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## Trade Policy in Financial Services

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### **Trade Policy in Financial Services**

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#### **Abstract**

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This paper reviews the economics of trade policy in financial services, highlighting differences between trade across borders and through commercial presence. Trade liberalization could complement other financial reforms by enhancing the efficiency, quality, and variety of financial services and by encouraging improvement of financial regulations and practices. However, it raises sectoral, strategic, and cultural concerns. The design of trade policy should therefore emphasize the nexus with the macroeconomic framework and other financial sector policies, especially prudential and capital account regulations. It should also differentiate between types of trade. National reforms should be coordinated with multilateral trade agreements and initiatives on international financial architecture.

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## I. INTRODUCTION

Financial services—insurance, credit, securities trading, and portfolio management—are increasingly becoming tradable in the modern global high-tech economy. Many countries have liberalized regulatory regimes for trading financial services across borders and via local presence, although the degree of liberalization varies across countries. Multilateral and regional initiatives under the auspices of the European Union, the Organization for Economic Cooperation and Development, and the World Trade Organization have also been instrumental in fostering integration of financial services markets.

Like trade in goods and other services, trade in financial services brings traditional gains from trade. It enhances competition and efficiency, lowers prices, and improves the variety and quality of financial services and products available in the market. At the same time, trade in financial services has some special features. It is closely linked to capital movements: the establishment of commercial presence requires direct investment, while cross-border trade often involves capital movements as an inherent part of services provision. Policy implications of trade liberalization thus depend largely on the mode of trade—across borders or via commercial presence. Given a unique and ubiquitous role of finance in the economy, the liberalization of financial services trade also raises special sectoral concerns about financial stability and market development. Addressing these concerns requires managing trade liberalization in a comprehensive manner as part of financial sector reforms. Trade liberalization in this context is not tantamount to deregulation. On the contrary, it could help discipline policy and encourage the modernization of financial sector regulation, especially in the prudential area.

In the global policy context, the liberalization of financial services trade is closely linked to the reform of the institutional architecture underlying the international financial system.<sup>2</sup> A coherent liberalization of financial services trade reinforces global financial reform by encouraging strengthening of financial systems, harmonization of financial standards and regulations, and improving transparency of financial regulations. In this setting, national and international initiatives for financial reform are complementary. The opening of the financial sector to foreign participation as part of national financial reforms contributes to the international efforts aimed at strengthening the global financial architecture. At the same time, international frameworks tend to support national programs of financial services liberalization. The most comprehensive of such frameworks is the General Agreement on Trade in Services (GATS) of the World Trade Organization (WTO). By providing an opportunity for binding services trade liberalization under multilateral rules, the GATS could make national financial reforms more credible and sustainable. However, since liberalization under the GATS is largely driven by market access bargaining between trading partners, policymakers face the challenge of linking the sequence and pace of multilateral trade liberalization to the general context of national financial sector reforms given countries' specific circumstances.

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<sup>2</sup> See Calomiris (1998) and Fischer (1998, 1999).

This paper reviews the economics of financial services trade and policy issues in its liberalization. In particular, it underscores policy implications of liberalizing different types of trade. Allowing foreign financial services providers to enter domestic markets via local presence requires removing barriers to direct investment and thus could raise strategic and cultural concerns about foreign ownership in the financial sector. It also brings sectoral concerns about the quality and soundness of foreign entrants, and the possibility that they would engage in "cherry-picking" in the most profitable segments of the market or would drive domestic providers "up the risk curve." To alleviate these concerns, the liberalization of commercial presence should be designed in the context of an internally consistent macroeconomic framework and, in particular, supported by the strengthening of consolidated supervision and licensing requirements, the resolution of bad loan problems, and the liberalization of interest rates and credit controls. Unlike the liberalization of commercial presence, opening to cross-border trade requires a broader liberalization of the capital account, including portfolio and other flows. It therefore should be coordinated closely with capital account liberalization in the context of prudent macroeconomic and financial sector policies.

The paper is structured as follows. The next section examines the economics of financial services liberalization as part of national financial reforms and presents countries' experiences in liberalizing trade in financial services. Section III then discusses international agreements on the liberalization of financial services trade and explores how the liberalization of financial services could contribute to the strengthening of the international financial system architecture. Section IV synthesizes national and international aspects of financial services liberalization and summarizes key policy principles for guiding trade liberalization in financial services.

## **II. THE LIBERALIZATION OF FINANCIAL SERVICES TRADE IN THE NATIONAL CONTEXT**

We begin by reviewing the economics of trade in financial services and key implications for the design of trade policy in the financial sector.

### **A. What is Trade in Financial Services?**

Insurance, banking and other financial services can be traded in four basic ways (modes):<sup>3</sup> cross-border trade (domestic consumers purchase services from a foreign supplier located abroad); commercial presence (a foreign supplier merges with or acquires a domestically-owned institution, or establishes an affiliate, typically, a branch or a subsidiary, in a territory of a country through direct investment and sells services to domestic consumers); consumption abroad (domestic consumers purchase services outside the territory of their country); and movement of persons (foreign persons supply services to domestic

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<sup>3</sup> This classification is prevalent in the literature and is used by the WTO.

consumers in the territory of a country).<sup>4</sup> The first two modes—cross-border trade and commercial presence—are most relevant for financial services trade, and further discussion focuses on them. Commercial presence is the dominant mode of trading financial services (Skipper, 1996; USITC, 1997; Chang and others, 1999), largely because proximity between supplier and consumer are necessary for providing most financial services (although regulatory restrictions may also affect the choice of the mode). Notable exceptions are reinsurance; insurance of large risks, which cannot be insured locally; and worldwide insurance of multinational businesses (Chang and others, 1999).

Trade, and the provision of financial services in general, tend to be regulated. Trade is managed primarily through restrictions on entry and operations of foreign providers and on cross-border exports and imports of financial services. More generally, financial regulations could be broadly grouped as follows: licensing requirements, disclosure requirements, controls on permissible activities, and controls on ownership. Economic incentives to “invent around” excessive restrictions, financial innovation and market development, and the rise of non-banks often prompt the need for redesigning financial regulations to increase reliance on market discipline instead of administrative control.<sup>5</sup> In the context of financial sector reforms, however, the liberalization of excessive economic regulations does not mean complete deregulation; in fact, prudential and information regulation may need to be strengthened to achieve public policy objectives. The rationale for prudential regulation and supervision stems from the need to manage systemic risks, preserve financial stability and protect small depositors.<sup>6</sup> Such regulation is typically aimed at correcting market failures,

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<sup>4</sup> According to balance of payments statistics, trade in financial services amounted to about US\$158 billion per year during 1994-96 (Chang and others, 1999). However, balance of payments statistics, which are compiled on the residency basis, reflect only cross-border trade and thus understate trade in financial services. When services are traded through foreign affiliates with the status of residents in the country where the services are supplied, such services transactions are not covered by the balance of payments statistics, and their measurement requires compiling separate statistics on activities of foreign affiliates. Although statistics on foreign affiliates are fragmentary, available data suggests that trade via this mode by far exceeds cross-border trade (Skipper, 1996; USITC, 1997; Chang and others, 1999).

<sup>5</sup> In this context, note that some financial regulations have similar objectives and complement each other, for example, both trade and line-of-business restrictions could serve to limit competition. A change in one type of regulation may therefore trigger changes in other regulations, for example, the liberalization of one measure could open opportunities for the circumvention of other regulations, making them ineffective and inducing further liberalization or redesigning of regulations, including in other sectors.

<sup>6</sup> Typical prudential measures include restrictions on the range of activities of financial institutions, entry and exit procedures, capital requirements, balance ratios, accounting and auditing standards, disclosure requirements, asset valuation, classification and provisioning  
(continued...)

moral hazard and adverse selection, which result from information asymmetry (Mishkin, 1996; also see Diamond and Dybvig, 1983).

