Chapter 5

FINANCES SERVICES AND INTERNATIONAL TRADE AGREEMENTS: THE DEVELOPMENT DIMENSION

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This chapter begins with an introduction to financial services and their special role in an economy, and distinguishes trade policy reform in financial services, domestic deregulation, and capital account liberalization. The second section examines the impact of trade policy reform drawing on empirical evidence. The third section defines the elements of successful trade policy reform, while the final section explores how financial services liberalization in the WTO negotiations can contribute constructively to development goals.

Introduction, Definitions and GATS Overview

The questions to be addressed are as follows: What are financial services? What is financial services trade liberalization? How does it differ from capital account liberalization? How does it relate to the GATS framework?

At the outset, a number of definitions are necessary to clarify terms common in industrial, empirical and trade policy usage.

The financial services sector is composed of users and providers of financial services and the government agencies that regulate them. Users of financial services are households, firms and governments. Households save, invest and finance purchases through personal loans from banks and other financial services providers (FSPs);

corporations use the services of banks in the form of secured and unsecured loans and revolving credit facilities or through the sale of debt obligations. Governments also borrow from banks and issue securities.

FSPs are of two main types:

- Financial intermediaries (institutions that create or acquire financial assets and obtain the funding for those assets by issuing liabilities) including *deposit-taking intermediaries (*commercial banks, savings institutions), and *nonbank financial intermediaries (NBFIs)* such as insurance, finance, credit, leasing and investment companies; and
- Direct finance institutions in capital markets such as brokerages and securities firms that facilitate transactions undertaken directly between the providers and users of funds, such as underwriting and selling bonds and equities. These firms may operate in both the primary (original issue) and secondary (resale) markets for these securities.

Financial services are defined in the GATS Annex on Financial Services as "… any service of a financial nature offered by a financial service supplier of a Member." Financial service suppliers do not include state-owned or -controlled entities. Financial services include insurance and insurance related services, banking, financial trading, asset management, brokerages, settlement and clearing services, provision of financial information and advisory services.

Financial institutions refer to the FSPs and the regulatory agencies that enforce the rules governing what FSPs may do and how they do it. Financial institutions mobilize an economy's resources and facilitate the transactions necessary for economic exchange.

One of the central problems that financial institutions address is that of information asymmetry between the providers and users of funds, that is, the unequal knowledge on the parts of providers of funds about the ability of users of funds (that is, the performance of firms or individuals' ability) to repay. Because of this "leap in the dark" (Caprio, 2002) characteristic of many financial transactions (will the borrower or issuer be able to repay in full at a later date?), the financial sector is inherently unstable.

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 financial institutions and must have confidence in those institutions. When these institutions are highly leveraged, 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.

Financial institutions play a critical role in managing risks and closing information gaps. They reduce the risks faced by investors by pooling their savings and distributing them 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.

The domestic banking industry can be a particular source of fragility in all countries, but more so in developing countries and transition economies. Why? Because many of these economies are relatively small and domestic economic activity is concentrated in particular industries or commodities, making it difficult to diversify risk and absorb shocks to the financial system. Immature financial systems (ones that rely exclusively on banking services and debt instruments, or on state-owned banks, for example) can add to the problems. Empirical evidence confirms that state ownership is generally negatively related to financial sector development and growth. "Greater state ownership of banks tends to be associated with higher interest rate spreads, less private credit, less activity on the stock exchange, and less nonbank credit even after controlling for many other factors."[1]

Domestic financial reform refers to the process of deregulation of domestic financial services. Deregulation has several dimensions: the withdrawal of government intervention through, for example, privatizing state-owned banks; freeing key prices like interest rates to be market-determined; and removal of restrictions on intra-sectoral activities so that, for example, banks can offer insurance. A third dimension is the strengthening of domestic financial institutions and markets to increase the efficiency with which finance is channeled from depositors and investors to borrowers and issuers.

Financial services liberalization, the most commonly used term for *trade policy reform in financial services* refers to the removal of discriminatory regulation, that is, either quantitative or qualitative regulations that discriminate against foreign FSPs and domestic FSPs with respect to market entry or commercial presence, that is, the opening of domestic financial markets to allow cross-border trade in financial services and the entry of foreign FSPs. It also includes cross-border supply, consumption abroad, and permission to foreign persons to move across borders taking four modes:[2]

- Mode 1: the *cross-border supply* of a service, which is analogous to international trade in goods, in that a product (service) crosses a national frontier; e.g. the taking of a loan or the purchase of insurance cover by a consumer from a financial institution located abroad.

- Mode 2: *consumption abroad*, including the movement of consumers to the territory of suppliers; e.g., the purchase of financial services by consumers while traveling abroad.[3]
- Mode 3: the *commercial presence* of a supplier of one Member in the jurisdiction of another Member; e.g., when a foreign bank or other financial institution establishes a branch or subsidiary in the territory of a country and supplies financial services. By defining trade to include sales through commercial presence, the Agreement includes foreign direct investment, which accounts for a large share of financial services transactions.
- Mode 4: the supply of services through the *presence of natural persons*, e.g., independent financial consultants or bank managers, of one Member in the territory of another Member.

Trade in financial services also entails certain GATS obligations:

- *transparency* requires each Member to publish promptly "all relevant measures of general application" affecting trade in services;
- *most-favored-nation* (MFN) principle prevents Members from discriminating among their trading partners. The Agreement, however, permits Members to list temporary exemptions to MFN.[4] In the case of financial services, a number of MFN exemptions had been maintained when the preceding round of negotiations were concluded in mid-1995, some of which reserved the right to apply reciprocity as a basis for

granting market access.[5] One of the key objectives of the extended negotiations was to achieve the removal of such exemptions and reach a full MFN-based result.

- *market access* (Article XVI) and *national treatment* (Article XVII). The liberalizing content of the GATS depends on the extent and nature of sector-specific commitments assumed by individual Members with respect to these two provisions. These provisions apply only to sectors explicitly included by a Member in its schedule of commitments and there too are subject to the limitations that a Member has scheduled. GATS commitments are guarantees but the absence of such guarantees need not mean that access to a particular market is denied. In fact, there are several markets where conditions of access are more liberal than those bound under the GATS.

  The *market access* provision prohibits six types of limitations, unless they have been inscribed by a Member in its schedule. These are: (a) limitations on the number of suppliers; (b) limitations on the total value of service transactions or assets; (c) limitations on the total number of service operations or on the total quantity of service output; (d) limitations on the total number of natural persons that may be employed; (e) measures that restrict or require specific types of legal entity or joint venture; and (f) limitations on the participation of foreign capital. In scheduled sectors, the existence of any of these limitations has to be indicated with respect to each of the four modes of supply, described above.

  National treatment is defined as treatment no less favorable than that accorded to domestic services and service suppliers. Members may inscribe limitations on national treatment in their schedules - with respect to each of the four modes of supply, as in the case of the market access provision.[6]

The Implications of GATS Commitments for National Policies

Frequently the question is asked about Members' GATS commitments in relation to national policy objectives. GATS commitments are not intended to compromise governments' ability to pursue sound regulatory and macroeconomic policies. Indeed GATS commitments allow considerable freedom to achieve such domestic economic objectives as *prudential regulation and macroeconomic policy*.

