Financial services liberalization: the role of the millennium round[1]

Chapter contributed to *Freer trade in the next decade: Issues in the Millennium Round*
(Subsequently published by Routlege, London)

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March 2001

Introduction

Predicting the future of financial services liberalization requires an understanding of the larger framework for negotiating services and the implications of that framework for recent negotiations in this sector. Trade policy experts provided the original rationale for including services negotiations in the WTO. They saw services as a way to rejuvenate the then-GATT and get at a proliferating variety of non-tariff measures that took the form of government regulations limiting access for consumers to modern services and limiting cross-border expansion by service providers. In essence the negotiations were to be about domestic regulatory and institutional reform. GATS was intended to create openness in the burgeoning services industries by applying the principles of MFN (most favored nation treatment by which all trading partners are treated equally), market access, national treatment (equal treatment of one' s own and foreign firms), and limited and transparent (published) exemptions.

The initial framework was not particularly relevant to what was happening to business, however. GATS was little understood and there was little demand for it although government commitments to a series of sectoral negotiations have been secured and some binding liberalization has occurred, in information technology in 1996 and financial services in 1997. No further progress was achieved at the Seattle ministerial in 1999.

The central focus in this chapter differs from the traditional approach. Instead of studying the contribution of financial services to the GATS and the future of the WTO, its focus is the reverse: since financial market development is a potentially-central factor in an economy' s long-term growth and development, how can WTO negotiations contribute to making that a reality? The central theme is that progress has, and will continue to be, slow because of the asymmetry of

[1] This chapter draws on joint work with Pierre Jacquet in Dobson and Jacquet (1998).

interests between the two main groups of players, the mature industrialized countries and the emerging market economies. The first section provides the historical context of financial services negotiations in the WTO. The second section summarizes the differing goals of the mature industrialized and the emerging market economies in the 1997 negotiations which help to explain the modest progress towards liberalization. The third section analyzes three major factors that will influence future negotiations. These include the limitations of the GATS framework and the impact of technological change and market forces. The final section addresses the question, Where to from here?

The issues

The financial services agreement (FSA), concluded in December 1997, included market-opening commitments by 104 WTO members which took effect in 1999. Five members made commitments in this area for the first time. The agreement is a milestone for the WTO because a significant number of WTO members agreed to a legal framework for cross-border trade and market access in financial services and a mechanism for settling disputes. It extends the General Agreement on Trade in Services (GATS) to financial services, adding to existing agreements in the telecommunications and information technology industries. The FSA was concluded in spite of unprecedented turmoil in Asian financial markets, perhaps because it held out the hope that offers would provide a signal of authorities' determination to undertake reforms that would help restore credibility and stability. The FSA replaces an interim agreement concluded in 1995 at the initiative of the European Union. In that agreement the United States withdrew most favored nation (MFN) treatment in financial services and committed itself only to granting market access and national treatment (that is, the same legal and regulatory treatment as for domestic firms) to the existing operations of foreign service providers. The United States and other industrial-country members of the Organization for Economic Cooperation and Development (OECD), faced with the reluctance of governments in some important emerging-market economies to provide reciprocal access, feared the latter would become free riders on a global agreement. A July 1997 US offer of unrestricted access to its market was conditioned upon such reciprocal market access.

In an important sense, however, the 1997 FSA is less than meets the eye. For the most part, it formalized the status quo. OECD country commitments amounted to little further market-opening. The United States provided reciprocal access that most OECD countries already have and which emerging market economies, with less mature financial institutions, found of little interest. With a few important exceptions, the latter economies offered little new access to their often-underdeveloped banking sectors. Much of the forward momentum occurred in the insurance sector.

Financial market development contributes to long-term growth and development in two ways: by changing the speed at which capital accumulates, and by influencing the efficiency of production in an economy. Financial institutions are considered, not only to mobilize an economy' s resources and facilitate the transactions necessary to carry on economic exchange, but also to play a critical role in managing risks and closing information gaps[2]. These institutions reduce the risks faced by investors by pooling their savings and distributing those savings among many users, so diversifying risk. They also collect and evaluate the information necessary to make prudent and productive investment decisions. And they participate in corporate governance by evaluating the performance of corporate borrowers and, when necessary, compelling them to act in the best interests of the firm--and therefore of its providers of funds (Levine 1996). Traditional analysis has tended to portray finance as an auxiliary factor in growth and development. More recently, however, as financial crises have occurred with increasing frequency, disrupting growth and other aspects of real economic activity, interest in financial reform has grown, and with it the realization of the potentially-central role in economic growth.