In the context of financial sector reforms, trade liberalization focuses on the removal of the restrictions that discriminate between domestic and foreign financial services providers. It involves the liberalization of restrictions on entry and operations of foreign providers and on export and import of financial services, i.e., market access. It also involves redesigning regulations in accordance with the principle of national treatment, which requires treating foreign financial services providers (at least) in the same way as domestic ones with respect to entry, business activities and exit from the industry.<sup>7</sup> Foreign providers, however, can be treated differently if their circumstances are substantially different from those of national providers. Stronger standards of liberalization, such as mutual recognition and effective market access, are also possible and have been undertaken by countries under national reciprocity principles, international agreements or supranational authority. These obligations, however, require closer harmonization between domestic and foreign financial regulations (Key and Scott, 1991). Another basic principle of trade liberalization is nondiscrimination across trading partners, i.e., the most-favored-nation (MFN) treatment. The MFN liberalization is an important accompaniment for liberalization commitments on market access and national treatment, as it precludes situations when foreign providers from a certain country are granted preferential treatment or market access in areas beyond those open to providers from other countries. Last but not least, transparency of financial regulations is essential for ensuring a fair application of national policies and regulations, and creating equal competitive opportunities for domestic and foreign providers.

Designing trade liberalization reforms in the financial sector is complicated by the fact that financial services trade is closely linked to capital flows. A capital flow arises from trade in financial services when it is related to the establishment of a service provider's affiliate in the foreign country, or is an essential part of the provision of a financial service itself. Nevertheless, it is often possible to differentiate restrictions on trade in financial services from those on capital movements. The former typically relate to activities of financial intermediaries and influence the ability of domestic consumers to use services of foreign-owned providers or the ability of domestically-owned providers to export services to foreign consumers. Capital controls, in contrast, determine access to financial markets, i.e., the ability of residents to use foreign capital and the ability of nonresidents to use domestic

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methodologies, the evaluation of risk management systems, certain investment regulations and special regulations related to the insurance sector.

<sup>7</sup> The application of the principle of national treatment could be hindered by regulatory and institutional differences in home and host countries (for example, lines-of-business regulations and capital adequacy requirements). Another complication relates to the fact that the concept of national treatment does not refer to the potentially useful role of international cooperative arrangements in regulating international financial activities (see Key and Scott, 1991).



capital. A restriction on using asset management services of foreign providers, for example, is a services trade measure, while a restriction on the issuance of securities by nonresidents in the domestic capital market is a capital control measure. Since financial services are predominantly traded via commercial presence, restrictions on financial services trade mainly concern establishment and operations of foreign affiliates (as well as restrictions on repatriation of profits and other payments and transfers for current international transactions).

The extent to which trade in a financial service is linked to the underlying capital movements generally depends on the type of the financial service and the way it is supplied, i.e., across borders or through commercial presence. Some financial services transactions, for example, consulting, advisory, and information services, are not accompanied by the underlying capital movements, and thus liberalizing cross-border trade in such services does not require liberalizing capital controls. We denote such transactions as Type I. Cross-border trade in some other services, for example, lending, is inseparable from capital movements, and, hence, liberalizing such services transactions is analogous to liberalizing the underlying capital movements. These services are denoted as Type II. For other services, cross-border trade and the underlying capital movement could be distinguished. In such a case, lifting restrictions on both services trade and capital movements is generally necessary for liberalizing services trade. For example, allowing residents to purchase capital market securities abroad is not sufficient to enable them to purchase asset management services abroad; the respective trade restrictions should also be removed. Liberalizing services restrictions, but not capital controls, would tend to limit trade significantly, although may not bring it to a complete halt. We denote such services as Type III. The above typology of financial services is shown in Table 1.

Trading services via commercial presence requires direct investment to establish such presence. In this case, when foreign-owned affiliates (typically, subsidiaries) are incorporated in the host country, they are considered residents of this country. Although services transactions of such affiliates, in principle, could involve capital movements, resident foreign affiliates could be subject to capital controls and thus would be able to engage only in those services transactions that involve capital movements permitted under the host country's capital account regulations (and in the services transactions that do not involve the underlying capital movements). If capital controls are imposed on the national treatment basis, they would not generally represent a trade barrier (although in some cases they may put foreign providers at a competitive disadvantage, at least temporarily). As regards branches, which are typically considered nonresidents, their services operations are analogous to cross-border trade in terms of the link with capital movements (see above).

In sum, the link between the liberalization of financial services trade and capital movements depends generally on the type of trade and the type of service. The liberalization of commercial presence in all financial services requires liberalizing direct investment in the financial sector and does not generally preclude the application of capital controls with respect to foreign providers. In contrast, the liberalization of cross-border trade in many, but not all, financial services requires liberalizing the underlying capital movements. For some financial services, cross-border trade liberalization is independent of capital account liberalization.

## **B. Potential Gains and Losses from Trade in Financial Services**

Different capital account implications of liberalizing cross-border trade and commercial presence suggest that the economics of financial services trade is likely to depend on the type of trade. Let us first consider the liberalization of commercial presence, the main mode of supplying financial services.

First and foremost, the liberalization of commercial presence tends to bring traditional gains from trade. The presence of foreign providers enhances competition and efficiency in financial services markets (Levine, 1996; Nicholl, 1997; Armendariz, 1997; Dobson and Jacquet, 1998; and Kono and others, 1998). In a more competitive industry, financial firms tend to provide more services at lower costs and prices. The efficiency of financial intermediation improves, as domestic providers have incentives to improve their productivity and become better at collecting and assessing financial information and pricing financial assets. Economic growth is also likely to rise as a result (McKinnon 1973; Shaw, 1973; Gelb, 1989; Roubini and Sala-i-Martin, 1992; King and Levine, 1993a, 1993b; Jappelli and Pagano, 1994).

Foreign competition also encourages domestic providers to improve variety and quality of their financial services and products, thus broadening opportunities for intertemporal trade and portfolio diversification (for example, Kono and others, 1998; Dobson and Jacquet, 1998). The liberalization of commercial presence could also bring technological gains, as firms take advantage of economies of scope (and, possibly, scale) and provide services at lower average costs. The entry of foreign providers also tends to facilitate the dissemination of new technology, managerial knowledge and financial expertise throughout the financial sector (Levine, 1996). More fundamentally, trade encourages countries to produce and exchange financial services in accordance with their comparative advantage, thereby bringing mutual gains from trade and improving efficiency of resource allocation.

The liberalization of commercial presence in the financial sector also tends to discipline policies and encourage policy-makers to improve clarity, consistency and transparency of financial regulation and supervision (Levine, 1996; Nicholl, 1997; Armendariz, 1997; Goldstein and Turner, 1998; Kono and others, 1998). Owing to its catalytic role in inducing improvements in financial infrastructure, the liberalization of commercial presence could help strengthen the financial system. Additionally, domestic providers have an incentive to encourage domestic regulators to harmonize regulatory and supervisory standards and practices to facilitate their entry into foreign markets, since, faced with foreign competition at home, domestic providers are likely to seek access to foreign markets to maintain their competitiveness and, to achieve this, would need to satisfy foreign regulatory requirements (Levine, 1996; Key and Scott, 1991).

Information management and disclosure practices are also likely improve (Levine, 1996). International brokerage and security underwriting firms require high-quality information about individual and corporate clients for providing their services. When such firms establish local presence, domestic credit rating, auditing and accounting firms have an

incentive to improve their information management practices. Also, if foreign providers are used to higher standards of information disclosure in their home country, their entry is likely to create competitive pressures for domestic providers to improve their disclosure practices.