In financial services, specific commitments are made in accordance with the Annex on financial services that complements the basic rules and definitions of the GATS taking into account the specific characteristics of financial services. Paragraph 2(a) states that:

> Notwithstanding any other provisions of the Agreement, a Member shall not be prevented from taking measures for prudential reasons, including for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial service supplier, or to ensure the integrity and stability of the financial system.

However, the same paragraph notes that prudential measures that do not conform with other provisions of the GATS, must not be used as a means of avoiding commitments or obligations under the Agreement.[7] Even so, regulators have discretion in their choice of prudential measures – especially since no definition or indicative list of such measures is provided in the Annex.[8]

In conducting macroeconomic policy, for example, when a central bank conducts open market operations, conditions in the financial sector could be affected through the impact of such interventions on the money supply, interest rates or exchange rates. Services supplied in the exercise of governmental authority, including activities conducted by a central bank or monetary authority or by any other public entity in pursuit of monetary or exchange rate policies, are excluded from the scope of the GATS.[9] As well, such macroeconomic management measures as reserve requirements on banks could presumably be justified as measures to ensure the soundness and stability of the financial system under the terms of the Annex on Financial Services.

Of course, governments may also wish to maintain other rules and regulations that influence the operations of markets and competition in a market, such as for example, a requirement to lend to certain sectors or individuals, or lending mandated on the basis of preferential interest rates for certain types of lending. Even though such measures may not be the most efficient means of achieving particular objectives, these policies are not necessarily subject to GATS commitments. If they are neither discriminatory nor intended to restrict the access of foreign suppliers to a market, then such domestic regulatory measures would be permitted provided they met certain basic criteria, such as impartiality and objectivity (specified in Article VI of the GATS).

Financial Services Liberalization and Policy Coherence

Policy coherence is a term that applies to these three complementary activities: trade policy reform; domestic financial reform; and capital account opening. The mutually reinforcing relationships among trade policy reform in GATS negotiations and domestic reform are emphasized in the extensive international programs conducted by the IMF, World Bank, Bank for International Settlements and other institutions to strengthen the domestic financial systems of their members (Key, 2004). Trade policy reforms that free up cross-border supply of services and market entry for foreign FSPs eventually require loosening of restrictions on at least some forms of capital flows. This inter-relationship sometimes raises fears about the impact of increased competition, loss of autonomy and increased volatility of capital flows, each of which is discussed below.

The interaction between capital controls and opening the market to foreign financial services providers arises when domestic financial services transactions involve international capital account transactions. While it is possible for some international trade in financial services to take place without cross-border capital flows, controls such as exchange controls substantially reduce users' freedom to buy financial services directly from foreign FSPs and may discourage the FSPs from entering an economy. Arrangements for delivering financial services across borders without affecting capital flows will also be costly. Opening the capital account, therefore, although a distinct issue from that of trade policy reform in financial services, sooner or later becomes an issue that countries must face.

In principle, domestic reform and trade policy reform can be seen as precursors of capital account liberalization. A sound and diverse financial system will better intermediate volatile international capital flows. But there is no one-size-fits-all approach to sequencing, as a variety of sequences seen in various countries will demonstrate. For example, Taiwan has not fully deregulated its domestic financial markets and still imposes some restrictions on the capital account, but it permits market access by foreign FSPs. South Korea restricted both market access and capital flows, yet in 1997 still experienced a severe balance of payments crisis related in part to a weak record of domestic reform.

Systematic studies of country experience demonstrate successful interactions among these three dimensions of policy. Brazil, Chile, New Zealand, Hungary, Portugal and Spain are all countries that have had successful experiences in opening up to foreign firms. They are also examples of countries that have engaged in domestic reforms to strengthen prudential supervision of their domestic financial systems (World Bank, 2002, p. 85). Other studies show that diversity in ownership contributes to greater stability of credit in times of crisis (Barth et al., 2000a;b; and LaPorta et al., 2000). Several countries with significant foreign presence, such as Argentina and Mexico, have benefited from the access of these institutions to foreign capital in times of crisis (Dages et al., 2000). Foreign presence also encourages a stronger more transparent regulatory and supervisory framework to ensure understanding of and compliance with local rules.

The record on foreign entry, domestic reform and removal of capital account restrictions is more mixed. Chile's experience is one example. Chile reformed its domestic financial market in the late 1970s, opened its capital account in 1980, experienced a financial crisis, re-imposed restrictions on capital flows and later resumed domestic reform and opening. Chile has also had successful experience with controlling capital inflows. [10] China and India, two large economies where domestic reform is still work-in-progress, restrict both capital account transactions (only FDI flows are permitted by China, for example) and market entry by foreign FSPs.[11]

It is important to note, however, that GATS commitments do not oblige a Member to allow international capital mobility. But if a Member undertakes a market-access commitment in relation to the cross-border supply of a service and if the cross-border movement of capital is an essential part of the service itself, that Member is committed to allow such movement of capital. Further, if a Member undertakes a market-access commitment in relation to the supply of a service through commercial presence, that Member is committed to allow related inflows of capital. But Members do not have any obligations with respect to capital flows related to consumption abroad, and with respect to capital outflows related to commercial presence.[12] The imposition of restrictions on current or capital transactions in the event of serious balance-of-payments and external financial difficulties or the threat thereof (Article XII) is permitted.[13]

The Impact of Trade Policy Reform in Financial Services

The following questions are considered in this section. What are the social and economic impacts of trade policy reform? What are the benefits and risks of trade policy reform for broader financial sector development, growth, income distribution and poverty?

Economic Impacts of Trade Policy Reform

Recent work traces the linkages between financial development, trade policy reform and economic growth.[14] Levine (1996) traces the channels by which foreign bank entry influences domestic financial development. Conceptually, it is argued that foreign banks can provide high-quality banking services at lower cost, spur quality improvements and cost-cutting in the domestic banking industry; promote better accounting, auditing, and rating institutions; and increase the pressure on governments for greater transparency in prudential regulation.

Enhanced market access for foreign insurers will also allow local markets to diversify risk more effectively and to benefit from the foreign companies' know-how and resources (Skipper, 1996). Such changes will increase the efficiency with which capital is allocated and spur economic growth over what would otherwise have been the case.

These arguments illustrate some of the economic impacts of trade policy reform. At least six impacts can be identified, beginning with the effect on domestic competition provided by FSPs, and the associated benefits to households, firms and governments as users of financial services.

Increased domestic competition

Users benefit from increased competition and access to foreign expertise in a number of intangible ways such as improved quality of services and wider choice. These benefits take the form of: (1) access to new service channels (credit cards and electronic banking being obvious examples); (2) faster access to services; (3) better credit assessment procedures and information-gathering techniques, and (4) wider choice of products and vendors. Users also benefit from easier and more effective diversification of risk.

