Within 3 years after accession, no restrictions will be imposed.

*ii)* *Banking and other financial services (excluding insurance):* the PRC has made commitments in two areas. The first is that, in terms of geographic coverage, foreign currency businesses will have no geographic restriction upon accession. Local currency business is possible only in Dialin, Shanghai, Shenzen and Tianjin

upon accession; within 1 year after accession, Guangzhou, Najing, Qingdao, Wuha and Zhuhai; within 2 years, Chengdu, Chongqing, Fuzhou and Jiha; within 3 years, Beijing, Kunming and Xiamen; and within 4 years, Ningbo, Shantou, Shenyang and Xian. There will be no more restrictions thereafter.

The second concerns licensing. Foreign financial institutions with total assets of at least $10 billion at the end of the year prior to filing of application may establish a subsidiary; for establishing a branch of a foreign bank, total assets should be at least $20 billion; and for a joint bank or a joint finance company, total assets should be at least $10 billion.

*Indonesia*

Indonesia's commitments to the AFAS (September 1998) and GATS (February 1998) on the banking sector (horizontal and general conditions) are summarised as follows: *i)* all market access and national treatment limitations specified will be eliminated by 2010 (2020 for the GATS) subject to a similar commitment by other members; *ii)* foreign bank(s) and foreign legal entity(ies) in co-operation with Indonesian national(s) and/or Indonesian legal entity(ies) are allowed to establish or acquire locally incorporated banks with existing regulations (a new license is not allowed for GATS); *iii)* branch offices of foreign banks and joint-venture banks may open their offices in the cities of Ambon, Bandung, Batam Island, Denpasar, Jakarta, Mandado, Medan, Padang, Surabaya, Semarang and in all other provincial capitals subject to economic need test (only one sub-branch and one auxiliary office per foreign bank branch); *iv)* acquisition of local existing banks through purchase of shares in the stock exchange is allowed up to 49 per cent (51 per cent for AFAS) of the listed shares; and *v)* as to the presence of natural persons, a non-Indonesian employed as manager or technical expert is required to have at least two Indonesian nationals as understudies during his/her term.

The commitment is generally conservative but in reality it is much more liberal. For example, ownership of a domestic bank by foreign investors is limited to a maximum of 49 per cent in the GATS (51 per cent in the AFAS) but the country is in fact allowing up to 99 per cent upon approval by the government. With regard to the entry of foreign banks, the issue on hand is finding the means to attract more funds from these banks, rather than restricting their business scope, given the large net outflows of foreign capital from Indonesia in recent years. Presence of natural persons is generally prohibited except for a non-Indonesian manager or technical expert. Temporary entry may be granted to technical experts/advisors of foreign bank branches for joint-venture banks for a maximum of 3 months per person for any given year.

Indonesia imposes several specific restrictions on non-banking finance: market access and national treatment for cross-border supply of non-life insurance, life insurance, factoring services, securities business, and investment advisory services are not allowed. These will be eliminated by 2020 subject to similar commitments by

other WTO members. To conduct securities business, foreign brokers/companies need to establish a broker/securities company. For the others, the following horizontal restrictions should be complied with: first, the share of ownership of a foreign services supplier is bound by prevailing laws and regulations; second, shares of non-bank financial companies listed in the stock exchange may be 100 per cent owned by foreign investors; and third, in relation to the presence of natural persons, expatriates may assume the positions of directors, managers, and experts/advisors with a term of 3 years that can be extended.

*Republic of Korea*

The policies on financial opening in the Republic of Korea (Korea) exhibited sharp contrast before and after the Asian crisis. Opening up of the financial sector after the crisis progressed more rapidly than in the pre-crisis period, though there had been significant opening efforts immediately before the crisis to prepare for Korea's accession to the Organisation for Economic Co-operation and Development (OECD). The rapid post-crisis progress was attributed to a combination of several factors: *i)* the urgent and impending need for foreign funds to fill the financial gap created after the crisis; *ii)* the new shift in the government's attitude into one that is highly favourable to foreign investment; and *iii)* international pressures by the OECD and international financial agencies for Korea to deregulate and open up its financial sector as a member of the OECD.

In the early part of 1998 some major policy actions were taken to increase the commercial presence of foreign financial institutions in Korea. In April 1998 foreign banks and securities firms were allowed to establish subsidiaries; 100 per cent foreign ownership of Korean financial institutions was also made possible. In May 1998 Korean banks were able to recruit foreign nationals as directors. As seen in Table 2, commercial presence of all financial institutions (branches, subsidiaries, and joint ventures) became possible by 2000. Foreign ownership of up to 100 per cent in a Korean bank was permitted in April 1999[7]. In principle, any foreign bank can enter Korean markets and enjoy virtually the same national treatment.

Table 2. **Commercial Presence of Foreign Financial Institutions in Korea (2000)**

| | Bank | Security | Investment Trust Company | Investment Advisory | Life Insurance | Non-Life Insurance |
|---|---|---|---|---|---|---|
| Branch | Open | Open | Open | Open | Open | Open |
| Subsidiary | Open | Open | Open | Open | Open | Open |
| Joint Venture | Open | Open | Open | Open | Closed | Not open |
| Cross-Border Trade | Partially open | Closed | Partially open | Open | Open | Aviation, Hull (open) |

*Source:* Korea Institute of Finance (2000).

Towards the end of 1997, Korea accelerated the opening of stock markets to attract foreign funds in the wake of the crisis[8]. In the case of state-owned companies, the ceiling on stock investment by foreigners was raised to 30 per cent from 18 per cent a year earlier. Ceilings on stock investments in private companies were drastically removed: to 23 per cent in May 1997, 26 per cent in November 1997, 55 per cent in December 1997, and 100 per cent in May 1998. Foreign investment in private company equities was fully liberalised in only 6 months after the crisis.

In bond markets, investments in and trading of both corporate and government bonds, which had not been allowed for foreigners till the end of November 1997, were fully opened by the end of 1997. Other important opening measures include:

*i)* markets for commercial papers and trade bills were opened in February 1998;

*ii)* all money market instruments including certificates of deposit (CDs) and repurchase agreements (RPs) were opened in May 1998;

*iii)* trading of listed bonds in over-the-counter markets was permitted in May 1998; and

*iv)* trading of non-listed bonds was allowed in July 1998.

Further, the government took various actions to liberalise foreign exchange markets. In July 1998, medium-term foreign loans were permitted to facilitate borrowing of foreign funds by the business sector. In April 1999 the Foreign Exchange Management Act that had long provided the legal basis for foreign exchange control in the country was replaced by the Foreign Exchange Transactions Act (FETA) to support financial liberalisation. Offshore issuance of securities and foreign borrowing by Korean firms and financial institutions became much easier. Since 2001, many restrictions on foreign exchange transactions by foreign and Korean individuals have been removed.