The increased competition could also encourage domestic providers to modernize their management practices, including internal controls and risk management (Kono and others, 1998; Kono and Schuknecht, 1998; Levine, 1996; Nicholl, 1997; Armendariz, 1997). At the same time, better variety and quality of financial services and products would tend to broaden opportunities for risk management through portfolio diversification and hedging. Competitive pressures may also induce domestic financial services providers to increase their capital, for example, through mergers and acquisitions (Armendariz, 1997). Foreign providers in turn may have additional incentives to manage risks well, if they are monitored by international rating agencies and international investors.<sup>8</sup>

Lastly, the entry of foreign financial services providers, for example, their participation in bank privatization, may help reduce the need for government involvement in investment into and ownership of financial institutions, and the provision of guarantees. If prudential regulation and supervision are adequate, this may generally help strengthen governance, reduce moral hazard and rent seeking (Nicholl, 1997). Corporate governance may also improve as financial services providers become more efficient (Levine, 1996), and regulators have more incentives to improve financial regulations, for example, strengthen shareholders' rights.

Like the liberalization of commercial presence, the liberalization of cross-border trade helps enhance efficiency and improve the variety and quality of financial services. Its impact on competition, however, is likely to be smaller, because proximity to the client is often essential for providing financial services. Likewise, the impact on technology transfer is likely to be smaller without a local presence. At the same time, since cross-border trade is more closely linked to portfolio and other capital movements, its economic effects are likely to be related more to the mobility of these types of capital, while trade via commercial presence is primarily linked to direct investment.

Notwithstanding the potential benefits associated with trade liberalization, an open and liberal trade regime in financial services raises concerns about sector-specific, strategic and cultural implications. These concerns generally differ across types of trade, and, as before, let us begin with a discussion of commercial presence.

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<sup>8</sup> Sometimes, although not always, a foreign affiliate, especially a branch, has access to its parent's capital and could obtain liquidity support from the parent at the time of need, thus transferring losses to foreign shareholders rather than requesting government support or shifting losses to local depositors. The parent may have its own incentives to provide such support if a failure to do this would damage its market reputation and affect its ability to raise funds (Armendariz, 1997). A similar point is made by Kono and others (1998) citing a study by the U.S. International Trade Commission (USITC, 1993).

The most important sector-specific concern is that, in the absence of an adequate prudential policy, the liberalization of commercial presence may contribute to financial sector instability (Dobson and Jacquet, 1998; Kaminsky and Reinhart, 1999; Goldstein and Turner, 1996; Sachs, Tornell and Velasco, 1996).<sup>9</sup> Domestic providers may respond to foreign competition by lending imprudently and engaging in excessively risky activities and thus worsening their portfolios, or unsound foreign institutions may enter the financial sector. However, it is not the liberalization of commercial presence per se that makes the financial system more vulnerable. The underlying reasons relate to weaknesses in prudential regulation and supervision, nascency of financial institutions, and large shares of nonperforming loans in banks' portfolios; macroeconomic volatility, lending booms and asset price collapses may also contribute. Thus, to safeguard stability of the financial system, the liberalization of commercial presence should be well-designed and supported by other policies. Most importantly, the opening to foreign competition requires modernizing and strengthening prudential policy with respect to licensing and consolidated supervision (as discussed in more detail in the next section). Entry requirements and their enforcement should be strengthened to prevent low-quality and unsound foreign institutions from entering the sector, and disclosure requirements should be improved as well (Levine, 1996; Kono and others, 1998; Nicholl, 1997).

Another sector-specific concern is that the entry of foreign providers may increase risks in the payment and settlement system (Nicholl, 1997; Levine, 1996; Armendariz, 1997). A common perception in this regard is that the payment system is likely to be more stable when the financial sector is controlled by domestically-owned institutions, since foreign providers are more attached to their home country, and, if their parent institutions experience serious financial problems, they may not honor their obligations. Notwithstanding the above possibility, it is important to recognize that risks in the clearing and payment system are general and not limited to foreign providers. These risks should therefore be addressed through general solutions, such as the improvement of risk measurement and pricing, and the overall design of the payment and settlement system (Nicholl, 1997).

In addition to the above regulatory considerations, the liberalization of commercial presence raises concerns about the development of the financial sector. The entry of foreign providers is likely to erode rents of domestic firms, which used to be protected from competition before. If domestic providers are less capable than foreign competitors owing to,

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<sup>9</sup> The existing evidence on how the presence of foreign financial institutions affects systemic stability is limited. Goldstein and Turner (1996) suggest, for example, that foreign participation in the financial sector helps maintain financial stability, and, in particular, was instrumental in stabilizing financial systems and preventing contagion during the Mexican crisis in 1995. Armendariz (1997) discusses how Mexico proceeded with opening its financial sector to foreign competition after the crisis, and this encouraged domestic banks to improve their efficiency and internal management. Kono and Schuknecht (1998) argue on the basis of a cross-sectional study of emerging economies that the presence of foreign banks tends to stabilize capital flows.

for example, poor expertise, small capital or unbalanced financial portfolios, they may experience financial difficulties and even become bankrupt as competition intensifies. Competition may also drive them “up the risk curve.” These undesirable consequences give rise to calls for temporary, “infant industry” protection to give domestic providers time to improve their competitiveness (Nicholl, 1997; Kono and others, 1998; Dobson and Jacquet, 1998; Levine, 1996). Such protection, however, comes at an efficiency cost. The decision regarding protection has to balance its benefits, which mainly accrue to domestic providers, with opportunity costs, which are borne primarily by domestic consumers in the form of higher prices, fewer services and of worse quality, and, overall, a less efficient financial sector. While in some circumstances temporary protection could be justified, in practice it often fails to provide the right incentives for “infants” to “grow up.” If domestic institutions have a strong lobbying power, protection tends to become permanent.<sup>10</sup>

A related concern is that foreign financial services providers would target the most profitable segments of the market, i.e., engage in cherry-picking, for example, servicing large corporations and high-income households (Levine, 1996; Nicholl, 1997; Armendariz, 1997). Foreign institutions may also choose to maintain a relatively narrow focus on providing services to corporations from their own country and on foreign exchange operations. Although cherry-picking makes financial services markets more complete, it could become a concern from a broader development perspective. To discourage cherry-picking, governments should seek to lower barriers and risks associated with operations in other market niches, for example, by strengthening the collateral law and the judicial system, improving governance and reducing cronyism in the financial sector. Cherry-picking may also eventually fade by itself, as foreign providers acquire sufficient market knowledge to expand their activities, or as technological advancement reduces the cost of entering other market niches.

Besides sector-specific considerations, opening to foreign participation poses questions about strategic and cultural implications of foreign ownership in the financial sector. Governments may view foreign ownership as a potential threat to their countries' economic, political or cultural independence and seek to limit competition by foreigners and prevent them from gaining positions of power in the financial sector. Although such national interest arguments may sometimes mask purely protectionist intentions, they often have a profound effect on the political agenda and the extent to which the financial services trade is liberalized. Addressing strategic and cultural concerns by restricting trade, however, has an efficiency cost, and thus may require revisiting the definitions of national security and national interest.

Compared to the liberalization of commercial presence, cross-border trade liberalization gives rise to the prudential concerns that are associated more closely with the related liberalization of the underlying portfolio and other capital movements. We discuss

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<sup>10</sup> Although infant industry considerations per se are not unique to trade liberalization in the financial sector, in this sector they tend to be linked to concerns about financial stability.

specific policy implications concerning cross-border trade and capital account liberalization in section C below. Generally speaking, capital movements are driven by the overall system of economic incentives inherent in macroeconomic, financial and structural policies and regulations. If incentives are strong, individuals, firms and financial institutions, independent of their nationality or ownership, will try to move funds.<sup>11</sup> Thus, the key to managing financial stability lies in creating and maintaining a coherent structure of incentives by pursuing sound and consistent macroeconomic policies and executing effective prudential surveillance at every stage of the financial system development (see Levine, 1996; Nicholl, 1997; Dobson and Jacquet, 1998; Kono and others, 1998).<sup>12</sup> Beyond the sectoral considerations related to capital movements, concerns about temporary protection, cherry-picking, and strategic and cultural implications generally are typically less prominent in the case of cross-border trade.