Households, businesses and governments are the main users of financial services, and they benefit from domestic reform and liberalization by realizing cost savings and quality improvements in financial services.[15] In the industrialized countries it has been demonstrated that as financial institutions face stiffer competition from both domestic competitors and foreign entrants they learn to exploit economies of scale and scope, reduce managerial inefficiency, and make better use of advanced technology. Savers and investors earn higher rates of return; they have wider choice of savings instruments and opportunities to diversify risk, as well as easier access to financial products. Those seeking funds benefit from better risk appraisal, reduced waiting times, a wider range of lending instruments, a wider range of maturities and expanded access to funds.

In Europe, the Cecchini Commission Report (Ceccini, 1988) predicted that opening trade in financial services would reduce unit costs by facilitating economies of scale, increasing competition, reducing price markups and increasing managerial efficiency. More recent studies broadly confirm these claims (Kono et al.,1997).

Catalysts for domestic reform

Because foreign entry is likely to make some domestic financial restrictions redundant, it may play a catalytic role in domestic reform (Edey and Hviding, 1995). The experience of countries acceding to the EU suggests that increased foreign entry bolstered the domestic financial sector framework by creating a constituency for improved regulation and supervision, better disclosure rules and an improved legal and regulatory framework (World Bank, 2002, p. 85).

Anticipating the arrival of foreign entrants can also be a powerful catalyst for domestic reform, as the recent Chinese WTO accession agreement illustrates. During a five-year phase in period, designed to allow domestic firms and individuals to adjust to increasing competition, the PRC will gradually remove geographic and regulatory restrictions on foreign FSPs and liberalize the scope of permitted business. The final commitments will fully open the sector to foreign access while maintaining some limitation on cross-border supply and foreign ownership. In insurance services, foreign non-life insurers were immediately permitted to establish a branch or joint venture with 51 percent foreign ownership, and to establish wholly owned subsidiaries in two years. Life insurers were permitted 50 percent ownership of joint ventures immediately.

Catalysts for great regulatory transparency

The participation of foreign financial institutions tends to require greater transparency of domestic regulations and practices. Information about laws, regulations, and administrative guidelines must become available to all market participants to ensure that they are fully aware of their rights and obligations arising from trade-related rules. Implicitly, entry of foreign financial institutions allows a country to import strong prudential supervision for that portion of the financial system, since, for example; the foreign affiliates of banks are supervised on a consolidated basis by regulators in the home country. The branches and subsidiaries of foreign financial institutions are also likely to have disclosure, accounting and reporting requirements that are closely aligned with best international practice.

Enhance robustness of the domestic financial system to shocks

Foreign banks can provide a more stable source of credit, in that they can call upon their parents for additional funding and capital if needed, which can make the banking system more resilient in the face of shocks. The parents are better able to provide such funds because they hold internationally diversified portfolios. Several countries with significant foreign presence, such as Argentina and Mexico, have benefited from the access of these institutions to foreign capital during times of crisis (Dages et al., 2000).

Suppliers of new skills, products, technologies

FSPs can provide new skills, new products and technology that eventually diffuse into the domestic financial system, assisting its modernization, as the president of a leading Indonesian insurance firm commented:

> It is common knowledge that the foreign banks operating in Indonesia are the source of banking expertise. They have trained a great many Indonesian men who later have become managers of national private banks. The number is so great that almost every national private bank has one of its managers originating from foreign banks. . . . It is noteworthy that the foreign banks who are operating in Indonesia have played a major role in improving the know-how and expertise of our Indonesian bankers.[16]

Facilitate access to international capital

Mode 3 reforms can facilitate access to international capital markets and augment the amount of saving available for productive investment. For example, the Thai trade policy regime lifted restrictions on foreign entry and foreign equity participation for ten years to help recapitalize the financial system following the 1997 crisis. One hundred percent foreign ownership is now permitted of Thailand's commercial banks and finance companies. This permission extends only until 2007, when any new foreign equity will then be limited to a 49 percent share. The rationale for this temporary reform is that foreign firms willing to assist in recapitalizing and modernizing the financial sector at a time of great crisis should be rewarded, but not indefinitely.

Economic risks and uncertainties

More recent work on the impact of foreign bank entry (summarized in IMF, 2000) debates some of these observations.

While empirical evidence confirms that foreign bank entry is most beneficial when it is part of a more general liberalization of trade and production of financial services, foreign entry is not without risks. Foreign FSPs with more diversified portfolios help to increase efficiency. Offsetting this benefit, however, is the risk that liberalization may not yield a more stable source of credit for domestic borrowers. If foreign bank entry is accompanied by reduced barriers to capital outflows, banks may use funds raised in the domestic market to undertake external lending. In such a case, domestic borrowers may not have the same degree of access to domestic savings as before liberalization. Another risk is that foreign banks might shift funds abruptly from one market to another as they perceive changes in risk-adjusted returns.

Governments make differing stability – efficiency tradeoffs, however. In Central Europe, for example, the need to build institutions quickly combined with the cost of bank recapitalization programs, persuaded authorities to liberalize foreign entry. In Mexico and Venezuela in the mid-1990s, the scale of domestic banking problems created incentives to allow more foreign entry to access new sources of capital and financial expertise. Thailand's case cited above is another example.

More generally, anecdotal explanations for slow increases in foreign participation suggest a number of concerns, real and perceived, particularly about foreign banks. Some of the arguments are as follows:

- foreign banks "cherry pick" the most desirable markets and customers, leaving the domestic banks with higher-risk assets and customers. This phenomenon was most likely to occur in the early stages of liberalization when domestic institutions still hold loans carried at fixed rates while foreign competitors are able to set higher rates for loans and deposits. The disadvantaged institutions then attempt to compensate by taking high-return, but high-risk activities, especially if their deposits are insured.

There are also concerns about the potential for selective servicing by foreigner suppliers. It is feared that the latter will only service profitable market segments and that the resulting under-provision of retail banking in rural areas, for example, could then have detrimental effects on the economy.

- foreign banks are more likely to "cut and run" during crises.
- foreign banks' contribution to efficient credit allocation has to be seen in the context of small and concentrated industrial structures in which credit risk evaluation methods, such as centralized credit scoring (widely used in mature markets), facing informational constraints in emerging markets will lead to reduced credit to small firms. The resulting impact can be to encourage the development of oligopolistic, rather than competitive, industrial structures.
- foreign "names" may not guarantee safety and soundness. Banks operating in industrial economies and with ownership links with reputable foreign entities may be a source of fragility, as with BCCI. Supervisory authorities have learned from such incidents and are increasing their attention to cross-border operations.

Empirical evidence for these propositions is limited. What is available is summarized in IMF (2002). This evidence indicated the beneficial impact on local banks of more competition. For example, a cross-national study of the behavior of 80 banks in mature and emerging market economies in the 1988-95 period shows that significant foreign bank entry was associated with the reduction of profitability and overall expenses of domestic banks (i.e., efficiency as well as profitability effects). Another study cited by IMF (2002) shows that foreign banks operating in a sample of emerging markets are relatively more efficient than domestic banks. But other evidence shows that domestic banks can improve their performance. For example, a study of Chile shows that local banks are more profitable for two reasons: one is that Chile developed a strong banking system after its banking crisis in the early 1980s; the second is that foreign banks performance was impaired during the execution of mergers with local banks. Another study of Latin American banks in 1999 shows, further, that local banks were able to overcome competitive disadvantages with foreign FSPs by developing new sources of international funding, resorting to international consultants, and selective association with foreign and local companies to improve their systems and products.