Korean laws largely prohibit cross-border financial services trade, which is increasingly important within the context of GATS negotiations. Although cross-border banking is not allowed in principle, a limited number of cross-border transactions are possible under the FETA (partially open). Table 2 shows the liberalisation status of cross-border trade as well as commercial presence by type of financial services. With respect to cross-border trade, banking and mutual fund investment are partially open, securities transactions are not open, while life insurance and investment advisory services are fully open. As of March 2002, there were 61 foreign bank branches and 26 foreign representative offices.

*Malaysia*

Malaysia has kept a financial liberalisation schedule within the context of the GATS (February 1998) and the AFAS (September 1998). The 10-year Financial Sector Master Plan also provides the country's financial sector with a road map on financial reform, opening of domestic markets, and development direction.

Market access and national treatment for cross-border supply, consumption abroad, and presence of natural persons of offshore banks, offshore investment banks, and offshore insurance companies are generally not allowed. Concerning market access, commercial presence of these offshore financial institutions is allowed only in Labuan, and entry is limited to establishment of a branch or a subsidiary incorporated in Malaysia. There is no restriction on national treatment.

Market access and national treatment for cross-border supply and consumption abroad of commercial banks and investment banks are generally not allowed. The 13 wholly foreign-owned foreign banks are permitted to remain 100 per cent foreign owned; new licenses are not allowed. Natural persons are not allowed to hold office on a temporary basis except senior managers and specialists. Entry of wholly foreign-owned banks is limited to equity participation by foreign banks in Malaysian-owned or controlled commercial banks and investment banks. Aggregate foreign shareholding in a commercial or investment bank shall not exceed 30 per cent. Shareholding by a single person individually or jointly is limited to a maximum of 20 per cent.

Market access and national treatment for cross-border supply and consumption abroad of direct insurance companies are not allowed in general. On commercial presence, branches of foreign insurance companies are required to be locally incorporated by 30 June 1998 and new licenses are not allowed. Acquisition by a foreign insurance company of more than 5 per cent aggregate shareholding in a locally incorporated insurance company is possible with the approval of the government, provided certain conditions are met.

The basic principles behind market access and national treatment for cross-border supply and consumption abroad of securities business are summarised as follows:

*i)* offshore financial institutions are only for non-resident customers;

*ii)* issues and placements as agents are open to investment banks and locally incorporated joint-venture companies;

*iii)* underwriting companies require commercial presence and authorisation;

*iv)* asset management companies require commercial presence and authorisation;

*v)* securities brokerage companies require equity participation in an existing stockholding company or establishment of a locally incorporated joint-venture company with a Malaysian stock brokerage company; and

*vi)* aggregate foreign shareholding in the company should not exceed 30 per cent.

To cope with challenges in this age of globalisation, Malaysia is considering a banking consolidation programme within which banks will be merged into three to four large banks to provide a full range of banking services, with another three to four medium-sized banks consolidated to perform specialised services. The consolidated banks will be better capitalised to meet international standards and to undertake a wider scope of business. The operational business integration process and rationalisation

exercise have been the major components of the recent consolidation efforts to reduce duplication of resources and/or functions and to attain higher levels of economies of scale and efficiency in banking institutions. There are currently 14 foreign banks operating in Malaysia out of a total of 47 banking institutions (composed of commercial banks, finance companies, and investment banks). Foreign bank branches totalled 145 out of 2 557 branches in the entire banking system.

*Singapore*

Cross-border supply and consumption abroad of all financial services are generally prohibited. Presence of natural persons is also limited.

The schedule of specific commitments within the context of the GATS (February 1998) and the AFAS (September 1998) deals with insurance and insurance-related services, banking, securities, and other financial services. The presence of natural persons is unbound, except for intracorporate transfers of managers, executives, and specialists. The entry of these intracorporate transfers is limited to 3 years, which may be extended for up to 2 additional years (horizontal restrictions). Specific commitments under GATS are summarised as follows:

*i)* For life insurance and non-life insurance, consumption abroad is allowed and foreign parties can acquire aggregate equity stakes of up to 49 per cent in locally owned insurance companies, provided the acquisition does not result in any foreign party being the largest shareholder.

*ii)* As to acceptance of deposits and other payable funds from the public (banks), market access is granted only for institutions approved as banks, investment banks, and finance companies; foreign banks can operate only one office and cannot establish off-premise ATMs, ATM networking, or new sub-branches.

*iii)* As to bank lending, Mode 2 (consumption abroad) is allowed; each offshore bank's lending in Singapore dollars to residents shall not exceed $200 million in aggregate; there is no limit on the establishment of off-premise cash dispensing machines for credit and charge cards.

*iv)* For financial leasing, guarantees, and money and foreign exchange market transactions, there are generally no restrictions.

*v)* Participation in issues of securities including underwriting and placement as agents is limited to foreign stockbrokerage companies; as non-members of the Stock Exchange of Singapore (SES), they can become Approved Foreign Brokers to trade directly in non-Singapore dollar-denominated securities quoted on SES.

*vi)* For advisory and other auxiliary financial services, commercial presence is required, and establishment of branches, subsidiaries, or representatives is allowed.

While the schedule generally keeps a conservative stance toward trade in these financial services, the Singapore financial authorities have, since 1998, taken many important steps to expedite internationalisation and liberalisation of Singapore's financial markets and the Singaporean dollar. According to the Monetary Authority of Singapore (MAS), Singapore has, since the Asian financial crisis, reviewed the East Asian growth model that emphasises high savings, reliance on foreign investment, and outward orientation. Some economists have argued that East Asian economies should lower savings and stimulate domestic demand, develop indigenous enterprises, and insulate themselves from volatile external conditions[9]. However, the review has reached a conclusion that, in particular, small economies like Singapore relying on small domestic markets and traditional-type indigenous enterprises to stimulate its growth and investment seems inherently implausible, and Singapore's economic regime should remain externally oriented.

Against this backdrop, Singapore has shifted from the previously conservative and risk-averse regulatory approach to an internationalised and liberalised approach supported by prudential supervision, while at the same time accepting calculated risks to promote competition and efficiency of the financial industry. The core of this liberalisation policy comprises two key elements: progressive internationalisation of the Singaporean dollar; and fostering capital markets, particularly bond markets with a goal to diversify Singapore's financial markets and develop the country as a global financial hub. On the first element, through two amendments in banking laws and regulations, most policy restrictions propping up the long-standing non-internationalisation policy have been phased out over the past 4 years. Singapore is retaining only two basic restrictions to prevent currency speculation: *i)* financial institutions may not extend Singapore dollar credit facilities exceeding S$5 million to non-resident financial entities, where they have reason to believe that proceeds may be used for speculation against the Singapore dollar exchange rate; and *ii)* when a non-resident entity wishes to obtain a Singapore dollar loan, or tap Singapore equity or bond markets to fund overseas activities, it must swap or convert the proceeds in Singapore dollars into foreign currency as and when it uses the proceeds offshore.