### **C. The Design of Trade Liberalization in the Financial Sector**

Trade should not be liberalized for trade's sake. It should be part of a comprehensive strategy for creating an efficient, diversified, strong and competitive financial sector. Trade liberalization complements other financial reforms, and its role in this regard is threefold. First, trade liberalization increases efficiency in the financial services industry by exposing it to foreign competition and encouraging production and exchange of services in accordance with comparative advantage. Second, it improves the variety and quality of financial services and products available in the market. Third, trade liberalization facilitates the transfer of new technology and financial expertise. As discussed above, these benefits tend to be particularly consequential when trade via commercial presence is liberalized.

The design of trade liberalization largely depends on country-specific conditions. They determine the opportunity costs of reform and, likewise, its potential benefits, and thus the appropriate pace of liberalization. Even if the state of the financial system is generally satisfactory at present, trade liberalization may be warranted to ensure that its efficiency and competitiveness is maintained in the future. Another consideration is the country's ability to implement the necessary supporting and complementary policies aimed at managing risks and maximizing benefits of trade liberalization. The political economy factors also bear on the pace and design of reforms. A far-reaching liberalization, for example, may be politically

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<sup>11</sup> A related issue to consider is implications of cross-border financial services trade for capital flows in a financial crisis. Kaminsky and Reinhart (forthcoming), for example, point out that during times of financial distress or crises, international banks may worsen the position of the domestic financial sector by calling loans and credit lines and fuel contagion by doing this in other countries, as they rebalance portfolios and recapitalize. This topic awaits future research.

<sup>12</sup> The existing empirical evidence on the relationship between financial services trade and capital movements is limited and generally ambiguous (see Kono and Schuknecht, 1998; Tamirisa, 1999).

infeasible if domestic financial institutions have a strong lobbying power and favor protection.

The place of trade liberalization in the context of financial reforms generally depends on the type of trade. As discussed above, cross-border trade liberalization implies a broader liberalization of the capital account than the liberalization of commercial presence. It thus raises policy considerations related to portfolio and other capital flows and should be coordinated closely with their liberalization. In contrast, the liberalization of commercial presence mainly requires liberalizing direct investment. Prudential concerns in this case focus on the soundness of foreign entrants and implications of foreign competition for the soundness of domestic institutions, while concerns related to portfolio and other capital movements could be generally addressed through capital account regulations and monitoring exposure of foreign providers. Although the liberalization of commercial presence could be politically sensitive in view of strategic and cultural concerns, apart from this, provided supporting policies are in place (as discussed below), it could generally precede the liberalization of portfolio and other capital flows.

First, and most importantly, the liberalization of commercial presence should be accompanied by the strengthening of prudential regulation and supervision. This is necessary to ensure that only sound foreign providers enter and operate in the domestic market and that the intensified competition does not undermine the soundness of the domestic financial system. The Basel Committee's Core Principles for effective banking supervision represent minimum requirements in this regard. According to these principles, in particular, the licensing process should include an assessment of the banking organization's ownership structure, directors and senior management, its operating plan and internal controls, and its projected financial condition, including its capital base. The consent of the home country supervisor should also be obtained.<sup>13</sup> It is also important that banking supervisors practice global consolidated supervision over their internationally active banking organizations, adequate monitoring and applying appropriate prudential norms to all aspects of the business conducted by these banking organizations worldwide. Supervisors from the home country should establish contact and information exchange especially with supervisors from the host country. Banking supervisors must also require the local operations of foreign banks to be conducted as is required of domestic institutions and must have powers to share information needed by the home country supervisors of these banks for the purpose of carrying out consolidated supervision.<sup>14</sup>

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<sup>13</sup> The modalities and quality of home country regulation and supervision also need to be assessed in the process of licensing.

<sup>14</sup> In addition to prudential policies, appropriate measures to prevent money-laundering and other criminal activities should be strengthened, including through cooperation with other countries and international agencies. For a case study of vulnerability to international crime in international finance, see a report to the U.S. Senate on the BCCI affair (U.S. Senate, 1992). Earlier high profile cases of fraud in international finance relate to activities of the

(continued...)

Prudential and other sectoral considerations may require differentiating the design of commercial presence liberalization by the form of establishment, the type of intermediary and the type of restriction. As regards the form of establishment, enforcing domestic regulations, monitoring risk exposure and dealing with insolvency problems are generally easier with respect to subsidiaries than branches, since subsidiaries are treated as legally separate entities. The regulation of branches, which are typically considered parts of their parent firms, raises questions about the applicability of home or host country laws and extraterritoriality. As for the differentiation of reforms by the type of intermediary, the need for such differentiation depends on the extent to which home and host countries' regulations are harmonized. It is getting increasingly difficult to differentiate reforms by the type of intermediary in practice, as distinctions between different financial intermediaries are becoming more blurred. Finally, the extent of liberalization is affected by limitations on market access, and national and MFN treatment. Foreign providers, for example, could be granted access to domestic markets but fail to receive full national treatment because of strategic reasons or not enjoy MFN treatment as entry of firms from some countries could be restricted on the reciprocity basis. Although such a partial liberalization allows flexibility in the implementation of reforms, it may limit welfare gains from liberalization. Granting equal competitive opportunities in terms of full national and MFN treatment generally helps maximize gains from trade.

In addition, problems with nonperforming loans should be addressed prior to or in parallel with the opening of the financial sector to foreign competition, if the financial system is encumbered by such loans. This should help discourage domestic financial institutions from taking on excessive risks in response to the intensified competition. Ailing domestic institutions could be either recapitalized by injecting additional public or private capital, merged with a stronger domestic or foreign institution, or liquidated. In this context, it is useful to consider whether and to what extent foreign institutions could help resolve the bad-loan problems by participating in mergers, privatization or recapitalization of domestic institutions. To make this possible, the acquisition or establishment of financial institutions by foreigners would need to be allowed before the bad-loan problems are resolved (probably after a partial cleaning of the balance sheets and a partial recapitalization by the government). In the meantime, discretionary controls on such investments would need to be retained.

Besides the strengthening of prudential policies and the resolution of the bad-loan problems, the deregulation of interest rates and credit controls is also essential for creating conditions for healthy competition. In particular, the freeing of interest rates and the elimination of subsidized and directed credit should precede the liberalization of commercial presence to make arbitrage and price mechanism operational in the financial sector. Last but not least, the design of trade liberalization should be integrated with an internally consistent and credible macroeconomic framework to ensure financial stability and to encourage an efficient intermediation of savings into investment.

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International Match Corp in the 1920s, Bank of Sark and the Investors Overseas Service in the 1960s, and Nugan Hand Bank in Australia in the late 1970s-early 1980s.



Unlike the liberalization of commercial presence, the liberalization of cross-border trade requires liberalizing the capital movements that are an essential part of the provision of financial services.<sup>15</sup> Thus, it should be closely coordinated with the reform of capital account regulations. [An exception to this principle is the financial services that could be liberalized independently of the capital account.] The capital account and cross-border trade should be liberalized in the context of an internally consistent macroeconomic policy framework and exchange regime on a case-by-case basis, ensuring that supporting macroeconomic and financial sector policies are credible and implemented consistently. The level of development, especially of the financial system, and overall objectives of financial reforms also should be taken into account, while recognizing that the opening of the capital account generally requires accelerating other financial reforms and strengthening prudential regulation and supervision. Given high risks associated with short-term capital flows, especially in the presence of exchange rate guarantees, the liberalization of such inflows may need to be postponed until the banking sector and prudential policy are sufficiently strong. The design of reforms should take into account that, while under certain circumstances capital controls on inflows may provide a temporary breathing space, they generally cannot substitute for the necessary policy adjustment. Their effectiveness depends on macroeconomic factors, administrative capacity and the extent of controls, and is limited by rapid financial innovation. Certainly, even after the regime for cross-border trade in financial services is liberalized, this should not preclude the possibility of introducing temporary and, preferably, nondiscriminatory controls on capital movements, including short-term ones, for prudential, balance of payments or macroeconomic policy purposes.