Available evidence also confirms the stabilizing impact of foreign bank participation, i.e., reducing the probability of a banking crisis, and evidence of a long term commitment to markets once entered. Unfortunately there are very few studies of these factors (IMF, 2000, pp.168-170).

The sharp rise in foreign bank participation in a number of emerging market economies suggests that authorities in these countries seem to see entry as having an overall positive effect on efficiency and stability of national banking systems. New Zealand's banks are almost entirely foreign-owned, albeit by Australians, located next door; in Chile foreign banks account for 54 percent of bank assets; the Latin America average, excluding Brazil and Mexico, was 40 percent in 1999; and in the Czech Republic, Hungary and Poland, foreign ownership averaged over 44 percent (IMF, 2000, Table 6.1).

These conclusions need some qualification with respect to African economies. While Africans were among the major liberalizers of core banking and insurance services in the FSA, more recent analyses of African financial sectors indicate that small domestic market size constrains financial system development in many of these countries. Thus, trade policy reforms that permit foreign bank entry, for example, may simply increase the concentration of banks in a small economy and reduce the marginal returns to foreign entry. Instead, a more desirable objective of such a small economy may be to increase market size (by liberalizing the cross-border supply of services by existing FSPs) and to diversify the sector by encouraging capital market institutions (World Bank, 2000, pp. 160-169).

Social Impacts

How should governments view the potential contribution of foreign FSPs to addressing issues of poverty alleviation and the access of low-income and rural-based savers and borrowers to financial services? Traditionally governments have assigned this task to government-owned savings banks and cooperatives or thrifts -- institutions that provide basic savings services and invest in low risk assets that provide low returns and few credit services.

Very few examples of foreign FSP activities are available. One example can be found in the Philippines where the insurance industry plays a significant role in mobilizing capital and channeling it to development requirements. A US firm, which established a presence in the Philippines in 1947, has developed a series of products to channel savings into investment projects. The first product was an endowment policy for farmers and small merchants, which helped them to build savings in rural areas where banks were scarce. Their savings were invested in roads and water facilities. In the 1950s a product was developed to channel funds into middle-income housing at a time of shortage. Later this firm developed the Philippines' first public mutual fund (Financial Leaders Group, 1997).

Conversely, some evidence is available indicating that financial services liberalization had an adverse effect on access to credit for rural areas and the poor. Mosely (1999) uses sample survey data on households in Uganda, Kenya, Malawi and Lesotho for the 1992-97 period and reports that the share of households with access to rural credit rose in Kenya and Uganda, but declined in Malawi and Lesotho. This study indicates that domestic financial reforms targeted to rural areas and the poor had more positive impact.

This finding is consistent with the growing number of examples of domestic programs that target finance to rural areas and the poor through micro-credit lending institutions, such as the Grameen Bank in Bangladesh and the Bank Rakyat Indonesia (BRI) in Indonesia. Grameen Bank demonstrates that peer pressure from other small savers and borrowers helps to operate successful credit programs involving modest individual credits. BRI has built a business of lending to small enterprises, both rural and urban. It began as a state-owned enterprise, was troubled by non-performing loans (NPLs) and then was overhauled to introduce lending expertise and appropriate incentive systems. Nearly one third of all Indonesian households hold accounts with the bank. In 003, BRI began preparing an IPO on the Jakarta Stock Exchange that will be open to oreign investors (McCawley, 2003).

It is also useful to note, in conclusion, that governments can under the GATS impose requirements that address concerns about the provision of financial services in rural areas. For example, universal service obligations might be considered as part of licensing requirements, provided these do not discriminate between foreign and domestic financial institutions. Social objectives could then be met without sacrificing the efficiency benefits of competition. But this conclusion should be balanced by the fact that foreign FSPs often consider themselves at a distinct disadvantage in providing retail services (i.e., to individual savers and borrowers) because they lack local knowledge necessary to observe the “know your customer” rule.

The Elements of Successful Trade Policy Reform

The questions to be considered in this section are the following. What can we say with confidence about the elements of successful trade policy reform? Where is there agreement? Where is more research required? Is there anything special about trade policy reform in financial services?

What Can We Say with Confidence about Successful Approaches?

The basic rationales for trade policy reform to allow cross-border supply and commercial presence are (1) to enhance domestic competition among producers thereby promoting efficiency and lower costs to users and (2) to contribute to the creation of stable and transparent policy regimes.

Foreign entry can be designed in various ways. Among the choices available to Members, particular attention should be paid to the distinction between foreign entry and permitted equity participation by foreign FSPs. As described below, a Member may liberalize foreign entry to introduce more competition in the domestic market. As noted below, China is following this route using precommitment as the instrument to allow domestic firms to prepare for future competition. Thailand has selected a different route, permitting foreign entry and full equity participation in banking for a ten-year period. Latin American Members have selected a combination of restricted entry and free equity participation.

- China: (pre-commitment to expanded national treatment; reduced ownership restrictions).[17]

In banking, China's WTO accession agreement permits the hundreds of foreign FSPs already in the market to provide the following services over the first five years. Foreign currency business was opened immediately with no geographic restrictions. Local currency services to Chinese enterprises, only permitted in some major cities, will then be extended geographically after 2 years, with all restrictions phased out in five years

In insurance, non-life insurers will be permitted to establish as branches or joint ventures with 51 percent ownership, rising to 100 percent foreign ownership within two years. Life insurers are permitted 50 percent ownership with a partner immediately. Companies offering large scale commercial risks, reinsurance and international marine, aviation and transport insurance and reinsurance are allowed immediately to form joint ventures with no more than 50 percent foreign equity, rising to 51 percent in three years and 100 percent after five years. Geographic restrictions confining operations to large cities are to be phased out over three years.

- Thailand (liberalization of foreign entry and equity participation, but for ten years).

The Thai government, after weighing the costs of foreign entry against more general economic benefits in the wake of the financial crisis, lifted restrictions on both foreign entry and foreign equity participation for ten years. Permitted services and foreign labor are still restricted. The rationale is political-economic: it is believed that these services are best owned and controlled by domestic interests. Domestic interest groups successfully exert political pressure to protect their interests, but with considerable public support.

New entrants must be approved by the relevant minister (the Minister of Commerce approves insurance and the Minister of Finance approves banks) and the Cabinet. Foreign banks are also restricted from participating in national ATM networks in Thailand. They are allowed only three branches, with one outside the capital city, Bangkok. ATMs are regarded as a branch.

Foreign equity in domestic insurance and finance companies is limited to 25 percent; and to 49 percent in services auxiliary to insurance. Since 1992, foreign insurance branches have been permitted, but no licenses have been granted. Thailand also uses Mode 4 restrictions: foreigners are not permitted to work as insurance brokers; and foreigners are prohibited from being brokers, dealers, traders or underwriters in the securities industry.

- Latin America (restricted foreign entry but unconstrained equity participation).