Concerning the second point, the country's efforts have yielded encouraging results. The outstanding volume of Singapore Government Securities (SGS) since 1998 had doubled to S$54 billion by 2001, and average daily turnover had increased about three times to S$1.9 billion in 2001. New corporate debt issuance has also continued to grow rapidly, with Singapore dollar and non-Singapore dollar corporate bond issues totaling a record amount of S$72 billion in 2001, an almost eight-fold growth over issuance volumes in 1998. The tenor of corporate issues ranges evenly across a spectrum of maturity of up to 15 years, exhibiting a greater diversity of corporate bonds.

The function of local bankers on the entry of foreign financial institutions into Singapore is highly favourable and they generally support the liberalisation measures that will create more efficient and vibrant markets. A reservation is possible over competition in local retail banking and insurance markets, with international financial

institutions taking away the business ground of smaller-sized local banks and insurance companies. In line with this, the MAS has licensed only six Qualifying Full Banks (QFBs) till now, which are allowed to establish additional local branches, off-premise ATMs, and ATM sharing to undertake retail banking. Further, a deposit insurance scheme is under consideration to protect small savers. The entry of insurers and independent intermediaries is allowed based on strict MAS criteria, despite the general liberalisation stance in place since early 2000. Securities business is virtually fully open.

About 200 foreign banks are operating in Singapore, with their share in total public loans (i.e. loans to non-bank clients) and total deposits being about 50 and 35 per cent, respectively. It is a significantly high share, noting a liberalised business environment in Singapore. Major clients of foreign banks, except for the six QFBs, are home-country enterprises.

*Thailand*

The following is a summary of major commitments under the GATS:

*i)* As to horizontal conditions, (a) commercial presence is permitted in principle only through a limited liability company registered in Thailand, in which foreign equity participation must not exceed 49 per cent of the registered capital[10] and the number of foreign shareholders must be less than half of the total number of shareholders of the company concerned; (b) national treatment for this mode has no limit in principle; (c) temporary movement of natural persons is unlimited except for corporate transfers at the managerial or executive level or for specialists for a 1-year period (altogether for no more than 3 years); and (d) foreigners are not allowed to purchase or own land[11].

*ii)* On specific commitments, (a) "cross-border supply" and "consumption abroad" are generally not allowed for banking, securities services, and non-life insurance; (b) the ceiling for foreign shareholding is: life and non-life insurance, 25 per cent of registered share capital; services auxiliary (excluding pension funds), 49 per cent; representative office of commercial banks, none; local incorporated banks, 25 per cent (each limited to 5 per cent); securities companies and *credit foncier* companies 25 per cent (each limited to 10 per cent); securities companies, 49 per cent; asset management companies, 25 per cent for the first 5 years followed by 49 per cent after 5 years; and financial leasing, factoring services, credit cards, and charge and debit cards, 49 per cent[12]; (c) as to presence of natural persons, for life and non-life insurance, only senior managerial personnel, specialists, and technical assistants are allowed, subject to the approval of the Insurance Commissioner; (d) on banking, consumption abroad and cross-border supply is without limit except for financial advisory and financial data processing; commercial presence has generally no restrictions for existing foreign bank branches; (e) for securities companies (brokerage, dealing, underwriting, investment advisory services) market access and national treatment for consumption abroad are allowed; national treatment for cross-border supply is

allowed; limitations on market access for commercial presence are absent for representative offices; share acquisition of existing companies is allowed up to 100 per cent of paid-up capital; and national treatment allowed.

The percentage of foreign shareholding in Thai banks has, since the Asian crisis, increased significantly due to the government's policy encouraging foreign participation for the sake of recapitalisation of domestic troubled banks and transfer of advanced banking techniques. In June 1997 before the outbreak of the crisis, the foreign share in the financial sector was zero but rose to 6 per cent as of December 2000 (all in commercial banks)[13]. The number of foreign bank branches decreased slightly from 21 in 1997 to 18 in March 2002 in the wake of the general consolidation of banking institutions in the country since the crisis. Local clients of foreign banks generally have a positive perception of these banks, noting that they can contribute to mobilising foreign funds for the country and that the major cause of the crisis was not simply capital inflows but, more importantly, lack of prudential supervision of financial activities.

## Implications of Banking Sector Opening

### ***People's Republic of China***[14]

#### *Implications and Issues*

The PRC has made far-reaching commitments in WTO negotiations in opening up its financial sector. During the phaseout period of 5 years, the PRC will gradually remove the geographic and regulatory restrictions for foreign financial institutions and liberalise the scope of businesses. The final commitments will open the sector to foreign access, while maintaining some limitation on cross-border supply and foreign equity participation.

Given the rapid development of the PRC financial sector and its integration into the global financial sector, the country faces a daunting task of improving its legal and regulatory system to address existing weaknesses and prepare for future challenges. Substantial development of the legal and regulatory framework for the financial sector has greatly accelerated the reform and growth of its banking and non-banking sectors. One noticeable example is the recent enactment of the Trust Law, which provides underlying principles for fiduciary duties and governing rules on the board of trustees. The law lays the foundation for development of legal trusts in the PRC. The future laws and regulations governing various trusts will comprise two general tiers: basic law such as the Trust Law, and other laws pertaining to detailed rules on specific trusts, such as pension funds and investment funds.

However, there are weaknesses in the legal and regulatory system, which may hamper financial sector development. There are still gaps or grey areas where no suitable law or subordinate legislation can apply. For example, there is neither a legal code for handling bankruptcy of financial institutions, nor are there regulations governing electronic transactions, anti-money laundering, and non-bank financial

companies, such as trust and investment companies, finance and leasing companies, etc., as they are regulated by various regulations and decrees. A consistent and effective approach to enacting and amending laws is also lacking, as well as transparent procedures to bring stakeholders' participation into the legislation process.

Enforcement laws and regulations are inadequate and on many occasions, financial sector supervisors would have to rely on the interpretation of the Supreme Court when implementing the law. Foreign participation in the PRC financial sector has been governed mostly by separate sets of temporary regulations and provisions. However, the PRC's entry into the WTO requires a complete overhaul of these temporary regulations and makes them consistent with the PRC's WTO commitment regarding opening up the financial industry.

The segregated regulatory system has overemphasised the regulation of market behaviours compared with the prudential regulation of financial institutions. Prudential supervision proves to be more difficult in a segregated system where financial institutions are engaged in cross-sector activities. There is no mechanism in the PRC to address solvency issues within a financial conglomerate such as double or multiple gearing, risks incurred by unregulated entities, and erection of firewalls between subsidiaries and between subsidiaries and parent companies.

International experience shows that in the long run, increased foreign participation in the banking sector has a generally positive effect on countries. The banking sector will also benefit in many ways from involvement in the process of global financial integration.