OECD governments seek market access through the FSA for their large financial firms faced with maturing markets at home and possessing technologies which have reduced

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2 Financial systems address the central problem of information asymmetry between the providers and users of funds. On the asset side, financial institutions take on risk in valuing projects and funding borrowers whose ability to repay is uncertain. On the liability side, creditors and depositors have imperfect information on the actual position of the financial institution and must have confidence in those institutions. When these institutions are highly levered, lack liquidity or provide little information on their assets, they are vulnerable to losses in confidence and depositors have an incentive to flee when confidence erodes (Lindgren et al 1996).

transactions costs to take advantage of business opportunities and higher rates of return in the dynamic offshore economies.

Emerging-market-economy governments' goals differ. They are more interested in foreign capital flows (and to a lesser extent foreign institutions) to accelerate growth; access to OECD country financial markets is of less interest. Capital inflows take several forms: as short-term debt and equity (portfolio) flows, as commercial bank lending and bonds. These instruments are subject to volatility if investors flee at signs of uncertainty or trouble. Of more value is long-term foreign direct investment (FDI), which brings foreign ownership or control but also the transfer of more sophisticated technologies. Financial services liberalization in the WTO will promote a country's growth and welfare in two main ways: first, by providing a legal framework that reassures foreign institutions investing for the long-term and second, by providing a source of external pressure for change and transparency. Domestic groups often resist such pressure in protecting their own interests, but it can promote sound financial institutions.

It should be noted that the term liberalization applied to financial services in the WTO refers to removing restrictions on market access for cross-border trade and for foreign service providers to locate in domestic markets. A country may allow foreign firms into its market yet restrict capital inflows and outflows from abroad. In other words, the WTO's concern with market access is distinct from capital account liberalization, a responsibility of the International Monetary Fund (IMF), referring to the freedom with which capital inflows and outflows of varying terms of maturity are allowed to move across borders[3]. These two policies are also related. De facto capital account liberalization has occurred in the past few decades as many countries have legalized foreign currency instruments in the face of increased trade flows, the internationalization of production and improved communications[4]. Provided there is adequate information, supervision and risk assessment, free capital movements can facilitate efficient international allocation of savings and channel these resources to their most productive

3 . In the Asian crisis, short-term capital flows -- particularly inter-bank loans, were a volatile form of capital.

4 All OECD countries have now eliminated capital controls. By the end of 1993, a quarter of developing country IMF members had removed restrictions on capital transactions, while 67 members maintained comprehensive controls on capital outflows and 17 on inflows (IMF 1995).

uses. This is purpose of what we call financial reform. Domestic residents benefit from access to foreign capital markets in several ways: through cheaper financing, a wider menu of options for diversifying risk and obtaining higher rates of return, and from a larger pool of investable funds.

Deregulation, market opening and capital account liberalization do not have to march in lockstep. Taiwan, for example, has not fully deregulated its domestic market and it still imposes some restrictions on the capital account, but it permits foreign entrants. The ASEAN economies of southeast Asia have not fully deregulated and still restrict foreign entry, but they have opened their capital accounts. Until its financial crisis began in late 1997, South Korea restricted both foreign entry and capital flows and had many domestic reforms to make as part of its accession agreement to the OECD. South Korea also agreed in the December 1997 IMF program to remove many of these restrictions. China is the only east Asian country that still has a closed capital account (FDI inflows are encouraged, however), and foreign participation in the financial sector is still heavily restricted.