Another option is to restrict foreign entry but allow unconstrained foreign equity participation, a practice often followed in Latin America. Restricting entry but allowing for equity participation will help strengthen weak financial institutions, promote technological transfer, improve products and raise skill levels. Some of these changes will benefit consumers through lower costs and more choice. Other benefits come in the form of technological innovations, such as new methods of electronic banking and improved management and credit assessment techniques, but also as higher standards of transparency and self-regulation.

These benefits must be compared to their costs, however. If FDI is attracted simply because the returns to investment are artificially raised by restrictions on competition, then the cost to the host country may exceed the benefits. Lack of competition will influence the extent to which these benefits are passed to consumers. With restricted competition, producers have few incentives to do so, and more incentives to collect “rents”. To some extent rent appropriation can be prevented by taxing profits, but such taxes are prevented if there is a commitment to provide national treatment. If, however, a Member decides to restrict licenses or equity, these should be allocated by holding competitive auctions of licenses or equity. Even then, the rents accrue to government or existing domestic shareholders.

What Issues Require More Research?

- The impact on domestic financial performance of foreign equity participation.

Two issues might usefully be the subject of further research. First, it is frequently argued that finance is special because of the 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 this regard, with the current GATS focus on freer cross-border trade and foreign entry in financial services, and the fact that many standard policy interventions in the financial sector are untouched by commitments within the GATS, are there generalizations that can be made about the impact of foreign entry on

Member economies? Members retain the scope for macroeconomic policy through the "carve-out provision" in the GATS designed to protect 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 the GATS.

A second argument that merits further investigation is the argument, made in relation to African economies, that small market size is more of a problem in developing a modern financial sector than lack of foreign competition. By this argument, regionalization and diversification of existing services (on a national treatment basis) is the priority. The question that follows is whether future trade policy reform should emphasize cross-border supply rather than foreign entry and permitted activities.

- Improve available data on and transparency of barriers to cross-border transactions and foreign entry.

Lack of comparable cross-country data is a general problem in the service sectors. Many services originate as non-tradables; thus, measures, if they are developed, tend to serve domestic purposes. The variety of measures therefore makes it difficult to aggregate across countries the existing information on parameters of services production and trade. Comparable information would have several benefits. First, it would help advance negotiations in that bargaining would be based on more reliable information. Second, it would assist researchers analysing the effects of liberalization. Third, it would help regulators and foreign FSPs managing across borders to aggregate information on risks and therefore to anticipate and better manage the concentration of risk. Indices of openness in the financial services industries in key emerging market economies are included in Table 5.1 summarizing commitments on the degree of financial liberalization at the end of 1996.[18]

Table 5.1: 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

Note: 1= most closed, 5= most open

Source: Claessens and Glaessner (1998).

- Measures used to moderate unanticipated impacts of liberalization.

Many developing country Members must respond to pressures from incumbent producers opposed to or anxious about intensified competitive pressures from the entry of foreign FSPs. These pressures should be distinguished from difficulties that might arise unexpectedly during the liberalization process once committed to in GATS negotiations. If it is accepted that consumers will benefit from modernizing and competitive pressures from new entrants, foreign entry can be managed by phasing in commitments to increase market access for foreign FSPs.

The Chinese example described above illustrates such an approach. With respect to managing difficulties during the liberalization process, discussion is underway in GATS of the question of whether to include an emergency safeguard mechanism (ESM) that can be used by governments, under specified conditions, to impose or increase protection to provide temporary relief when difficulties or pressures arise as a result of liberalization commitments and obligations. The main features of an ESM would be that it target a specific product or industry in which "injury" to domestic producers can be demonstrated; be applied on MFN basis; be of limited duration; and be progressively liberalized over the period of its application (Sauve, 2002). The other option is to not make a negotiated commitment. Further research would be desirable to determine whether the absence of a mechanism to address difficulties, real or imagined, is one of the reasons why actual liberalization has been modest.

- Further elucidation of the rationales for Members' FSA commitments.

What were the rationales for Members' commitments (or lack thereof) in the FSA? In particular, when a service is not listed in a Member's schedule or a specific mode is unbound, schedules provide no clue as to what actual policies may be. Further empirical research is needed to obtain a more comprehensive picture of the policies governments actually pursue with respect to the financial sector. It should then be possible to examine more thoroughly not only the determinants of trade policy (such as the conditions in the domestic financial sector, the adequacy of regulatory mechanisms, and political economy aspects), but also what influences the relationship between actual policy and GATS commitments (benefits of binding versus the costs of giving up policy flexibility or negotiating currency).

More research is also desirable to study the impact of trade policy choices (both national and in terms of international commitments) on the performance of the financial sector and the economy more generally.[19]

Is There Anything Special about Trade Policy Reform in Financial Services?[20]

One reason for the willingness of governments to make liberalization commitments may be the realization that liberalization is a good idea and that the WTO offers a useful instrument for consolidating and promoting liberalization, as well as defining and formalizing future liberalization plans. Yet the use of the GATS as a mechanism for lending credibility to liberalization programs has been somewhat disappointing. The result in the 1997 FSA compares unfavorably with the experience in the basic telecommunication negotiations (Low and Mattoo, (2000)) – although financial markets are generally much more competitive than those in basic telecommunications. Again it is possible that many governments were reluctant to tie their hands in the environment of financial instability in which the negotiations were concluded.

At the other end of the spectrum, however, some governments have undertaken unilateral liberalization of financial services regimes to signal their interest in attracting foreign investors and strategic partners in the cross-border supply of services. For example, Japan and Singapore have unilaterally accelerated foreign-entry provisions because they fear being bypassed for other international financial centers.

Does the Role of Financial Services in the Economy Raise Issues for Trade Policy?

Several points that have been made in previous discussion help to answer this question. First, the fact that financial institutions are characterized by asymmetric information differentiates financial services from other services because they are crisis-prone. Second, the emphasis on strengthening domestic financial systems following the crises of the 1990s, points to the mutually reinforcing nature of trade policy reform and strengthening of the domestic financial system. Third, as pointed out above, the economics literature provides growing evidence that a well-functioning financial system contributes to an economy's long-term prosperity. Well-functioning financial services promote growth and reduce volatility. A fully-developed range of financial services in an economy with a reasonable degree of competition among financial service providers can be expected to allocate capital more efficiently, promote higher-quality services and provide lower cost of capital to households, business and government users than would be the case in an immature financial system.[21] The full range of financial institutions will mobilize savings, finance productive investments, ensure that borrowers spend their funds as promised, and pool risks of lending through the aggregation by institutions of those risks and also enabling those that carry risk are also willing to bear it.

Trade policy reforms can assist this process by removing discrimination and market access barriers to foreign FSPs that may provide more competition, access to new technologies, products, and skills that bolster the sector's contribution to overall efficiency in the host economy. Strengthened GATS disciplines on regulatory transparency and procedural fairness can also contribute to stronger domestic financial systems. Measures to promote the stability and integrity of a country's financial system or to protect consumers are still possible under the prudential carve-out.[22]

The Role of International Negotiations

The questions to be considered below are the following. How can international negotiations help? What can we learn from how international rules have been designed and commitments undertaken? Is there scope for improvement? Do existing commitments promote desirable policies? Are there reasons for refraining from commitments? Is there need for more research?