#### **D. Country Experiences in the Liberalization of Financial Services Trade**

Before proceeding further, it would be useful to discuss briefly the importance of trade in financial services in different countries. In the absence of comprehensive country statistics on trade via commercial presence, the share of foreign bank assets in total bank assets could be used as an indicator of such a trade. For recent years, this share ranges across countries from virtually zero to almost hundred percent (Folkerts-Landau and Mathieson, 1988; Kono and others, 1998; Nicholl, 1997). Banking sectors in New Zealand, Hong Kong Special Administrative Region, and Singapore are characterized by the highest degree of foreign ownership, exceeding seventy five percent. Foreign banks also play an important role in the United States, the United Kingdom, Netherlands, Belgium, and France, as well as in Argentina, Chile, and Malaysia. In other industrial and many developing countries, including Germany, Japan, Indonesia, Korea, Colombia, South Africa, and Russia, foreign participation in the banking sector is relatively small, less than fifteen percent.

Likewise, the importance of cross-border trade varies across countries, as is evidenced by the relatively skewed geographical pattern of cross-border trade. Trade takes

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<sup>15</sup> For more details on the sequencing of capital account liberalization, see McKinnon (1973, 1993); Mathieson and Rojas-Suárez (1993); Quirk and Evans (1995); Eichengreen, Mussa, and others (1998); Johnston (1998, 1999); and IMF (forthcoming).

place mostly between industrial countries (Chang and others, 1999; Kono and others, 1998; Mukherjee, 1999). Ten largest exporters and importers, for example, accounted for about 70–90 percent of total trade in financial services in 1995. The leading exporters of financial services (excluding insurance) were the United States, Switzerland, the United Kingdom, Belgium-Luxembourg, Italy, France, and Germany. The leading importers included Italy, France, Belgium-Luxembourg, France, Austria, and the United States. Among emerging countries, Brazil, Turkey, Poland, Argentina, Hungary, Czech Republic, Slovak Republic, and Korea were notable exporters and importers of financial services. In insurance, Germany, France, the United Kingdom, China, Italy, the United States, and Switzerland were the leading exporters, while the major importers were Germany, France, the United States, China, and Japan. Many emerging countries also were involved actively in trading insurance services across borders.

Countries' experiences in reforming their financial systems is a subject of numerous earlier studies (see, for example, Gupta, 1997; Faruqi, 1994; Diaz-Alejandro, 1985; Sundararajan and Baliño, 1992). The literature generally concludes that the rationale for financial liberalization is linked to further enhancement of efficiency and competitiveness, and closer integration of domestic and international capital markets. Financial liberalization tends to intensify competition and reduce the profitability of existing firms and, in the absence of effective prudential policies, could lead to insolvency and failure of domestic financial institutions, particularly those that are inefficient and whose portfolios are overburdened by nonperforming loans. Domestic financial institutions may also respond to the increased competition by lending imprudently and engaging in other excessively risky activities.

Some studies focus specifically on experiences in financial services trade liberalization.<sup>16</sup> Gardener, Molyneux, and Moore (1997), for example, discuss the contribution of the European Union's Single Market Programme (SMP) to the restructuring of European financial services markets. They argue that the SMP helped make EU banking more competitive and discouraged collusive practices, protective regulation and regulatory capture. Together with changes in capital adequacy rules, increased market pressures provided incentives for banks to improve their efficiency. Banks started to put more emphasis on nonprice competition, including product diversification and innovation. Notwithstanding the significant liberalization that has taken place under the SMP, certain barriers continue to restrict trade in financial services, e.g., various legal and tax treatment regulations and "opt-out" rules. And this trend is not unique to Europe. In OECD countries, in general, although barriers to the establishment and cross-border trade have been largely liberalized, some countries continue to maintain restrictions, for example, on the market share of foreign banks (OECD, 1998). As regards emerging economies, Glaessner and Oks

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<sup>16</sup> See, for example, Gardener, Molyneux, and Moore (1997) for a study on the EU; Dobson and Jacquet (1998), Nicholl (1997) - New Zealand; Drake (1997) - Australia; Armendariz (1997) and Glaessner and Oks (1994) - Mexico; Barajas, Steiner, and Salazar (1999) - Colombia.

(1994) examine the role of trade liberalization in Mexico in the context of NAFTA. They discuss its potential benefits in fostering competition and modernizing the financial sector, while underscoring its implications for financial regulation and macroeconomic policy. Similarly, in an empirical study, Barajas, Steiner, and Salazar (1999) find that financial liberalization generally had a beneficial effect on banks' behavior in Colombia. The liberalization of entry for new banks, including foreign ones, helped improve operative efficiency and competition, but led to a deterioration in the loan portfolio of domestic banks.

To gain additional insights on the sequencing of financial services liberalization, we examine experiences in Chile, Kenya, Korea, and Portugal (see Appendix I). Although the sample of countries is small, it is diverse geographically, and, with a caveat, could be used to draw some preliminary policy lessons.<sup>17</sup> These brief case studies focus on the place of trade liberalization in the context of financial sector reforms and are not intended as comprehensive reviews of financial reforms.

The analysis of country case studies suggests that financial services trade tends to be liberalized as part of financial sector reforms. In the countries in question, the place of trade liberalization varied from the early stages of the financial reform (Kenya) to middle (Chile and Portugal) to later (Korea) and generally depended on the type of trade. Restrictions on the entry of foreign institutions tended to be lifted along with or after the deregulation of credit and interest rate controls (all countries, except Korea where establishment was liberalized only partially). Sectoral and strategic considerations were at the core of debates concerning foreign ownership in the financial sector. The liberalization of cross-border trade was linked to that of the capital account; both typically took place later in the reform process (all countries, except Kenya). The strengthening of prudential regulation and supervision was the key policy supporting financial services liberalization (failures in this area were a main reason for Chile's aborted liberalization and contributed to financial crisis in Korea). Adequate prudential surveillance, along with consistent and credible macroeconomic policies, were essential for avoiding a financial crisis (this partly explains the relatively smooth process of liberalization in Portugal). The liberalization of financial services trade was generally viewed as a way to reduce structural weaknesses in the financial sector (in Korea, for example, the liberalization of establishment rules was expected to strengthen the financial system by promoting competition and the harmonization of financial standards and practices). National programs of trade liberalization were sometimes structured on the basis of international agreements (Portugal, for example, liberalized financial services trade and

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<sup>17</sup> The liberalization of financial services trade in transition economies is particularly challenging, in part because it requires creating a new institutional framework for the financial sector, and, at the same time, strengthening bankruptcy laws, restructuring state-owned institutions and dealing with nonperforming loans inherited from decades of directed lending. Poland's and Hungary's experiences could be particularly illustrative of successful approaches in this regard. Although a detailed study of transition economies is beyond the scope of this paper, conclusions of the paper are generally applicable to transition economies.

the capital account in the context of the EU accession, using the EU framework as a general template for reforms).