First, involvement in global integration and competition will act as a catalyst for banks to reform and improve efficiency, thus accelerating the process of economic development. Second, internationalisation can help in the process of building more robust and efficient financial systems by introducing international best practices and standards; by improving the quality and efficiency of financial services; and by attracting more stable sources of funds. Third, domestic banks surviving the competition will learn to establish more sophisticated services and systems that meet international standards and thereby increase their productivity. Fourth, it will facilitate the PRC's access to international markets and the opportunity for PRC banks to open up overseas operations. Finally, a liberalised and efficient financial sector will make a significant contribution to the overall development of the economy. Better and more efficient banking services will stimulate the development of the industrial, agricultural, and service sectors.

In the short term, however, there will be costs associated with WTO accession. Once the current protective measures are removed, the PRC's state-owned commercial banks would be placed in a rather unfavourable competitive position.

One of the important drawbacks will be a fall in the market share of domestic banks. Estimates suggest that 5 years after the PRC's entry to the WTO, the market share of foreign banks in the total banking business would increase from the current 2 per cent to about 15 per cent. Ten years later, the market share of foreign banks will rise to one third of the total banking business. This increase in the foreign banks' share indicates a corresponding decrease in domestic banks' share.

Another drawback is the decline in the profitability of local banks. Some high-quality clients with good creditworthiness, particularly those located in the coastal areas, may shift to foreign banks, leaving the less creditworthy clients and some policy-based business with the domestic banks. This probable shift is a major threat to the domestic banks.

Increased competition with international banks may adversely affect the liquidity of domestic banks as some funds available for domestic banks may gradually shift to foreign banks. Given the high proportion of bad assets among domestic banks, especially the state-owned commercial banks, the loss of liquidity will worsen the precarious situation of these banks and threaten their survival.

With the strength of their flexible management mechanisms and better remuneration packages, international companies would be likely to attract skilled personnel from domestic banks, leading to a "brain drain" of the PRC's financial firms. This will pose a threat to their operation and management and force domestic salary scales to increase. In fact, competition for personnel has already started. Initial estimates show that about one third of the managers or higher positions employed by foreign banks in Beijing and Shanghai came from domestic banks.

Domestic banks are given 5 years to assess these challenges and take appropriate measures. The reform of the financial sector must be accelerated to face the challenges arising from international competition.

*Addressing Non-Performing Loans*

The key challenge for the government is to strengthen domestic banks by addressing the problem of non-performing loans (NPLs). The official figure for NPLs of the big four state-owned commercial banks is about 25 per cent of their total loan portfolio. This excludes the 10 per cent equivalent of total portfolio NPLs transferred to the four asset management companies established in 1999. However, if a more strict, international NPL classification were adopted, NPLs might be close to half of the loan portfolio of the four state-owned banks. The NPLs of other commercial banks are lower due to their shorter operational history and lower exposure to the state-owned enterprises. Further, the NPLs in the rural and urban credit co-operatives could be as high as, or even higher, than that in the four big banks.

A comparison of the level of NPLs in other countries suggests the severity of the NPL problem in the PRC. Table 3 shows that with the exception of Indonesia, the ratio of NPLs in the PRC is higher than those countries badly hit by the Asian financial crisis. However, a simple comparison of the NPLs in the PRC with those of the other countries may be somewhat misleading. A large proportion of NPLs in the PRC result from the transition cost from a centrally planned economy to a market economy, particularly related to reform of state-owned enterprises. The NPL situation in the PRC has to be addressed as part of the ongoing transition and structural changes of the economy, a long-term process involving many steps.

Table 3. **Non-Performing Loan Rates in Selected Asian Countries, 2001**
(percentage of total loans)

| | People's Republic of China | Indonesia | Korea | Malaysia | Philippines | Thailand |
|---|---|---|---|---|---|---|
| NPLs | 25 | 18 | 5.4 | 9.4 | 16.7 | 17 |
| NPLs (broad)* | 35 | 57 | 16 | 16 | NA | 27 |

* Includes NPLs transferred to asset management companies.

*Commercialisation of State-Owned Banks*

Accelerating the pace of commercialisation of state-owned banks is another important task if domestic banks are to enhance their international competitiveness. As a first step, domestic banks should establish an effective corporate governance structure. The governor of the central bank has recently announced that some state-owned banks will be listed in the stock exchange in the next few years. To do so, the banks must operate under market rules and improve disclosure and transparency.

To improve the competitiveness of domestic banks, expeditious development of privately owned banks is strongly suggested. For a long time, banking regulations have restricted private sector participation. The significance of developing a privately owned banking system has great merit in two areas. First, it facilitates competition by ending the monopoly of major state-owned banks. Creating a competitive environment will improve efficiency, innovation, and the development of new services. Second, development of private banks will help address the distortion in credit allocation in which the state sector benefits at the expense of the non-state sector, particularly small and medium enterprises. State-owned industrial enterprises contribute less than 30 per cent of total industrial output. However, they receive more than 70 per cent of the credit allocated by the banking sector. If a non-state sector banking system is developed, SMEs, private enterprises, and consumers will have better access to bank credit.

*Human Resource Development*

Domestic banks must develop better human resource management systems, compensation systems, and incentive packages. There is an acute shortage of high-quality and senior personnel familiar with modern commercial bank management. The central bank is considering employing an officer from Hong Kong, China as its deputy governor. The government also plans to modify its policy by allowing domestic banks and brokerages to hire overseas Chinese professionals as department heads, in an effort to accelerate their development as commercial entities. This shows the government's willingness to upgrade professional skills to better respond to the changing environment.

***Republic of Korea***

Table 3 shows that in Korea, the market share of foreign banks remained at 6-7 per cent except for 8 per cent in 1997 when the crisis started. The share is low, indicating that the role of foreign banks in Korea is far from significant and that Korea's financial opening has not led to any major change in the foreign banks' share in the Korean market. However, it is noted that their share has steadily increased since 1998. It is not clear, though, whether this is a long-term trend or temporary.

Hwang and Shin (2000) examined the cyclical character of foreign and domestic currency loans by foreign banks in Korea for the period 1981-99. They ran regressions to find out the relationship between growth rates of foreign and domestic currency loans, and nominal GDP growth rates and interest rate differentials between Korea and the United States. The first finding is that domestic banks provided a more stable lending service in domestic currency, while foreign banks did so in foreign currency. Looking into the relationship between loan growth and nominal GDP growth, this study concludes that domestic currency loans by foreign banks are procyclical, whereas no significant relationship was found in the case of domestic banks. However, highly contrasting results were achieved in the case of foreign currency loans. GDP growth did not have any significant explanatory power in foreign currency loans by the foreign banks but it had a significant positive relationship with domestic banks' foreign currency loans. Given this result, they concluded that foreign banks played a stabilising role in economic fluctuations. Similarly Goldberg *et al.* (2000) found that foreign banks in Argentina and Mexico had lower volatility in lending, contributing to financial stability in times of financial crisis and economic depression.

