

Issue Brief

The Coming Crisis in Cross-Border Finance



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History shows that income and wealth distribution matter for the evolution of economic policy and that in this respect globalization can plant the seeds of its own destruction. This was arguably the story of the late 19th and early 20th centuries, and at least in part the cause of the subsequent retreat from free trade in goods and services, the free movement of capital, and likewise the free movement of people. This set of issues therefore matters a lot.¹

In this brief, Federal Financial Analytics (FedFin) assesses the outlook for trade in financial services in light of the strong “America First” policy declared by President Trump. Although action since the inauguration has focused only on trade in manufactured goods, trade in financial services is intimately caught up in broader trade matters. If the U.S. becomes as protectionist for manufactured goods as Mr. Trump now demands, then it will also step away from the free-trade regime that has long governed cross-border finance. No nation facing barriers to trade in goods at the U.S. will welcome U.S. finance, nor will any agreements on goods be revised without attention also to financial services – the knot is simply too tightly tied in the fabric of global trade policy.

In this brief, we first forecast what is likely given Mr. Trump’s moves so far on both trade and finance. Then, we turn to what this will mean for the free flow of capital across major financial markets that has long seen as a bulwark of economic prosperity and financial stability. Free trade in financial services is also a profit cornerstone for any international financial institution, making changes to this regime of critical strategic importance. We also lay out decision factors for immediate consideration and action by U.S. versus foreign companies and for banks, insurance companies, other non-banks, and fintech. In terms of our forecast, we conclude that:

- An array of pending initiatives that ring-fence U.S. financial activities will advance in tandem with retaliatory foreign measures. Although Mr. Trump’s executive order included references to continued participation in global financial negotiations, the substance of U.S. positions so far combined with the animus resulting from trade-in-goods policy will make compromise very challenging.
- Unless Congress intervenes or Mr. Trump’s appointees quickly take office, U.S. regulators will nonetheless continue to participate in global negotiations and implement gold plated domestic requirements. In part because of divergent U.S. policy, international harmonization will end in practice in 2017 and then by decree in 2018.
- Key strategic factors (e.g., M&A prospects, subsidiarization, permissible activities) will vary based on home country and charter. Chinese companies – already a deep U.S. worry – will face still more stringent sanctions, as will financial institutions from any country believed to be uncooperative with U.S. trade or foreign-policy initiatives that need approval from the Trump Administration.
- New challenges will emerge to cross-border financial infrastructure and capital flows.
- Trade-in-goods barriers that result in higher prices, even if short-lived, will force higher FRB interest rates absent a still larger QE program. An array of profitability, stability, and distributional challenges result, although specific implications will depend also on the structure

of the U.S. financial policy and the extent to which Mr. Trump's financial-reform agenda has advanced.

Reflecting this, U.S. financial-services firms with cross-border operations and foreign ones with significant U.S. stakes will need quickly to:

- identify stress points for financial services in forthcoming trade talks and quickly determine optimal policy for affected operations;
- determine which aspects of global financial negotiations are essential to continued cross-border operation and financial-market stability, crafting an analytical and advocacy response to ensure continuing cross-border work in areas such as resolution, privacy, licensing, and central-bank access;
- anticipate areas of strain in global negotiations with adverse implications for U.S. operations (e.g., those resulting in stricter isolation from parent companies, tougher capital, reduced M&A opportunities), crafting an analytical and advocacy strategy to preserve key forward-looking plans and/or to redesign affected U.S. operations to reduce home-country concerns;
- understand the impact of pending Trump Administration reform initiatives for U.S. operations to capture opportunity or reduce risk, likely doing so in concert with Congressional advocacy and analytics providing persuasive argumentation to regulatory decision-makers;
- identify firm-specific flashpoints in the new policy framework (e.g., home-country domicile in Trump-targeted regime or trade agreement, prospective significant M&A, structure of U.S. dollar-clearing operations); and
- determine which aspects of the emerging trade-in-financial-services framework pose macroeconomic and monetary-policy risk, developing an effective analytical and advocacy response as a matter of urgent attention.

The U.S. Trade-In-Financial Services Framework

The U.S. enjoys a surplus in trade in financial services – in contrast of course to the overall U.S. trade deficit. Nonetheless, the very short tenure so far of the Trump Administration has taught us one thing: don't count on anything other than uncompromising efforts to implement Mr. Trump's campaign pledges. He has begun to do so with regard to the TPP, NAFTA, and immigration. Each of these actions has direct and indirect financial-services impact, as will an array of forthcoming Administration policies that are likely to blow accepted cross-border finance assumptions to smithereens.

First and most obviously, any pending cross-border agreements with trade-in-financial-services implications are in as much limbo and are as unlikely to advance as unfinished manufactured-goods trade deals. Any lingering hopes for the U.S.-EU TTIP should be abandoned and the still more desultory Trade in Services Agreement among twenty-three nations, including the U.S. is also dead in fact if not soon also by edict.

However, even though these and other pending agreements are now essentially irrelevant, there is still a trade-in-financial-services regime binding on the U.S. The WTO remains the foundation on which both bilateral and global trade now rests. Thus, even though other agreements would have gone farther to reduce barriers to cross-border finance, the WTO framework ensures a considerable degree of open cross-border capital flow as well as private-sector financial-services operations.