The main actors

The main players in financial services negotiations are emerging market economies and the mature industrial economies in the OECD (South Korea and Mexico are represented in both groups, but for the purposes of this analysis are included in the former group). The widely differing objectives of these two groups suggest good reasons that so little movement beyond the status quo was negotiated in1997. Developing countries must decide how quickly they will integrate their economies with the rest of the world and the role they wish foreign institutions to play in that process and in the domestic economy. They encourage foreign savings in order to accelerate growth over what it would be were they to rely exclusively on domestic savings. But as the Asian financial and economic crisis of 1997-98 (and the experiences of the southern cone countries in Latin America in the 1980s) demonstrated, mobile capital by itself can be dangerous if such flows are allowed without sufficient planning and management. Indeed, it is worth noting that an exclusive focus on attracting foreign capital could mean that a country overlooks a significant ingredient of financial system development, namely the role of foreign financial firms in improving its efficiency.

Going forward, the focus of the WTO negotiations on freer cross-border trade and foreign entry in financial services will reflect the fact that many standard policy interventions in the financial sector are untouched by commitments within the GATS. In particular, countries retain the scope for macroeconomic policy; the so-called “carve-out provision” in the GATS protects prudential regulation. To the extent that they are compatible with broad market access, national treatment, and scheduled commitments to liberalize, other government financial policies can still be maintained, but in a more open context, under a multilateral agreement.

Still, while many emerging market economies have begun to reform their financial services sectors and to open their markets have begun to realize these benefits, some are reluctant to deregulate fully, whereas others are reluctant to open. They cite several significant reasons. First, the experience of countries which have deregulated financial markets, opened their markets and liberalized their capital accounts have been mixed. Banking and financial crises are associated with reform and internationalization, or the wrong sequence of such changes. One analysis of banking crises worldwide found that, in 18 of 25 cases studied, financial liberalization had occurred some time in the previous 5 years (Kaminsky and Reinhart 1995). Reforming the domestic financial system and internationalizing it does entail risks, especially if governments continue to regulate and supervise financial systems in the same way they operated them before. To minimize these risks, regulatory institutions and supervisory systems must be modernized and strengthened, to enable those charged with oversight to evaluate the risks inherent in a more complex, market-oriented system. Striking a balance between financial-market efficiency and economic stability is difficult, as demonstrated by the US savings and loan crisis of the 1980s and its aftermath, and by Japan’ s ongoing struggle to work out the banking crisis that began there in the early 1990s. Dobson and Jacquet (1998) evaluated this trade-off, drawing on the results of a number of case studies of national experiences with reform over the past two decades. These findings emphasize the importance of multiple factors in the trade-off. The general conclusion, reinforced by lessons from the 1997-98 financial crisis, is that there is neither a universal recipe nor a standard sequence for domestic reform and internationalization. The case studies agree, however, that macroeconomic preconditions and the strength of the financial sector influence the chances of successful adjustment to these changes. Economies with stable and realistic prices (including the exchange rate regime) and prudent fiscal policies do better, because the creditworthiness of potential domestic borrowers is superior. Those that have reformed and strengthened the domestic financial sector – by freeing up interest rates, reducing credit subsidization, strengthening financial institutions and their supervision – have met necessary pre-conditions to easing restrictions on the capital account and full-scale internationalization.

Second, it is frequently argued that finance is special--some would say strategic--because of the crucially important services the financial sector provides to a growing and developing economy. These services, in this view, are therefore best owned and controlled by domestic interests. More sophisticated foreign entrants, pursuing different objectives, could come to dominate the industry to the detriment of national objectives. In the extreme, this argument has merit--few governments would tolerate 100 percent foreign ownership of major domestic financial institutions[5]. On the other hand, foreign participation brings substantial benefits and can be managed--indeed the Uruguay Round agreement explicitly allows for such management. Not only does foreign participation, judiciously supervised, provide access to foreign savings, technical transfer and a force for modernization, but the presence of foreign firms increases the competitiveness, efficiency and diversity of the financial sector. The speed of innovation and the interconnectedness of markets are raising the costs of maintaining the status quo. Failure to deregulate and to open markets denies households better returns and denies businesses lower financing costs. These costs reduce growth and competitiveness. This link between real-sector activity and finance is perhaps the central issue, and one that is best addressed by practicing macroeconomic prudence.