In relation to the Asian financial crisis, foreign banks had not contributed to the eruption of the crisis given that foreign banks' assets (both in size and share) including loans did not show any sharp increase immediately before the crisis (Table 4). Their market share in the pre-crisis period was even much lower than in the post-crisis period.

On the contrary, since 1998 foreign banks have been increasingly relying on domestic sources in mobilising their operating funds (Table 5). This trend is attributed to the country's active liberalisation policy under the new government since the crisis, which provides a more favourable operational environment to foreign banks. This signifies localisation of foreign banks. Until 1997, the share of domestic liabilities of foreign banks remained at about 20 per cent of total liabilities but it sharply rose to 37.4 per cent in 1998, followed by 62.3 per cent in 2000, and 68 per cent by end-November 2001. Now the major source of liabilities is deposits received from domestic customers in both Korean won and foreign currencies.

Table 4. **Market Share of Foreign Banks in Korea, End of Period**

| | Assets of Foreign Banks (trillion won) (A) | Assets of All Banks (trillion won) (B) | Market Share (A/B) (%) |
|---|---|---|---|
| 1995 | 19.4 | 379.5 | 5.1 |
| 1996 | 24.7 | 451.2 | 5.5 |
| 1997 | 45.8 | 573.7 | 8.0 |
| 1998 | 33.8 | 576.9 | 5.9 |
| 1999 | 34.7 | 640.0 | 5.4 |
| 2000 | 46.9 | 737.8 | 6.4 |
| November 2001 | 49.3 | 762.1 | 6.5 |

*Source:* The Bank of Korea ( 2002).

Table 5. **Source of Operating Funds of Foreign Banks in Korea, End of Period**
(trillion won)

| | Domestic | Foreign | Total Liabilities |
|---|---|---|---|
| 1995 | 3.1 (23.5) | 10.1 (76.5) | 13.2 (100.0) |
| 1996 | 3.2 (18.6) | 14.0 (81.4) | 17.2 (100.0) |
| 1997 | 7.1 (21.1) | 26.5 (78.9) | 33.6 (100.0) |
| 1998 | 9.2 (37.4) | 15.4 (62.6) | 24.6 (100.0) |
| 1999 | 12.5 (45.6) | 14.9 (54.4) | 27.4 (100.0) |
| 2000 | 24.3 (62.3) | 14.7 (37.7) | 39.0 (100.0) |
| November 2001 | 30.2 (68.0) | 14.2 (32.0) | 44.4 (100.0) |

*Note:* Figures in parentheses represent percentage in total.
*Source:* The Bank of Korea (2002).

It has been argued that opening domestic banking markets involves both costs and benefits. Possible costs include dominance in local markets, increased influence of foreign capital in economic activities, and intervention in corporate management. Benefits include increased competition, introduction of advanced banking and risk management techniques, diversification in resource mobilisation of the country, and facilitation of foreign trade and investment. In the case of Korea, while benefits appear to be dominant and costs non-existent or minimal, this observation has not been tested by a field survey. Foreign banks contributed to higher competition and introduction of new banking and financial techniques and helped Korean companies expand foreign trade with new clients.

### *Indonesia and Malaysia*

The share of foreign banks' loans in total loans has been checked to examine whether foreign banks in Indonesia were procyclical or countercyclical after the crisis. Table 6 shows the share of credits of foreign and joint banks in 1996-2001. The share, which remained at 9.4 per cent in 1996, has risen every year till 2000 when it reached 27.7 per cent. The growth rate of foreign and joint banks' loans has been higher than that of domestic banks throughout the period when the Indonesian economy was severely depressed, foreign capital flows reversed, and enormous financial and corporate restructuring efforts were made. This pattern suggests that foreign banks' lending was more countercyclical and stable than that of domestic banks, contributing to financial and economic recovery and private sector investment (Table 7). Sector lending performance indicates that the share of foreign banks' loans to manufacturing has steadily increased in the post-crisis period but the services and trade sectors suffered a sharp decline in the same period (Table 8). Foreign banks should have also contributed to manufacture of goods for export and employment opportunities.

In Malaysia, the share of foreign banks' lending in total lending has been stable at 23-24 per cent since the crisis (Table 9). Foreign banks in Malaysia did not cut down their lending after the crisis; rather, they showed a countercyclical lending pattern that must have contributed to the country's economic recovery, employment creation, and financial stabilisation in this period (Table 10).

Table 6. **Credits of Foreign and Joint Banks, Indonesia**
(trillion rupiah)

| | 1996 | 1997 | 1998 | 1999 | 2000 | Nov 2001 |
|---|---|---|---|---|---|---|
| Foreign and Joint Banks (A) | 27.6 | 48.6 | 66.7 | 50.0 | 74.4 | 74.9 |
| All Banks (B) | 292.9 | 378.1 | 487.4 | 225.1 | 269.0 | 303.0 |
| Share (A/B, %) | 9.4 | 12.8 | 13.7 | 22.2 | 27.7 | 24.7 |

*Source:* Bank of Indonesia (2001).

Table 7. **Growth of GDP and Bank Credits, Indonesia**
(percentage)

| | 1997 | 1998 | 1999 | 2000 | 2001 (est.) |
|---|---|---|---|---|---|
| GDP (current) | 17.8 | 57.6 | 13.0 | 15.3 | 13.0 |
| GDP (real) | 4.7 | (13.1) | 0.9 | 4.8 | 3.3 |
| Credits (Foreign and Joint Banks) | 76.1 | 37.2 | (25.0) | 48.8 | 0.7 |
| Local Banks | 24.1 | 27.6 | (58.4) | 11.1 | 17.2 |

*Sources:* Asian Development Bank, Statistical Data Base System (SDBS); and Bank of Indonesia (2001).

Table 8. **Credits of Foreign and Joint Banks to Economic Sectors, Indonesia**
(percentage)

| | 1996 | 1997 | 1998 | 1999 | 2000 | Nov 2001 |
|---|---|---|---|---|---|---|
| Agriculture | 1.4 | 2.7 | 2.5 | 3.4 | 3.8 | 3.2 |
| Mining | 1.4 | 1.9 | 2.2 | 3.8 | 4.3 | 1.2 |
| Manufacturing | 55.4 | 59.3 | 61.9 | 62.4 | 65.5 | 65.6 |
| Trade | 17.4 | 15.6 | 16.5 | 14.4 | 6.5 | 6.5 |
| Service Industry | 18.5 | 16.5 | 14.2 | 12.4 | 12.4 | 15.0 |
| Others | 5.8 | 4.1 | 2.7 | 3.6 | 7.5 | 8.5 |
| Total | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

*Source:* Bank of Indonesia (2001).