### **III. INTERNATIONAL ISSUES IN THE LIBERALIZATION OF FINANCIAL SERVICES TRADE**

Besides unilateral reform, financial services trade could be liberalized on a multilateral or regional basis. The most ubiquitous international agreement on financial services trade is the General Agreement on Trade in Services (GATS), which is described in detail in Box 1. It sets international rules for the liberalization of services trade and provides a framework for binding liberalization and preventing policy reversals. Other major agreements concerning financial services trade are described in Box 2. Most of these agreements preceded the GATS and in many ways served as examples for the development of the GATS framework. Unlike the GATS, however, they have limited membership.<sup>18</sup> International agreements, along with national reform programs, influence the architecture of the international financial system, especially in such areas as transparency and the orderly process of liberalization. These issues are discussed in this section, including the role of the GATS in enhancing credibility of financial reforms and implications of financial services trade liberalization for the architecture of the international financial system.

#### **A. The General Agreement on Trade in Services**

The GATS was negotiated under the Uruguay Round in 1994. It sets the rules for international trade in all services, including financial services, and presents a framework for ongoing liberalization in world services markets. Key features of the GATS are summarized in Tables 23 and Box 1.<sup>19</sup> All 135 WTO members are parties to the GATS, and most of them have made commitments in financial services. Under the agreement, negotiations on further liberalization of services trade are to be undertaken periodically. The first round of multilateral negotiations on financial services in the context of the GATS was concluded in December 1997, following a failure to reach an agreement at the end of the Uruguay Round and an interim agreement of July 1995. The next round is expected to start in 2000.

The 1997 agreement mainly bound the existing trade reforms in financial services sectors. Although countries made more market-access and nondiscrimination commitments in financial services than in any other services sector, except tourism (see Kono and others, 1998), the number of limitations was also high in financial services, in part reflecting prudential and political concerns associated with financial liberalization. Countries generally

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<sup>18</sup> A detailed discussion of the international frameworks that focus primarily on prudential issues, e.g., the Basel Accord, is beyond the scope of this paper.

<sup>19</sup> For more details on the liberalization of financial services under the GATS, see Key (1997); Sorsa (1997); Vocke (1997); Mattoo (1998); Kono and others (1998); Schuknecht and Kono (1998); and Dobson and Jacquet (1998).

### Box 1. Financial Services in the General Agreement on Trade in Services

The GATS has three main components: (a) a framework agreement defining general obligations; (b) a schedule of specific commitments made by each WTO Member and applying to service industries or activities, subject to qualifications or conditions; and (c) annexes, which mainly set rules for specific services sectors.

**General Obligations:** The most important general obligation is the MFN treatment that binds Members to treat services providers in the same way as they would treat those from their most favored Member. Although MFN treatment does not ensure a greater degree of openness, it prohibits signatories from discriminating between services and services providers from different Member countries. The MFN obligation is weakened by the Annex on MFN exemptions, which allowed countries to exempt measures relating to services sectors from MFN treatment. Such exemptions, however, have a limited duration and could only be taken during the Uruguay Round and in the follow-up negotiations on financial services. The remaining articles in the General Obligations and Disciplines relate to requirements such as transparency and disclosure of information, economic integration, recognition of standards, domestic regulation and monopolies, emergency safeguards and other general issues. Of particular importance for financial services are the safeguards and rules on capital mobility. The safeguards allow countries to impose restrictions on the provision of financial services if their balance of payments is under threat. This can include restrictions on underlying capital flows. On capital account transactions, the agreement requires countries to allow capital inflows related to foreign establishment and free movement of capital related to cross-border financial transactions, when they are an essential part of the provision of a service.

**Schedules of Specific Commitments:** Schedules (or lists) of liberalization commitments for each Member refer to Market Access, National Treatment and Additional Commitments. As a signatory to the GATS, each member makes specific commitments on Market Access and National Treatment for a list of industries (a *positive* list). Within each industry, commitments are made for different modes of services supply. An example of a liberalization commitment might be allowing a 60 percent foreign equity participation in domestic banks. Even when they are listed, liberalization commitments are subject to qualifications, and this significantly weakens the liberalization or binding in this part of the Agreement. National Treatment is defined as treatment to a Member service or provider no less favorable than that accorded to a like domestic service or provider. Once again, this treatment is circumscribed by the positive list of commitments so that it applies only to those sectors specifically listed by the Member (and subject to any additional listed qualifications). The articles described above define the GATS' hybrid approach to establishing multilateral discipline in international services markets. On the one hand there is a general MFN obligation in Article II which is limited by a negative list of exceptions. On the other hand, there are sector-specific Market Access and National Treatment obligations, which are governed by the positive list approach. These are again subject to a negative list of nonconforming measures (i.e., the measures that violate Market Access and National Treatment). The extent of liberalization under this scheme, therefore, is reflected in the number of services sectors not listed in the exceptions to the MFN obligation and in the sectors entered under the positive list of commitments for which no nonconforming measures are maintained.

**Annexes:** Attached to the GATS are seven annexes which outline issues in specific sectors, including professional services, air transport, financial services, maritime transport, and telecommunications. In financial services the annexes recognize the need for adequate prudential regulation, but contain provisions that restrict such regulation from being used as a barrier to foreign providers. Prudential measures are not considered restrictions, and the measures undertaken for monetary policy purposes are outside the scope of the Agreement.

Commitments in financial services trade were made under the Financial Services Agreement negotiated after the conclusion of the 1994 Uruguay Round and were implemented during two years, starting November 1995. Financial services negotiations resumed in April of 1997, and a new Agreement was concluded on December 12, 1997. It expanded the set of countries with GATS financial services commitments to 102, including all industrial and major developing countries. While the agreement liberalizes financial services trade in some countries, in practice it tends to bind status quo restrictions to financial services trade.

Source: Authors' assessment based on WTO (1995).

## Box 2. International Agreements on Trade in Financial Services

Besides the General Agreement on Trade in Services, a number of other multilateral, regional and bilateral agreements cover trade in financial services. A brief overview of some of these agreements is provided below.

***OECD Codes of Liberalization of Capital Movements and of Current Invisible Operations.*** The Codes were adopted in 1961 to provide a framework for the collective pursuit of unilateral liberalization. Since 1992, the Codes have a comprehensive coverage of invisible operations and capital movements, including international capital movements, the establishment of branches and subsidiaries of nonresident financial institutions, and the cross-border provision of all banking and financial services. The legally binding Codes are complemented by a non-binding National Treatment Instrument, which covers post-establishment operations. All obligations in the Codes are general, including MFN principle and nondiscrimination. MFN exceptions exist for customs or monetary systems, reciprocity-existing investment measures, and prudential measures (for instance, based on mutual recognition of standards), but there are no specific exemption lists. The Codes also require transparency, including the notification of all measures having a bearing on the Codes to the OECD, publication of all measures by the OECD, and listing of all restrictions as reservations. The liberalization standard of the Codes is based implicitly on national treatment, i.e., no discrimination between residents and nonresidents; a similar concept of equivalence applies to foreign affiliates. A specialized body the Committee on Capital Movements and Invisible Transactions oversees the implementation of the Codes through periodic reviews of countries policies and monitoring of obligations.

***The European Communities Banking and Investment Services Directives.*** The directives stipulate a free right of establishment in member countries and a liberal provision of services across border. They also provide for the harmonization of key regulatory and supervisory rules across countries. Throughout the European Union, establishment requires a single license only, and the same rule applies to subsidiaries of firms from outside Europe. Additionally, the directives describe the principles of home country regulation and mutual recognition by members of each others regulations. They also set capital adequacy requirements and disclosure rules for financial institutions, and this has raised issues of consistency with standards established by the Basel Committee on Banking Supervision.