Third, it is argued that domestic financial reform and internationalization are often politically difficult because, although users of financial services (including businesses, households and governments) stand to benefit, other powerful interests stand to lose. Introducing competition threatens significant interests within the local financial industry, just as reduction of the role of government threatens the position of certain bureaucratic interests. Reluctant governments who must manage the difficult political economy of financial reform and

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5 New Zealand is one exception; its banks are 98 percent foreign-owned. Argentina also has a high degree of foreign ownership of its widely-held banks.

internationalization do have a point, which trade negotiators should take into account. Market opening and capital account liberalization present real risks as well as political risks if financial supervision and financial institutions are not strengthened and if weakness in the real economy undermines borrowers' creditworthiness.

The answer, however, is not to halt the process of reform and liberalization. Rather it is to proceed, while putting primary emphasis on strengthening the system's ability to evaluate risk. The implication for negotiating strategies is that diplomatic pressure should be applied in a way that strengthens the process. This requires a delicate mixture of determined pressure for more opening with enough flexibility to make sure that the domestic political debate responds to rather than rejects that pressure, thus strengthening the hand of those who push for opening. The downside risk of complacency--of failing to insist on progress toward reform--is that nothing worthwhile gets done, but the downside risk of too rigid a position and too demanding requirements is that anti-foreign sentiment builds, eventually upsetting the domestic coalitions required to support reform. Clearly, such arguments convinced only a few governments. In the 1997 negotiations only limited progress on market access to these economies was achieved, and mostly in the insurance and securities industries (table 1).

The future of FSAs

Several factors will influence the future of multilateral financial services sector negotiations. The first is the GATS framework and its impact on market access issues in the financial sector. GATS faces some significant design challenges which also apply to financial services. Services are a heterogeneous group of products, with the common thread that most of them are subject to government intervention. There is the added complication that financial services are seen by Finance Ministers to be in their, not trade negotiators , purview. The other significant problem is that weaknesses in the GATS framework cast doubt on its ability to sustain further market opening. One source of weakness is the positive list approach to commitments. Positive lists identify sectors on which commitments are made rather than those on which they are not. This approach was all that could be agreed at the time the GATS was negotiated. It contrasts with the negative list approach, employed in the North American Free Trade negotiations, in which countries commit to full liberalization unless specific exclusions are negotiated. With the negative list approach, opening and market access are the central objective; in contrast, the positive list tends to reinforce the status quo and makes it difficult to identify potentially significant sectors that are untouched by liberalization. Further, it implies that as new sectors

Table 1

World Trade Organization financial services agreement:
Market access in selected emerging markets, 1997

	Banking	**Insurance**	**Securities**
Status quo plus	Malaysia Mexico	Brazil Indonesia Japan South Korea Philippines Mexico	Brazil Indonesia South Korea Malaysia Philippines
Status quo	Argentina Brazil Chile India Indonesia Japan South Korea Thailand	Chile India Thailand	Argentina Thailand
Less than status quo	Philippines	Malaysia*	Chile India

Source: Dobson and Jacquet 1998:93.
Notes: * This entry compares existing practice in 1998 with Malaysia' s commitment in December 1997.

emerge, they stand outside the market-opening framework until explicitly brought into it.

A related weakness of the GATS framework is problems with reciprocity. The division of the WTO negotiations along sectoral lines, that is separating services from goods and individual services from each other, makes reciprocity less credible and less effective. Reserving financial services negotiations for Finance Ministers makes such linkages even more difficult. Asymmetry in the interests of OECD and developing countries in services negotiations also adds to the difficulties. This asymmetry of interests was evident in the 1997 FSA where developing countries complained that they had made most of the market opening and other concessions. This is because it was OECD producers who sought access to their markets, not the converse. Nevertheless, the fact that the ITA and FSA were completed shows that the approach can deliver something.

The second factor affecting the future of financial services negotiations is the circumscribed nature of multilateral negotiations within the larger market-based trend toward an internationalization in this sector. The 1997 negotiations reflected GATS principles to the extent possible but the outcome, at least in financial services, was largely to bind the status quo on market access and create agreed procedures for settling disputes, as table 1 illustrates for financial services. Examined more closely, it becomes apparent that in these negotiations it was not so much GATS that created sectoral openness, but that liberalization in these sectors had a certain life of its own for other reasons. Telecommunications and financial services are among the fastest-growing and fastest-evolving industrial sectors in the world economy. Their growth and evolution are being driven by the information and communications technology (ICT) revolution and by domestic deregulation as governments scramble to catch up with market forces that drive the rapidly-changing transactions, business arrangements and cross-border flows in these services.