Table 9. **Credits of Foreign Banks, Malaysia**
(billion ringgit; end of period)

| | 1996 | 1997 | 1999 | 20001 | 2001 (Nov) |
|---|---|---|---|---|---|
| Foreign Banks | | | | | |
| Assets | 80.1 | 87.5 | 109.1 | 124.0 | 130.0 |
| | (22.2) | (22.5) | (22.6) | (24.2) | (24.9) |
| Loans | 50.3 | 55.6 | 68.0 | 72.1 | 80.3 |
| | (23.1) | (23.6) | (23.8) | (23.8) | (24.6) |
| Domestic Banks | | | | | |
| Assets | 280.0 | 300.8 | 373.6 | 388.7 | 392.6 |
| | (77.8) | (77.5) | (77.4) | (75.8) | (75.1) |
| Loans | 167.6 | 179.9 | 216.6 | 231.2 | 245.8 |
| | (76.9) | (76.4) | (76.2) | (76.2) | (75.4) |
| Country Total | | | | | |
| Assets | 360.1 | 388.3 | 482.7 | 512.7 | 522.6 |
| | (100.0) | (100.0) | (100.0) | (100.0) | (100.0) |
| Loans | 217.9 | 235.5 | 285.2 | 303.3 | 326.1 |
| | (100.0) | (100.0) | (100.0) | (100.0) | (100.0) |

*Source:* Bank Negara Malaysia (2001).

Table 10. **Growth of GDP and Bank Credits, Malaysia**
(percentage)

| | 1997 | 1998 | 1999 | 2000 | 2001[a] |
|---|---|---|---|---|---|
| GDP (current) | 11.1 | 0.5 | 6.0 | 13.5 | 6 |
| (real) | 7.3 | (7.4) | 6.1 | 8.3 | 0.4 |
| Loans: Foreign Banks | 10.5 | 11.1[a] | 11.1[a] | 6.0 | 13.1 |
| Local Banks | 7.3 | 10.2[a] | 10.2[a] | 6.7 | 7.9 |

*Note:* *a)* estimate.
*Source:* Bank Negara Malaysia (2001).

## Comparative Assessment of Financial Opening Policies

Many studies indicate that the opening up of financial services involves both advantages and risks. Advantages include reduction in unit costs by facilitating economies of scale, increasing competition, reducing price mark-ups, and increasing managerial efficiency (Cecchini, 1988). Local consumers can benefit from increased competition and access to foreign expertise in several ways: a wider choice of financial products; better credit assessment procedures and information services; faster access to advanced services; and increased availability in credit. However, there are also reservations to market opening, of which the most noteworthy would be the following argument: opening is often accompanied by capital account liberalisation, and banking and financial crises in most cases are associated with capital account liberalisation or wrong sequencing of liberalisation measures.

The debate on the source of the Asian financial crisis has uncovered several causes of the crisis, but the root cause would be the serious mismanagement of huge overseas borrowing by domestic (not foreign) banks and finance companies and business corporations. International hedge funds, the size of which was much smaller than bank borrowing, also played a significant role, though it is not the primary factor. All these are associated with the capital account liberalisation of the crisis-hit countries that had been actively pursued since the late 1980s in these countries. In contrast, the size of foreign banks' lending and assets remained too small to be a major contributor to the crisis.

Immediately before the crisis, from the early 1990s to the second quarter of 1997, domestic commercial banks, finance companies, and large corporations continued to borrow enormous short-term funds from international banking markets. The borrowing was spurred by a big difference between domestic and foreign interest rates and a rigid foreign exchange policy in the crisis-hit countries, which resulted in significantly cheaper financing through overseas bank borrowing (for details, see Kim, 2000). The misalignment of interest and foreign exchange rates is shown in Tables 11 and 12.

Table 11. **Comparison of Domestic and Overseas Interest Rates before the Crisis**[a]
(percentage per annum; period average)

| | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | Oct. 1999 |
|---|---|---|---|---|---|---|---|
| Indonesia | 20.60 | 17.80 | 18.90 | 19.20 | 21.80 | 32.20 | 22.80 |
| Korea | 8.60 | 8.50 | 9.00 | 8.80 | 11.90 | 15.30 | 9.00 |
| Malaysia | 9.10 | 7.60 | 7.60 | 8.90 | 9.50 | 10.60 | 6.80 |
| Thailand | 11.20 | 10.90 | 13.30 | 13.40 | 13.70 | 14.40 | 8.30 |
| LIBOR[b] (US$) | 3.64 | 5.59 | 6.24 | 5.78 | 6.08 | 5.53 | 5.70 (Jul.) |

*Notes:* *a)* Commercial bank lending rates, unless otherwise stated.
*b)* London interbank offered rate; for one year.
*Source:* Kim (2000).

Table 12. **Purchasing Power Parity of Crisis Economies' Currencies Before the Crisis**

| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 |
|---|---|---|---|---|---|---|---|
| **Indonesia** | | | | | | | |
| Relative Price (I) | 100 | 104.9 | 109.6 | 119.7 | 128.0 | 135.7 | 140.6 |
| Exchange Rate (II) | 100 | 105.8 | 110.2 | 113.3 | 117.3 | 122.0 | 127.1 |
| PPP (II/I) | 100 | 100.9 | 100.5 | 94.6 | 91.6 | 89.9 | 90.4 |
| **Korea** | | | | | | | |
| Relative Price (I) | 100 | 104.9 | 108.1 | 110.0 | 113.9 | 115.8 | 118.1 |
| Exchange Rate (II) | 100 | 103.6 | 110.3 | 113.4 | 113.5 | 109.0 | 113.7 |
| PPP (II/I) | 100 | 98.8 | 102.0 | 103.1 | 99.6 | 94.1 | 96.3 |
| **Malaysia** | | | | | | | |
| Relative Price (I) | 100 | 100.2 | 101.8 | 102.4 | 103.5 | 106.0 | 106.7 |
| Exchange Rate (II) | 100 | 101.7 | 94.2 | 95.2 | 97.0 | 92.6 | 93.0 |
| PPP (II/I) | 100 | 101.5 | 92.5 | 93.0 | 93.7 | 87.4 | 87.2 |
| **Thailand** | | | | | | | |
| Relative Price (I) | 100 | 101.4 | 102.4 | 102.8 | 105.4 | 108.4 | 111.5 |
| Exchange Rate (II) | 100 | 101.4 | 101.8 | 101.0 | 99.6 | 100.1 | 101.5 |
| PPP (II/I) | 100 | 100.0 | 99.4 | 98.2 | 94.5 | 92.3 | 91.0 |

*Note:* If the PPP number is less than 100 it is overvalued; undervalued if over 100.
*Source:* Kim (2000).

Among the countries reviewed in this paper, Korea's financial markets are most liberalised, followed by Singapore and other ASEAN countries (a summary is shown in Table 13). Foreign equity holding of up to 100 per cent in Korea is allowed for any kind of financial institution, while other countries restrict it to below 50 per cent in general. Commercial presence of all types in foreign financial institutions is possible in Korea. Participation in capital markets is much easier in Korea than in the four countries of the Association of Southeast Asian Nations (ASEAN). Both corporate and government bond markets had been fully opened to foreigners since December 1997, while in May 1998 ceilings of stock investments by foreigners in non-state-owned enterprises were removed. This action has promoted a large amount of foreign portfolio investment in Korea since 1998. Foreigners' share in the Korean stock market in 2001 was as high as 36.6 per cent, compared with Japan, 12.4 per cent; Singapore, 9.6 per cent; and Taipei, China, 9.4 per cent.