But, during the campaign, Mr. Trump said he would pull the U.S. out of the WTO. In practice, doing so would at the least require debate by Congress if not also official ratification. Nonetheless, if Mr. Trump says the U.S. is out of the WTO, every other nation will take it as given and a new global-trade framework will start to take shape in what will surely be an uncertain, angry, and complex process intimately integrated with ongoing geopolitical developments.

During this process – sure to be chaotic – bilateral trade deals such as the one with South Korea should also be considered very much in play, with the Trump Administration seeking to withdraw from and/or significantly rewrite many of them. Apparent concessions to the EU in areas such as data privacy will also come under skeptical scrutiny.

U.S. national-security concerns will take precedence in this country, especially with regard to M&A review by the Committee for Foreign Investment in the United States (CFIUS). CFIUS has broad authority to reject any acquisition by a foreign company for institutions with significant U.S. assets. Although finance has yet to be overtly in the President's sights, any transaction which appears to put U.S. financial operations – especially those of size or potential systemic importance – at the behest of a foreign parent or government will face far more scrutiny. Transactions with problematic nations from the manufactured-goods and/or currency-valuation perspectives will be particular targets, but harsh rhetoric about longstanding allies such as Germany, Canada and Australia suggests no one should feel safe.

The Future of Global Financial Institutions

In addition to the WTO, cross-border finance is also based on multilateral financial institutions such as the International Monetary Fund and World Bank. These do not set the terms for capital flows and cross-border financial operations, but attempt to ensure both the stable sovereign economies necessary for vibrant finance and the best practices that advance growth and development. An array of global standards-setting bodies such as the Financial Stability Board and Basel Committee also play critical roles.

There is no reason to believe that Mr. Trump will support continued U.S. participation in the IMF or World Bank – conservatives have long pressed for the U.S. to reduce its role and/or shutter these institutions. U.S. withdrawal from the Fund and World Bank would likely increase China's influence over them in the near term as well as force a far more fundamental review of how well each functions in the face of challenges not only resulting from the U.S. election, but also from continued fall-out of the IMF's handling of the Greek crisis, the growth of newly-empowered regional infrastructure institutions, and fragmentation of the global financial order. We think it's a very, very long shot that the U.S. would return to the Gold Standard, but top officials likely to have positions of considerable influence in the U.S. will espouse it along with other fundamental reforms that will shake the Fund and Bank to their core.

The prospects for continued U.S. participation in the FSB and its subsidiary bodies is at least as uncertain as that in the Fund and World Bank. Republicans have signaled strong opposition to U.S. agreements on matters such as systemic designation, bank capital, and orderly resolution. Indeed, one influential Member – the Vice Chairman of the House Financial Services Committee – has effectively

instructed the Federal Reserve to cease its participation in any of these forums. Pending legislation will at the least complicate U.S. participation in these negotiations. The February 3 Presidential Executive Order on Mr. Trump's plans for financial regulation expressly mentions continuing participation in global financial negotiations apparently to enhance the competitiveness of U.S. financial institutions mentioned elsewhere in the Order. It is thus unclear what the White House may ultimately choose to do. In practice, however, U.S. negotiating counterparties meeting at these regulatory bodies will use the Administration's ambiguous stand on negotiations in concert with its very tough positions on trade in goods to demand victories against the U.S. in pending negotiations such as those surrounding "Basel IV." Reasoning here will be that it is senseless to make concessions that are painful at home to the U.S. in order to preserve a global framework from which the U.S. may well soon walk away.

Additional Considerations

Just as many other demands in Mr. Trump's February 3 order on financial reform must proceed under the control of Congress and U.S. regulators, so too does implementation of cross-border barriers to foreign financial operations in the U.S. This is particularly true for banking, where a body of law begun with the International Banking Act of 1978 demands that foreign banks be accorded national treatment – i.e., given the same access or subjected to the same restrictions governing like-kind U.S. banks. This same body of law also requires "competitive equality" – a phrase that is often interpreted to advance foreign-bank access but could as easily be used to deny it. Provisions in U.S. law requiring regulators also to determine that a foreign bank is subject to comprehensive regulation on a consolidated worldwide basis also stand ready at hand to constrain foreign banks if the FRB or Trump Administration choose to deploy them.

What Needs Now to Be Done

All of the changes to the U.S. posture on trade in financial services is a paradigm shift in the true sense of a phrase initially meant to convey rapid-breaking, ground-shifting rewrites of long-established assumptions. These now include assumptions about the impact of Basel capital rules, the ability of global regulators to handle a cross-border failure, the structure of global financial institutions, and the relative competitiveness of each major domicile. Now, it may well be quicksand under these once-bedrock assumptions.

Since each of these vital drivers of competitiveness and stability is at its root a political decision, success in this fast-changing framework will come to institutions and industries that most quickly identify their desired course of action and then press effectively for it. Donald Trump may be the newly-elected economic nationalist with the biggest stick, but Brexit and other populist initiatives quickly gaining ground around the globe show that the fundamental assumptions on which cross-border finance is premised are facing the sternest test since the 1930s. For cross-border financial companies, this is a critical strategic dilemma even as it is proving a structural challenge to the economies that depend on them for financial intermediation and the rest of the basic clockwork of spending, saving, insuring, and prospering.

¹ Financial Conduct Authority Chief Executive Andrew Bailey, *Speech at the Economic Council Financial Markets Policy Conference: "Free trade in financial services and global regulatory standards: friends not rivals,"* Berlin, Germany (January 26, 2017), available at <https://www.fca.org.uk/news/speeches/free-trade-financial-services-global-regulatory-standards-friends-not-rivals>.