The third factor affecting the future of such negotiations is the increasingly significant role financial market development is seen to play in an economy’ s long-term growth and development. The reciprocity dimension of GATS weakens the case for reform: that opening is in the self-interest of all countries. Some see the precommitments made by some countries as part of the reason they delivered concessions in the FSA. This may be, but there were several other significant factors as well, especially with respect to the East Asian economies. One was that US and EU governments, instead of being adversaries, were united in their determination to make the agreement. Another was that US and EU businesses gave a big push to the negotiations. Yet another was the Asian crisis itself. The severity of the crisis and its extensiveness by late 1997 made it clear that weak financial systems were one of a combination of significant causal factors in the crisis economies. Thus, although they saw little to gain from reciprocal access to the OECD economies, they were anxious to signal their commitment to reform as a way to restore tattered credibility.

Where to from here?

Where should we go from here? What should be the goals for financial services negotiations in the new round? These goals will be influenced by the weaknesses in the GATS and market factors outlined above. One implication is that, unlike earlier progress in goods negotiations in the GATT, future advances in market access in financial services may not come primarily from multilateral negotiations. Instead, there is a discernible trend towards other routes to market access: gradual unilateral opening has occurred in a number of countries as part of overall structural reforms; in others it has been part of regional or bilateral liberalization arrangements. Hence, while it is worthwhile to ask how the current WTO process can be improved, experience with the FSA suggests that future progress may be expected from a combination of such sources. For example, countries on IMF programs in the Asian crisis have agreed to faster and more extensive domestic reform and foreign entry than was negotiated in the FSA. A commitment by APEC Leaders at their 1996 summit in the Philippines gave the ITA agreement a push. Japan and Singapore have unilaterally accelerated the modernization of their financial sectors by allowing further foreign entry because they fear being bypassed for other international financial centers. The combination of non-WTO processes and market forces, plus the WTO providing the binding mechanism and dispute settlement can jointly contribute to an effective international trade regime.

The WTO role in providing the binding mechanism under the status quo can be improved upon. For example, financial services reforms agreed as part of IMF programs to strengthen national financial systems and increase resilience to future crises, should also be bound into the WTO. This does not mean the IMF and WTO should gang up on a country; rather it means the country should be willing to bind the reforms that serve its long-term interests. One of the agenda items in the next round, then, should be to formalize a mechanism that allows countries to receive credit for such changes for use in future multilateral negotiations.

Another obvious goal is to improve data on and transparency of barriers to cross-border transactions and foreign entry (Hoekman 1999). Lack of comparable cross-country data is a general problem in the services sectors. Many services originated as non-tradables; thus, measures if they were developed, tended to serve domestic purposes making existing information on parameters of services production and trade scarce and difficult to aggregate across countries. Indices of openness in the financial services industries in key emerging market economies are included in table 2. They summarize commitments on the degree of financial liberalization at the end of 1996. As table 1 has already indicated, little forward movement occurred in 1997.

The index in table 2 weighs various types of barriers, including measures that limit the right of establishment and ownership, limits on business activities such as granting the ability to establish branch offices or ATMs (banks' automated teller machines), restrictions on lending, or on permission to carry on universal banking services and residency requirements for the officers or staff of foreign financial institutions. It also compares commitments (made in the 1995 FSA) with existing practice.