Table 13. **Highlights of Individual Countries' Opening of Financial Services within GATS**

| Country | Banking | Equity Holding (financial institutions) | Presence of Natural Persons | Other Restrictions |
|---|---|---|---|---|
| Indonesia | Branch offices operate only in 10 cities in principle. Foreign-Indonesian joint ownership is allowed with existing banks, but a new license is not allowed for the GATS. | Local existing bank: 49% of the listed shares.<br>Non-bank finance company listed in the stock exchange: 100%<br>Others: 49% | Expatriate directors, managers, experts, advisors can be engaged for 3 years and can be extended. Manager or technical experts require two Indonesian under-studies at least. | Cross-border supply and consumption abroad are generally prohibited. Securities brokers must establish a local company to run the business. |
| Korea | No restriction in general. In 1998 after the crisis, most restrictions were removed to increase commercial presence. | 100% for any kind of financial institution. Stock investments in private companies: 100% (May 1998). Bond markets are fully open. | Allowed. Korean banks can recruit foreign nationals as directors (May 1998). | Cross-border and consumption abroad are partially allowed for banking and investment advisory services. |
| Malaysia | The 13 wholly foreign-owned foreign banks are permitted to remain wholly foreign owned. New licenses are not allowed. | Entry of foreign banks is limited to equity participation in local commercial banks and investment banks. Aggregate foreign shareholding in a bank shall not exceed 30%. Securities company (a locally incorporated joint-venture): not to exceed 30 %. | Not allowed except for temporary presence of senior managers and specialists in relation to establishing commercial presence. | For cross-border and consumption abroad, similar to Indonesia. Offshore institutions allowed in Labuan. |
| Singapore | One office only and cannot establish off-premise ATMs and new sub-branches. Money and foreign exchange market transactions generally unrestricted. | Banks: 40%<br>Insurance: 49% of locally owned insurance companies.<br>Securities companies: unbound | Unbound, except for intra-corporate transfers of managers, executives, and specialists. Limited to a 3-year period that may be extended for up to 2 additional years | For cross-border and consumption abroad, similar to Indonesia, but insurance is allowed. |
| Thailand | Commercial presence generally has no restrictions for existing foreign bank branches. Foreign bank share: zero in 1997, 6% as of December 2000. | Foreign equity participation up to 49% in principle. But the following only 25%: life and non-life insurance, local incorporated banks, securities companies. | Unbound except for corporate transfers at the managerial or executive level, or for specialists for a 1-year period (altogether not more than 3 years). | For cross-border and consumption abroad, similar to Indonesia. Foreigners are not allowed to purchase or own land. |

An interesting feature of Korea's liberalisation is that the country opened its domestic markets more actively in the post-crisis period compared to the pre-crisis period. Singapore has taken a similar policy, while other ASEAN countries have not taken new measures since the crisis but have generally kept the commitments originally made in 1998. A comparative assessment of the Korean and ASEAN patterns will draw some interesting and useful lessons. In terms of economic growth and financial restructuring since the crisis, Korea has performed better than the other crisis-hit countries. The question is whether such better performance has encouraged the Korean government to expedite opening of domestic markets, or whether the active opening policy has contributed to fast growth and restructuring. Given that most of the liberalisation measures were taken not long after the eruption of the crisis in Korea, the latter appears to be more convincing, implying that financial opening has had a significant positive impact on the domestic economy and financial markets in Korea. Also, it should be noted that foreign banks' lending has been more countercyclical than domestic banks' lending.

Foreign banks in these countries generally concentrate their business on expatriate home-country enterprises. There are two views on the role of foreign banks in developing countries (Clark *et al.*, 2000). The first, referred to as the traditional view (Aliber, 1984), is that foreign banks follow their domestic clients to finance their trade and service their needs in other countries. The second view envisions a more active role by foreign banks in the development of the host country's banking sector. Drawing on the theory of comparative advantage, the second view posits that foreign banks can use management technology and banking expertise developed for their home use at a very low marginal cost abroad. In the ASEAN countries in general (except for the Singapore offshore market), the role of foreign banks is basically consistent with the first view. In Korea, however, some foreign banks such as Citibank are rapidly cornering local clients, exacting a more positive and deep impact on the local banking sector. Foreign banks generally enjoy more advanced banking practices than local banks, and thus contribute to introduction of new techniques into local markets. Foreign banks hold comparative advantages particularly in risk analysis and management, loan project assessment, credit analysis, portfolio management, and computerisation.

## Conclusions

The four ASEAN countries studied in this paper have retained their original commitments since 1998. Korea has revised its original commitments significantly in 1999, while the PRC has just become a member of WTO. Given this, the ASEAN countries may have to consider substantial revisions, particularly in response to the Doha round of multilateral trade negotiations. In opening financial services, however, it is advisable to take three guiding principles into account: *i)* resource mobilisation for economic recovery and sustained development; *ii)* financial stability; and *iii)* market competition. Some policy suggestions within this context are presented below.

First, ASEAN countries may have to consider more active liberalisation of financial services in light of their extensive economic exposure to foreign trade and the global economy, as well as the immense need for foreign capital and financial services. Although economic circumstances in these countries are different from those in Korea, they may draw valuable lessons from the Korean experience after the crisis to figure out the best liberalisation strategy. The ASEAN countries are committed to not only the GATS but also to the AFAS arising from the ASEAN Bangkok Summit in 1995, which provides a basis for liberalisation of seven areas of services: banking, tourism, air transportation, maritime transportation, telecommunications, construction, and professional services. However, the scope of commitments either in the GATS or in the AFAS is not broad enough and the progress in liberalisation is slow.

Second, sequencing of liberalisation is of prime importance. In this regard, priority should be placed on the banking sector. Foreign banks bring foreign capital, facilitate foreign investment through their support of trade and production activities of foreign investors in the host country, and increase market competition in the banking industry. We have found that foreign banks' lending attitude is more countercyclical than that of domestic banks. In the case of Singapore, it would be important to develop its offshore financial market more vigorously within the context of its goal of transforming into an international financial centre.

Third, Indonesia, Malaysia and Thailand may need to consider further opening up other non-bank financial markets to minimise inflows of short-term speculative money and at the same time promote foreigners' long-term direct investment in local infrastructure and productive sectors. Opening of leasing, guarantees, local bond markets, underwriting of international bonds issued by domestic enterprises, and foreign direct investments in local banks/securities companies are consistent with this objective. Each of these countries needs to carefully envision its long-term financial sector objectives by undertaking a thorough study, and then formulating short- and medium-term negotiation strategies to maximise the benefits of financial opening.