This section contains an analysis and interpretation of the negotiating results of the 1997 FSA to illustrate the negotiating approaches that were taken; it also looks forward, suggesting areas for improvement in the Doha Round and other financial services negotiations.[23]

In general, few developing countries made sweeping commitments to market access and national treatment in the 1997 FSA negotiation.[24] Latin American and Asian economies were among the most reluctant to open their insurance and core banking sectors (Figures 5. 1 and 5. 2), with Eastern Europeans and Africans ahead of them in their commitments.

Figure 5. 1

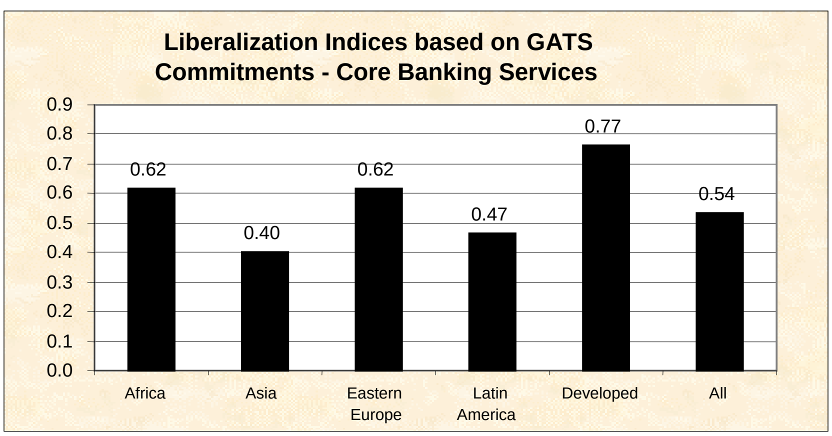
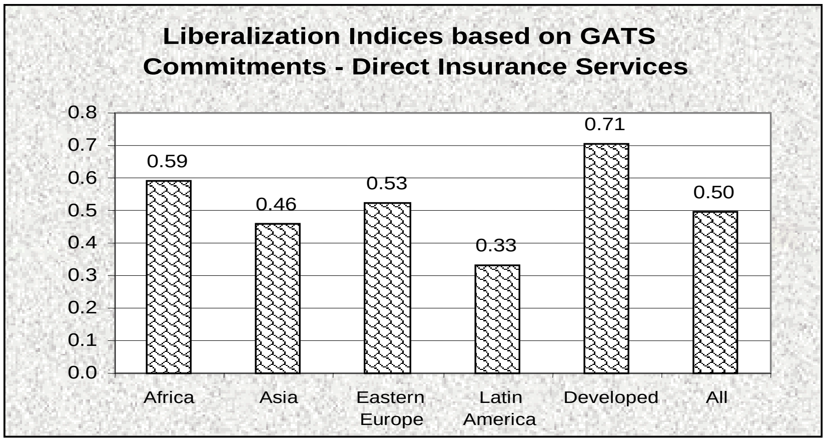


Figure 3



Source: Hoekman and Mattoo. 2002.

Figure 5.2

The ı sector negotiation following the failure to complete the negotiations before the end of the Uruguay Round. This sectoral focus tended to divide participants into countries looking for export gains and those whose focus could only be the conditions of competition in the domestic market. Despite the absence of any possibility for cross-sectoral trade-offs, or for improvements in the policy environment facing exports for those without export potential in financial services, many governments did make new commitments.[25]

In the banking sector, more participants made commitments on the acceptance of deposits and lending. Country participation was again highest in Eastern Europe and Africa. African participation was greater than in insurance. Full liberalization was rare and provided only by very small economies such as Gabon and Gambia that made full Mode 1 and 2 commitments. Other countries, including Egypt, Ghana, Kenya, Nigeria and Tunisia made more limited commitments. South Africa, Sierra Leone, Senegal, Lesotho, Nigeria and Gambia made full Mode 3 commitments while Kenya and Ghana imposed foreign equity limitations. On the whole, African countries guaranteed more openness to foreign entry, followed by Latin America and Asia. But again, Latin American reluctance was on free entry while Asian reluctance was foreign ownership. Asians were also more likely to restrict foreign branching (although India allows entry only in the form of branches licensed and supervised in their home countries).

In the insurance sector, country participation was highest in Eastern Europe and Africa. But only four small countries (Bahrain, Gambia, Guyana and the Solomon Islands) committed to remove all barriers. Participation in opening to insurance services was lowest in Africa (although the large countries were all included), but participants were willing to allow foreign entry. Ghana and Kenya already allow majority foreign ownership. Egypt limits foreign equity to 49 percent but is committed to raising the limit to 51 percent by 2003. Asian economies were more likely than Latin Americans to provide assurances of fully open markets for foreign investors, but more reluctant to assure full foreign ownership. Latin Americans, in contrast, were more ready to allow full foreign ownership but also more likely to restrict permitted activities.[26]

Lessons from the 1997 FSA [27]

In broad terms, governments that participated in the FSA adopted three different approaches: (1) binding the *status quo*, arrived at after liberalization, either unilateral or in the context of the negotiations; (2) binding commitments that represent less than the *status quo* in policy terms; and (3) pre-committing to future liberalization, 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 liberalization processes.

(1) Binding the status quo

Governments binding at the *status quo* signaled that existing market conditions are guaranteed in the future. Even though much greater knowledge of national regimes than is available would be required to make a definitive judgment, most of the FSA commitments were of the *status quo* variety. Such consolidation is positive in that it is the easiest thing for governments to do but also signals a positive intent and a commitment to the trading system. It is also important to recognize that in many cases, the *status quo* itself was reached after recent liberalization, either unilateral or during the course of negotiations.

The improvements in commitments by countries since the last round of negotiations ended in mid-1995 provide some idea of the extent of recent liberalization.[28] The clearest evidence exists for the Eastern European countries. Several (like the Czech Republic, Slovak Republic and Slovenia) gave up the possibility of discretionary licensing in banking based on economic needs, while others (like the Czech Republic in air transport insurance) eliminated monopolies in certain areas of insurance. Several countries (like Bulgaria in insurance) allowed commercial presence through branches while others liberalized cross-border trade and consumption abroad (like Poland with respect to insurance of goods in international trade). Liberalizing trends were also visible in other regions: some countries (like Brazil) replaced prohibitions on foreign establishment with a case-by-case authorization requirement and some liberalized cross-border trade (for instance, the Philippines with respect to marine hull and cargo insurance).

It is notable that many of the improvements pertained to relaxation of foreign equity limitations. For instance, Malaysia agreed to raise foreign equity limits in insurance on incorporation of existing branches (and for original owners who had been forced to divest) from 49 per cent to 51 per cent. Mexico raised its limits on foreign participation from 30 per cent of common stock to 40 per cent of common stock (plus 30 per cent and 40 per cent of non-voting common stock in insurance and banking, respectively), Kuwait allowed up to 40 per cent foreign participation in banks and Singapore up to 49 per cent in local insurance companies. Egypt and El Salvador completely removed the limits on foreign ownership of shares in banks (previously at 51 per cent and 50 per cent, respectively). Ghana removed the requirement that at least 20 per cent of the capital of insurance companies be owned by the government and allowed foreign partners to obtain management control of local firms. Hong Kong removed a requirement that made eligibility for new full banking licenses contingent on Hong Kong ownership; and Kenya removed the requirement that one-third of the equity in non-life insurance companies be held by Kenyan citizens.