***The U.S.-Canada Free Trade Agreement and the North American Free Trade Agreement.*** The 1989 free trade agreement between the United States and Canada for the first time attempted to formulate rules and procedures for financial services in the context of trade policy. The principle of national treatment and market access were the basis of the agreement. Provisions concerning market access, however, were limited, as they were aimed at preserving the existing access rather than enhancing it. This was rectified in the North American Free Trade Agreement (NAFTA). Under the NAFTA, all providers of financial services should have access to all customers in all participant countries either through cross-border trading or establishment. Legislation should be nondiscriminatory, and furthermore national treatment should be de facto rather than just de jure. The NAFTA also requires transparency in regulation of trade in financial services. Dispute settlement mechanism under the NAFTA allows arbitration of investor-state and state-state cases by international bodies such as the International Center for the Settlement of Investment Disputes of the World Bank. Although the NAFTA provides for host-based supervision, it allows regulators to negotiate bilateral agreements on harmonizing regulations or supervision practices. Provisions of the NAFTA explicitly account for differences in the banking system structures of the member countries concerning multi-branching and universal banking.

Sources: White (1996), OECD (1991).

focused on liberalizing commercial presence rather than cross-border trade: most commitments were related to the liberalization of foreign presence and these commitments were stronger than those on cross-border trade.<sup>20</sup> Developing countries largely concentrated on making commitments in banking and securities services rather than in insurance. Some countries maintained exemptions to MFN treatment primarily to reserve the right to grant access to their markets on the reciprocity basis. Overall, countries largely limited their commitments to binding the status quo. For example, they put more emphasis on maintaining foreign equity participation and protecting incumbents' position rather than liberalizing entry further (Matoo, 1998). The relatively limited extent of liberalization in part reflected the historical context at the end of negotiations, which were concluded in December 1997, in the midst of the Asian crisis, and suggests that there is a scope for further improvement of commitments during subsequent rounds of negotiations.

Multilateral commitments to liberalize financial services trade under the GATS can help make national financial reforms more credible and sustainable. The GATS has an important benefit—market opening commitments are “bound,” meaning that liberalization cannot be reversed unless compensation is offered to affected trading partners. While such bindings may induce countries to be more cautious in making commitments, at the same time bound commitments make reversing policies more difficult. The GATS thus can potentially play an important role by fostering liberalization in financial services trade in a multilateral framework and preventing policy reversals, thus enhancing credibility of national reforms. Besides binding liberalization, the GATS helps improve the transparency of the regulatory regime concerning trade in financial services, thereby reducing information costs and facilitating international exchange of financial services. Making commitments to their trading partners by itself helps countries improve transparency of national policies. Additionally, the GATS requires members to publish key laws and regulations affecting financial services trade and inform the WTO promptly of any major changes in regulations. Additionally, each country is required to establish at least one enquiry point from which other countries can obtain information on laws and regulations affecting trade in services. While requests for information through enquiry points go through national governments, developed countries are also required to establish contact points from which contacts could be made directly with an objective of assisting service providers from developing countries.

The design of countries' obligations under the GATS generally seeks to avoid conflicts with national programs of the financial sector reform. General obligations concern such matters as the equal treatment of services and service providers from all partner countries (MFN treatment); the transparency of policies pertaining to services; and more specialized measures concerning domestic regulations and operations of monopoly service suppliers. Such obligations are likely to be complementary to national reforms. Specific commitments, too, are broadly supportive of countries' plans for financial sector reforms and

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<sup>20</sup> An analysis of the reservations invoked under the OECD Code of Liberalization of Current Invisible Operations renders a similar conclusion that restrictions on cross-border trade tend to be more pervasive than those on commercial presence (Tamirisa, 1999).

opening to international capital markets. First of all, stability of the trade regime is an important determinant of the level and efficiency of investment in services sectors, particularly since trade policy in services is defined to include key aspects of the investment regime. Second, the possibility for specific commitments in financial services can, as in goods trade, help countries commit to a pre-announced reform strategy. In goods sectors, for example, schedules of liberalization that are bound by multilateral obligations have proven to be much more sustainable over time than purely unilateral reforms. Moreover, the GATS' specific commitments are generally limited to market access and national treatment restrictions. Prudential measures are not considered restrictions under the so-called prudential "carve-out." A country may also base the application of its liberalization measures on selective recognition of other countries' prudential regulations and standards. Monetary and exchange-rate policies fall outside the scope of the agreement. Nonetheless, conflicts between multilateral liberalization of financial services trade under the GATS and national financial sector reforms are not precluded.

Potential discord relates to the sequencing of financial liberalization in the multilateral and national contexts, particularly with respect to prudential regulation, monetary and balance of payments management, and capital account liberalization. As a trade agreement, the GATS tends to focus on market opening, leaving the responsibility for an appropriate sequencing of financial sector reforms to national authorities. The concern is that the process of developing financial services commitments under the GATS may not always give proper consideration to the economics of financial reform. While in principle national governments are expected to agree to undertake only those commitments that are consistent with their national programs of financial reform, this may be difficult to achieve in practice, because commitments are a part of a bargaining package negotiated with many countries generally with mercantilistic purposes. Economically stronger trading partners, for example, may press a smaller country to open market access for foreign financial institutions in their own interests without due regard for the adequacy of the prudential framework in this country.

Although specific commitments on financial services undertaken in the GATS are not meant to restrict the scope for prudential supervision of the financial sector or for implementing monetary and exchange rate policies, they may place an enhanced premium on the quality of supervision and the consistency of the macroeconomic framework and may not be desirable if preconditions for liberalization do not exist yet. Moreover, while the GATS specifically allows countries to keep prudential measures in place, it precludes their use as a means for avoiding or circumventing obligations and commitments under the GATS, and this may constrain prudential regulation in some circumstances. Additionally, the liberalization of cross-border trade under the GATS may limit countries' freedom to restrict related capital flows. For example, if cross-border trade in financial services is liberalized under the GATS, related capital inflows must also be liberalized. Restrictions can be subsequently imposed only if they satisfy certain criteria, for example, address balance of payments or prudential concerns, or represent monetary or exchange rate measures.

There is, therefore, a need for coordinating national programs of financial sector liberalization and multilateral obligations under the GATS. As discussed in section II above,



considerations generally include macroeconomic conditions and policies; the level of development of prudential regulation and supervision; the need for restructuring of the financial sector; the regulatory structure of interest rates and credit markets; and the depth of financial markets more generally. Country-specific circumstances also bear on the pace and sequence of national and multilateral liberalization. Financial reform programs need to be formulated in terms consistent with the GATS concepts. In particular, programs need to consider the opening of the financial sector to cross-border competition and the related issue of the establishment of foreign financial institutions (or foreign investment in existing domestic financial institutions) and their regulatory treatment. The opening of the financial sector to foreign competition through the liberalization of cross-border transactions and the establishment of foreign financial institutions can have different implications for regulation and supervision and the level and composition of capital flows. In some cases, it may be appropriate to open the financial sector to international competition through one mode of supply more quickly than another (for example, by opening to foreign investment by foreign banks more quickly than opening to cross-border banking, or vice versa). On the other hand, it is important to take into account that modes of supply are not perfectly substitutable, and a liberalization unbalanced across modes of supply may introduce new distortions.

All in all, the GATS gives the WTO jurisdiction over the trade-related aspects of the financial sector liberalization.<sup>21</sup> This jurisdiction is set to expand and tighten as WTO members undertake further specific commitments to liberalize financial services trade in future negotiations.<sup>22</sup> The GATS obligations that countries agree to undertake would tend to support national policies toward an efficient and stable financial sector, as long as these obligations are consistent with prudent programs of reforms tailored to countries' specific circumstances. As countries reform their financial sectors, binding reforms in a multilateral context could help strengthen their credibility and sustainability and reinforce the resulting welfare gains. The GATS also serves as a general framework for structuring national trade policy with respect to financial services for different modes of supply, types of service, and types of restriction.

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<sup>21</sup> The WTO defers to the Fund on current account controls subject to Fund jurisdiction, capital controls imposed at the request of the Fund, and balance of payments analyses.