Table 2: An index of openness in financial services, 1997

	Banking		**Securities**		**Insurance**	
	Commitment	Practice	Commitment	Practice	Commitment	Practice
Hong Kong	4.20	4.75	4.00	4.40	4.40	4.00
Indonesia	3.15	3.20	3.50	3.00	3.10	2.60
South Korea	1.10	1.70	1.70	2.10	1.20	2.60
Malaysia	2.40	2.40	2.50	2.50	2.10	2.10
Philippines	2.80	3.35	2.40	2.40	2.90	2.80
Singapore	2.25	2.50	2.70	2.70	4.10	4.10
Thailand	2.95	2.85	2.00	2.00	2.80	2.80
India	2.70	2.25	2.50	2.10	1.00	1.00
Average	2.69	2.88	2.66	2.65	2.70	2.75

Source: Claessens and Glaessner (1998).
Note: 1 = most closed, 5 = most open

Commitments fall short of practice in some economies (such as banking in Hong Kong), and exceed practice in others (securities in Indonesia). By sector, entry to banking was more liberal than to securities or insurance. By economy, many economies carried on discriminatory practices, with the international financial centers in Hong Kong and Singapore being the most open. Hong Kong was the most open to all financial services, while South Korea was virtually closed to banking services, India was similarly closed to insurance services, and Thailand the least open to securities firms. Interpretation of these indices requires fairly detailed country knowledge; for example, Malaysia appears to restrict foreign entry, but one of the reasons is that it has restricted new licenses for insurance or securities firms to both domestic and foreign firms. Cross-border trade is less restricted than entry by foreign firms to the domestic markets. Before the 1997-98 crisis, several countries allowed free access to offshore banking services; in the wake of the crisis some of these were substantially modified (to correct distortions associated with the Bangkok International Banking Facility, for example).

Improvements in transparency would also reduce the difficulties of considering a negative list to replace the positive list approach to negotiations. In order to put more pressure on countries for broader commitments, it is necessary to be able to evaluate and compare barriers to entry and cross border flows in a wider variety of services sectors. This suggests that more could be made of the negative list approach as an alternative framework. While likely difficult to accomplish, the negative list approach has the potential of increasing transparency and the momentum for wider coverage and market opening.

A broader coverage of bound commitments is also required. Few countries have made sweeping commitments to market access and national treatment in financial services. Thus, another issue for the next round is to encourage countries to commit that all service sectors will be subject to national treatment and market access disciplines, with target dates and transition periods. Surprising as it may seem, aiming to bind the status quo for only a specified share of all commitments is a moderately ambitious starting point. Complementing this with efforts on rules to increase the impact of multilateral disciplines for certain modes of supply, particularly national treatment for FDI, would also be timely.

Another implication of table 2 is that we can expect the goals of the OECD countries to continue to focus on market opening – to deepen and broaden the limited commitments made in 1997, particularly for a wider range of choice of commercial presence of the suppliers of financial services (such as majority joint ventures, wholly-owned subsidiaries and branches); to improve the scope of national treatment commitments; and in view of the explosion of internet services since 1997, further commitments to the cross-border provision of financial services by electronic means.

While the protesters at the Seattle ministerial were not aiming at the FSA, their objections have significant implications for financial services. Objections to the negative list approach because it might "put national health services on the table" and objections to the heavy weighting of developed countries' and multinational interests are each relevant to future financial services negotiations. It is, thus, in the interests of the WTO to structure financial services discussions in the context put forward in this chapter: by asking how the FSA contributes to an emerging market economy's growth and development. Preparatory discussions in 1997 reflected this concern, but sometimes lacked sensitivity to the importance of a country's sequencing of domestic reforms and market opening. The importance of sequencing, however, is now firmly established as one of the central lessons for emerging market economies from the 1997-98 financial and economiccrises.

Before concluding, it is also useful to stand back and look at the long term strategic fundamentals of trade in services. The GATS framework suffers from architectural limitations that cast doubts on its ability to create a liberalization-enhancing regime for trade in services, that is, one that exerts continuous pressure for opening. Market access in services is a basic issue in the management of globalization that involves trade instruments and practices as well as policies directed at FDI and competition policy. The latter are crucial dimensions in a globalizing economy with mobile factors of production. FDI remains key to providing retail services, even though the information and communications technology revolution may facilitate cross border trade. In addition, oligopolistic market structures and the potential for cross-border mergers increase the need for a multilateral approach to competition policy. This is another reason for extending the domain of multilateral negotiations to include liberalization of direct investment regimes and better coordination of competition policy. Through the definition of broad principles in these areas that would apply to all goods and services, such an agenda would help to circumvent the limitations of the GATS and increase the liberalization thrust of the multilateral trade regime.

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