Fourth, issues of "commercial presence" of foreign suppliers should be addressed, followed by those of "cross-border" supplies, given that the latter involves free movement of services, capital, and information (e.g. international hedge funds) without sufficient supervisory mechanisms in place.

Fifth, it is crucial to implement sound capital-account liberalisation policies in parallel with financial opening, given that opening of financial services is closely associated with capital-account liberalisation. An important lesson drawn from the Asian crisis is that it is not advisable for developing countries to liberalise their capital accounts fully until effective regulatory and supervisory regimes for their financial systems are operational and appropriate macroeconomic policies, including a well-aligned exchange rate regime, are in place.

Lastly, domestic equity markets need to be opened up in a phased manner, taking into account capital market development, corporate sector capacity, and the urgency for foreign currency resources. It is also important to establish regulations to prevent

sudden and large capital flights, while financial authorities monitor capital flows so closely that they may take relevant policy actions when necessary. Equity investment flows into and out of a country are determined by many factors, both external and domestic. Domestic factors include economic reforms, capital control, explicit and implicit government guarantees, and transparency and disclosure of information. External factors include changes in interest rates in the United States, terms of trade shocks, and increases in international risk premia.

# Notes

1. Generally, the GATS rules over all services with two exceptions: the services provided in the exercise of governmental authority and, in the air transport sector, air traffic rights and all services directly related to the exercise of traffic rights.
2. The GATS identifies four different modes of trade in services. Mode 1 (cross-border) means that the service is delivered to consumers in the trade partner country across borders; in Mode 2 (consumption abroad), consumers go to the service provider; in Mode 3 (commercial presence), the providers establish a branch or subsidiary; and in Mode 4 (movement of natural persons), individuals travel from their own country to supply services in another. In the case of the first two, the provider of services stays in the home country, whereas the provider comes to the country of the consumers in Mode 3. Mode 3 is presently the dominant mode of financial service trade (WTO, 2002).
3. The MFN principle applies also to newly acceding countries. The MFN principle or non-discrimination principle means treating one's trading partners equally. It guarantees equal opportunities for suppliers from all WTO members. However, it does not require any degree of market openness (WTO, 2002).
4. Refer to GATS Article XVI, footnote 8.
5. The commitments under the AFAS are slightly more liberalised than those under the GATS.
6. According to the Schedule of Specific Commitments of the PRC, "foreign invested enterprises" include: *i)* foreign capital enterprises (also referred to as wholly foreign-owned enterprises); and *ii)* joint ventures that are either equity joint ventures or contractual ventures.
7. Prior limit was 4 per cent for a nationwide bank, 8 per cent for a bank converted from other financial institutions, and 15 per cent for a regional bank.
8. This section on Korea is based on Hwang and Shin (2000).
9. Refer to the Special Keynote Address delivered by Lee Hsien Loong, deputy prime minister and chairman of the Monetary Authority of Singapore, at the Euromoney Asia-Pacific Issuers and Investors Forum, 19 March 2002.
10. In reality, the stock exchange of Thailand allows any share exceeding 49 per cent to be held in a special fund. The exceeding portion is not entitled to vote.

11. Some changes have recently been made to allow foreigners to purchase land to construct manufacturing facilities.

12. The schedule of commitments under the AFAS is different from the GATS in that three more commitments have been added: foreigners' shareholding of securities companies, the increase in number of expatriates of a securities company from two to three, and pension fund consulting services.

13. The percentage of foreign share as of March 2002 was 48.77 for Bangkok Bank; 46.82 for SCB; 48.98 for Thai Farmer; 2.97 for Thai Military; 50.27 for DBS Thai Danu; 75 for ABN Amro Asia; 75.02 for Standard Charted Nakornthon; 75.02 for UOB Radanasin; and minimal in Ayudhaya, Krung Thai, Bank Thai, Siam City Bank, and Metropolitan Bank.

14. This section is heavily indebted to an internal paper prepared by Min Tang (2002) of the Asian Development Bank.

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*Eighth International Forum on Asian Perspectives*

# PROGRAMME

## Experts' Meeting
Monday, 24 June 2002

| | |
|---|---|
| Opening | Herwig Schlögl, Deputy Secretary-General of the OECD<br>John Lintjer, Vice President, Asian Development Bank<br>Jorge Braga de Macedo, President, OECD Development Centre |

### Session I

| | |
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| Chair | Jorge Braga de Macedo, President, OECD Development Centre |
| Presentation | **Liberalisation and Competition in the Service Sector**<br>by the Asian Development Bank and the OECD Development Centre |
| Discussants | Raden Pardede, Advisor to the Vice President of Indonesia, and Head of Danareksa Research Institute<br>Jacques Pelkmans, Director, Economics Department, College of Europe, Belgium<br>Robin Simpson, Policy Advisor, Consumers International, United Kingdom |

### Session II

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| Chair | Jean-Marie Metzger, Director, OECD Trade Directorate |
| Presentations | **Some Stylised Facts on Trade in Services in Developing Asia**<br>by Sailesh K. Jha, Economics and Research Department, Asian Development Bank<br>**Financial Opening Under the WTO Agreement in Selected Asian Countries: Progress and Issues**<br>by Yun-Hwan Kim, Economics and Research Department, Asian Development Bank |
| Discussants | Patrick A. Messerlin, Professor of Economics, Institut d'Etudes Politiques, France<br>Moon Soo Chung, former Chairman, Trade Dispute Settlement Committee, Ministry of Trade and Industry; Professor, Department of International Trade and Regional Studies, Inha University, Korea |

### Session III

| | |
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| Chair | Jean-Pierre Verbiest, Assistant Chief Economist, Asian Development Bank |
| Presentation | **The Treatment of Services in Regional Trade Agreements: Lessons from Asia**<br>by Pierre Sauvé, OECD Trade Directorate |
| Discussants | Yun-Hwan Kim, Economics and Research Department, Asian Development Bank<br>Rolf Adlung, Trade in Services Division, World Trade Organization |
| Conclusions | John Lintjer, Vice President, Asian Development Bank<br>Jorge Braga de Macedo, President, OECD Development Centre |

**Public Conference**

Tuesday 25 June 2002

## Asia and Europe: Services Liberalisation

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| Welcoming Remarks | Jorge Braga de Macedo, President, OECD Development Centre |
| Keynote Address | John Lintjer, Vice President, Asian Development Bank |
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| | Moon Soo Chung, former Chairman, Trade Dispute Settlement Committee, Ministry of Trade and Industry; Professor, Department of International Trade and Regional Studies, Inha University, Korea |
| | Fabrice Lorillon, Vice President, Asia Pacific Business Unit, GIE AXA |
| | Krirk-Krai Jirapaet, Advisor to the Prime Minister; former Permanent Secretary, Ministry of Commerce, Thailand |
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