(2) Binding below the status quo

Several countries bound at less than *status quo*, in some areas. The Philippines, for example, did so with respect to foreign-equity participation in commercial banks:

binding at 51 per cent when domestic law allows 60 per cent.[29] Korea's FSA offer did not include all its OECD liberalization commitments: for instance, in the FSA offer foreign portfolio investment in listed companies is bound at 23 per cent (compared to an OECD commitment to raising this ceiling progressively and eliminating it by the end of the year 2000).[30] While any binding at all provides an identifiable measure of security of market access, the value of a binding at below *status quo* is attenuated by the scope it gives a government to worsen existing conditions of market access without violating a GATS commitment.

Why would countries choose to bind less than the status quo? Mattoo and Schuknecht (2000) suggest two reasons: domestic macroeconomic instability and regulatory weaknesses appear to have had a negative impact on the level of commitments; and membership of international trade coalitions, such as the groups of agricultural and textile and clothing exporters, was in general associated with a lower level of commitments.[31] This suggests that even small countries that do not have much bargaining power on their own in negotiations, may nevertheless have chosen to retain bargaining chips for future multi-sectoral negotiations when they were part of trade coalitions. Even though such mercantilistic bargaining, and concern with reciprocity, are often judged inappropriate and damaging, it is nevertheless true that countries could benefit additionally if their trading partners were also to liberalize. From a political standpoint, governments may also generate more domestic support for liberalization from interest groups in the sector and in others, if other governments are liberalizing in areas of their export interest at the same time.

(3) Precommitment to future liberalization

GATS is also a vehicle for promoting future liberalization. One reason governments may be reluctant to liberalize immediately is the perceived need to protect the incumbent public/national suppliers from immediate competition, either because of the infant industry type of argument or to facilitate "orderly exit." In the financial sector, the vulnerability of domestic suppliers is related to a larger concern about the stability of the financial system. The fear is that inefficient or otherwise handicapped domestic banks, if exposed to competition, may fail and set off a chain reaction affecting other financial institutions.[32]

Infant industries have either failed in the past or remained infants because governments have been unable to commit credibly to liberalize at some future date, either because they have taken stakes in national firms, or because of vulnerability to the pressures from the interest groups that are being protected from competition. The GATS offers a valuable mechanism to overcome the difficulty of making credible commitments to liberalize, that is, provided market access and national treatment at a future date are binding under WTO law. Failure to honor these commitments would create an obligation to compensate those who are deprived of benefits. This need to compensate does in fact make the commitment more credible than a mere announcement of liberalizing intent in the national context. A precommitment to liberalize can also instill a sense of urgency in domestic reform, and in efforts to develop the necessary regulatory and supervision mechanisms.

Scope for Future Improvements

Looking to the future, several issues can be identified for improvement in the Doha Round. A notable improvement would be to see countries commit to subjecting all service sectors 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.

Another improvement to complement such commitments would be efforts on rules to increase the impact of multilateral disciplines for certain modes of supply, particularly national treatment for FDI.

In addition, at least two mechanisms used in the 1997 FSA can be applied to future negotiations: precommitments and grandfathering.

- *Precommitment:* Several governments took advantage of the precommitment mechanism to strike a balance between, on the one hand, their reluctance to unleash competition immediately on protected national suppliers, and, on the other hand, their desire not to be held hostage to the weakness of domestic industry in perpetuity. For example, India and the Philippines committed in the FSA to allow an increased number of branches rather than to change the existing regime. The Czech and Slovak Republics committed to endeavor to remove or reduce the scope of monopolies in certain areas in which insurance is compulsory.[33] Egypt and Slovenia committed to relax certain elements of discretionary licensing, whereas Hungary, Poland and Slovenia will allow branches of financial institutions to operate. Bulgaria and Egypt committed to allow majority foreign ownership in insurance in the near future, while Thailand has created a 10-year window of opportunity for foreign investors to acquire higher equity shares than the maximum 25 per cent normally permitted, as discussed earlier. The commitments by Hungary, Slovenia and Brazil are interesting in that they have been made contingent on parliamentary approval of new legislation. This approval is not certain, but the current commitment has value because there is an obligation immediately to translate future domestic law into an international commitment.

- *Grandfathering, a scheduling innovation:* A central problem in the FSA negotiations was solved by a scheduling innovation. The conflict arose because certain countries were unwilling to make *status quo* commitments on commercial presence. Thus, they were either inclined to bind foreign ownership levels below current levels, or to insist on legal forms (local incorporation) other than those currently in the market (branches), or both. The problem arose because policy regimes had become more restrictive than those that prevailed when the incumbent foreign firms first entered, e.g., in Malaysia, where the indigenization policy was being implemented after the establishment of many foreign firms. The negotiated solution was to drive a wedge between the conditions facing firms that were already present and those that would enter when the commitments came into effect. In effect, the privileged situation of existing firms was "grandfathered". This innovation was employed mainly by Asians.

Three types of grandfathering provisions were employed: *foreign equity-related, legal form-related* and *general.* The grandfathering provisions reflect the relative emphasis in these negotiations on guaranteeing the rights of incumbents. They provide the benefits of security to investors who are already present in the market rather than to *new* investors. But they may even place new entrants at a competitive disadvantage where differences in ownership and legal form affect firm performance.

Future Research

The foregoing discussion suggests the following three areas for research:

- *What were the main reasons for liberalization commitments in the 1997 FSA?*

The discussion in this chapter has been based on analysis of actual commitments in a single sector negotiation. One of the outstanding questions arising from the record is why countries that liberalized in 1997 did so when so many others simply bound at or below the status quo. Research into specific cases would be useful to understand more precisely the impulses for further liberalization. For most members there were no immediate benefits in terms of improved access to foreign markets. Was foreign pressure a major impetus? If so, how did this compare as a determining factor with domestic policy considerations?

- *What are the rationales for the goals of OECD countries in financial services negotiations?*

Another potential focus of research is to identify more precisely the rationales for the negotiating goals of OECD countries and to provide greater understanding of the role of business strategies in these objectives. Further research is desirable to confirm several rationales that have been advanced.

For example, it has been argued that OECD firms' decisions to enter foreign markets are driven more by reputational concerns than market share. If problems arise in foreign markets, these are likely to undermine the reputation of their global brands. Reputational factors determine the desire for full control of local operations to ensure that rigorous operational standards are met. Furthermore, their interests are also served by being subject to regulatory treatment that is identical to that for domestic companies. Current practices, such as countries' limits on foreign bank ATM offerings, deny foreign FSPs the network externalities that are increasingly relevant to the provision of modern financial services. Restrictions on cross-border trade in services limit the ability to monitor and manage risk concentrations; beyond an obvious interest in limited and transparent exemptions, grandfathering is also desirable to protect existing investments from any new exemptions to established principles.[34]

Investment decisions are also influenced by evidence of best practice regulation in host economies. In the insurance industry, for example, representatives of industry associations in OECD countries have prepared a model schedule for use by WTO members in scheduling commitments in the Doha Round (Financial Leaders Working Group (FLG), 2002). The model schedule has two aims: to promote some uniformity in insurance commitments and to help increase regulators' awareness of what is internationally regarded as best practice. The FLG propose a text for use in scheduling commitments within the existing GATS framework on market access and national treatment using existing methods. But they encourage time frames for staging obligations to encourage greater clarity and predictability to commitments since foreign investors take these into account in investment decisions. The model schedule goes beyond market access and national treatment to address certain aspects of domestic regulation by outlining best practices with respect to transparency of regulations, solvency and prudential focus, rules and rights with respect to insurance monopolies and independence of the regulatory authority.

- *What is the record of financial services liberalization outside the WTO, i.e., in regional trade agreements (RTAs)? Through unilateral liberalization commitments?*

A recent partial analysis (covering East Asian, Latin American and North American agreements) of financial services liberalization in RTAs shows that participating countries broadened the levels bound in the FSA, with the exception of Mode 1 supply of core banking, core insurance and securities services (see Contreras and Yi, 2003). A global analysis along these lines would be desirable.

Notes

[1] See Caprio (2002, p. 15).
[2] This section draws on Mattoo (2000).
[3] However, the Explanatory Note on Scheduling Commitments (GATT Document GNS/MTN/W/164) gives examples of Mode 2 that do not necessarily involve the physical movement of the consumer to the location of the supplier - for instance, when a consumer's property alone moves abroad, as in the case of ships being repaired abroad. Rather than clarifying what is meant, such elaboration blurs distinction between Modes 1 and 2.
[4] The exemptions are subject to review and should, in principle, not last more than ten years.
[5] Among them was the MFN exemption of the United States, which reserved the right to discriminate between trading partners with respect to new entry or the expansion of existing activities, in order to "protect existing activities of United States service suppliers abroad and to ensure substantially full market access and national treatment in international financial markets." See Key (1997).
[6] Negotiators rejected the traditional GATT approach of making national treatment an overarching principle of general application. Granting market access with full national treatment would have been the equivalent of establishing free trade, whereas governments wanted the option of adopting a more gradual and conditioned approach to opening up their markets. Some have suggested that it may be desirable to replicate a goods-like regime in services with full national treatment and bound taxes on foreign providers that would be progressively negotiated down.
[7] This language differs from and is weaker than that in Article XIV dealing with General Exceptions in that it does not require that the measures be *necessary* to achieve the stated objectives.
[8] Such measures presumably include capital adequacy requirements, restrictions on credit concentration or portfolio allocation, and disclosure and reporting requirements, as well as licensing criteria imposed on financial institutions to ensure the solvency and healthy operation of those institutions. As Kono et al. (1997) argue, the continuing process of regulatory harmonization and enhanced cooperation among financial regulators and supervisors at the BIS (Bank for International Settlements) and in IOSCO (International Organization of Securities Commissions) and elsewhere maintain discipline in the introduction and implementation of prudential measures.
[9] Under Article I:3 of the GATS and the Annex on Financial Services.

[10] Chile's requirements that a percentage of the value of new lending and investments into the country be placed in an interest-free deposit with the central bank for one year (this requirement has been 0 percent since 1998) and that foreign investors keep their investments in Chile for at least one year are associated with a change in the mix of foreign borrowing and reducing volatile short-term debt.

[11] As part of its WTO accession agreement in 2001, China's undertakings include permission for foreign entry within five years, yet it has no announced plans to open the capital account further. Indeed, many observers argue that China should not open its capital account more extensively until reform of the banking system is further advanced and the high level of non-performing loans has been reduced. Further details on China's financial sector reforms are noted in Box 5.2 below.

[12] This can be inferred by reading Article XI, the provision on international payments and transfers together with footnote 8 to Article XVI, the market-access provision.

[13] Article XII stipulates that the restrictions shall not discriminate among Members, shall be consistent with the Articles of Agreement of the Fund, and shall be temporary and be phased out progressively as the situation improves.

[14] See, for example, King and Levine (1993 a,b,c); Levine (1996); Levine et al. (2000); Baekert et al. (2001); and Caprio (2002).

[15] For a summary of research and research results, see Berger et al. (1993). Claessens et al. (1998) using bank level data for 80 countries show that foreign ownership reduces the profitability and overall expenses of domestic banks, suggesting positive welfare gains for consumers.

[16] Munir Sjamsoeddin, President and Director of TP Asuransi Bintang, at the XVth Conference of the East Asian Insurance Congress, Jakarta, 15-20 September 1990.

[17] For further details, see Box 5.2 below.

[18] Figures 5.1 and 5.2 below summarize the changes made in the 1997 FSA.

[19] An example of recent research along these lines is the paper by Claessens and Glaessner (1998).

[20] See Mattoo (2000).

[21] For a full development of these arguments and summary of the evidence, see Caprio (2002).

[22] See Key (2004) for arguments along these lines.

[23] See Box 5.1 below for an assessment of liberalization of trade in financial services in the context of Western Hemisphere regional and bilateral free trade agreements.

[24] For summaries and interpretations, see Kono et al. (1997); Dobson and Jacquet (1998); Mattoo (2000); Low and Mattoo (2000); and Key (2004).

[25] But several countries, including Hungary, Mauritius, Pakistan, Peru, Philippines and Venezuela, maintained MFN exemptions in their schedules that state that access may be granted on a reciprocal basis. Given the structure of the GATS, regardless of the MFN exemption, the benefits of specific commitments made by these Members must be extended to all other Members on a non-discriminatory basis. Thus the exemption has meaning only where commitments have not been made, or where it is used to provide better treatment to some Members than specified in their schedules.

[26] This section draws on Mattoo (2000).

[27] See Mattoo (2000).

[28] Unless, of course, there was significant binding below the status quo in 1995, which Sorsa (1997) argues was the case.

[29] Where a binding involving foreign equity limitations is less than the level actually allowed to any investor subsequent to the entry into force of the commitments, the MFN principle will have the practical effect of "ratcheting up" the equity-limitation commitment. This is because a new entrant could demand the same level of equity participation on MFN grounds as that granted to another supplier.

[30] Furthermore, under the terms of the IMF agreement, the de facto regime with respect to foreign capital is already more liberal than the GATS offer. For instance, the new president Kim Dae-Jung was quoted as saying that "From now on there is no need for discrimination between indigenous and foreign capital. We are living in an era where foreign investment is more important than foreign trade." (*Financial Times*, 29 December 1997).
[31] This is probably not true of the developed country members of the Cairns Group.
[32] For instance, the presence of too many financial institutions is sometimes cited as an argument against liberalization in financial services trade. To the extent that this reflects concern about the viability of individual financial institutions, it is best addressed through prudential measures and measures to facilitate orderly exit from the market. In Argentina, for instance, one quarter of the country's 200 banks were liquidated in 1995 and 1996. See also Kono et al. (1997).
[33] This is by virtue of their subscription to the Understanding on Commitments on Financial Services.
[34] See, for example, Dobson (2002).

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