<sup>22</sup> In this context, future WTO negotiations on financial services are unlikely to be adversely affected by the failure to launch a new trade round at the WTO's Third Ministerial Conference in Seattle in November 1999. New services negotiations are mandated by the GATS and are to be initiated during 2000. Furthermore, scheduling of commitments under the previous negotiations on financial services concluded in 1997 was based on the "top-down" approach (i.e., there were no minimum commitments or obligations for all members to sign on), which makes reaching an agreement easier. Some uncertainty, however, remains. The GATS, for example, does not set priorities among services sectors subject to negotiation, does not prescribe any level of liberalization to be attained, and does not set deadlines for the end of negotiations.

## **B. The Liberalization of Financial Services Trade and Global Financial Reform**

Trade liberalization in financial services is closely linked to the recent initiatives on the strengthening of the international financial architecture. Interaction between them is bi-directional. A well-designed opening of national financial sectors to foreign participation could contribute to the strengthening of coherence and integrity of the institutional architecture underlying the international financial system (Calomiris, 1998; Fischer, 1998 and 1999). It could increase the effectiveness of initiatives in this area (improving transparency, standards and surveillance; strengthening national financial systems, promoting an orderly integration of international financial markets, and involving private sector in the prevention and resolution of financial crisis) without replacing them. In turn, initiatives on the strengthening of the international financial architecture, which in a broad sense interface with other international financial agreements such as the GATS, contribute to the success of national financial reforms, including trade liberalization.

Allowing entry of foreign financial services providers under adequate prudential regulation and supervision could help strengthen financial systems. It tends to promote market discipline and encourage domestic providers to improve operational efficiency and strengthen their internal controls and risk management practices. It could also facilitate technology transfer and encourage improvement of financial infrastructure. Fundamentally, an open and liberal trade regime is essential for creating an efficient financial sector. When a financial sector is protected from foreign competition, it is more likely to become structurally weak over time and fall behind, given the rapidly moving frontier of knowledge in finance.

Opening to foreign presence could also help improve transparency in the financial sector. Foreign brokerage and security underwriting firms could create demand for high-quality information and induce improvements in credit rating, auditing and accounting practices. The presence of foreign providers also tends to create competitive pressures on domestic providers to improve their information disclosure practices.

The liberalization of commercial presence helps propagate the use of international standards and the harmonization of financial regulations and practices. An open and liberal regime for entry of foreign providers disciplines financial sector policies and encourages their improvement. Furthermore, since commercial presence is often liberalized on the reciprocity basis, domestic providers are likely to encourage domestic regulators to harmonize regulatory and supervisory standards and practices to facilitate their entry into foreign markets.

The opening of the financial sector to foreign presence may also enhance involvement of the private sector in the prevention and resolution of financial crises. The entry of foreign financial institutions could generally help improve assessment and management of risk exposure. Before and during a financial crisis, the presence of foreign financial institutions

could generally facilitate coordination and communication among the parties involved,<sup>23</sup> particularly, in arranging club loans, and rolling over and restructuring debt obligations.<sup>24</sup>

Finally, the liberalization of financial services trade, along with that of the capital account, is a necessary condition for international financial markets to become fully integrated. Thus, for the financial market integration to proceed in an orderly fashion, the liberalization of financial services trade should be designed prudently to ensure that it contributes to the development of the financial system without generating excessive short-term and misallocated inflows. Differences in policy implications of liberalizing commercial presence and cross-border trade are relevant in this regard. The liberalization of trade via commercial presence requires removing controls on direct investment in financial sector, but not controls on direct investment in other sectors, portfolio and other capital flows, and thus could precede a broad liberalization of the capital account. In contrast, cross-border trade liberalization cannot be separated from the liberalization of portfolio and other capital flows.

#### IV. CONCLUSION

The design of trade reforms in the financial sector is unique in comparison with trade reforms in the real sector and generally depends on the type of trade. Trade liberalization complements other financial reforms, among other things, by encouraging efficiency in the provision of financial services and inducing improvements in financial regulation. However, it could also give rise to a number of concerns. The liberalization of commercial presence, for example, raises questions about strategic and cultural implications of foreign ownership in the financial sector, financial stability, and cherry-picking. Cross-border trade liberalization presents additional challenges relating to the increased mobility of portfolio and other capital.

To alleviate concerns and maximize gains from trade liberalization, it should be designed in the context of an internally consistent macroeconomic framework and an overall development strategy, especially pertaining to the financial sector. The liberalization of

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<sup>23</sup> Likewise, Levine (1996) argues that the local presence of foreign banks could facilitate access to international capital markets owing to their contacts within the international financial community.

<sup>24</sup> Experiences with the involvement of private sector creditors during the recent Asian crisis are particularly relevant in this regard. In Thailand most of the short-term debt was owed by local affiliates of foreign banks to banks from their home country, and this helped reaching agreements with creditors on the roll-over of debt (Lane and others, 1999; Box 4.1). In Korea and Indonesia the process of private sector involvement was more complicated, mainly because the build-up of the short-term debt was to a large extent due to cross-border borrowing by domestic banks from foreign banks, and the geographical structure of debt on the creditor side was dispersed (Lane and others, 1999; Box 4.1). Notably, prior to the crisis, Korea prohibited establishment of foreign banks in the form of subsidiaries.

commercial presence requires liberalizing direct investment and could precede the liberalization of portfolio and other capital flows. It should be accompanied, in particular, by the strengthening of prudential policies, the resolution of bad-loan problems and the deregulation of interest rate and credit controls. Cross-border trade liberalization implies a broader liberalization of the capital account and should be closely coordinated with it. National reforms should also be linked to multilateral initiatives on the liberalization of financial services trade and on the strengthening of international architecture.

Table 1. Cross-Border Trade in Financial Services and Capital Flows 1/ 2/

Financial Services	Portfolio investment		Other investment			
	Equity securities	Debt securities	Trade credits	Loans	Currency and deposits	Other liabilities
<b>Insurance and insurance-related services</b>						
- Direct insurance (including co-insurance): life and non-life 3/						
- Reinsurance and retrocession						
- Insurance intermediation, such as brokerage and agency						
- Services auxiliary to insurance: consultancy, actuarial, risk assessment, claim settlement						
<b>Banking and other financial services (excluding insurance)</b>						
- Acceptance of deposits and other repayable funds from the public						
- Lending of all types, including consumer credit, mortgage credit, factoring and financing of commercial transactions						
- Financial leasing						
- All payment and money transmission services, including credit, charge and debit cards, travelers checks, and bankers' drafts						
- Guarantees and commitments						
- Trading, whether on exchange, in an over-the-counter market or otherwise, money market instruments (including checks, bills, certificates of deposit); foreign exchange; derivative products; exchange rate and interest rate instruments; transferable securities, and other negotiable instruments and financial assets, including bullion						
- Participation in issues of all kinds of securities, including underwriting and placement as agent (publicly or privately) and provision of the related services						
- Money broking						
- Asset management, such as cash or portfolio management, collective investment management, pension fund management, custodial, depository and trust services						
- Settlement and clearing services for financial assets, including securities, derivative products, and other negotiable instruments						
- Provision and transfer of financial information, and financial data processing and related software by suppliers of other financial services						
- Advisory, intermediation and other auxiliary financial services on all activities classified as banking and other financial services above, incl. credit reference and analysis, investment and portfolio research and advice, advice on acquisitions and on corporate restructuring and strategy						

Source: Authors' assessment based on IMF (1993) and WTO (1995).

1/ The classification of financial services is based on the Annex on Financial Services of the GATS.

2/ Financial services of Type I (II, III) are indicated by a white (black, gray) cell.

3/ Non-life insurance services are Type I.

Table 2. Key Features of the General Agreement on Trade in Services

Features	GATS
Membership	All WTO members (135 countries, as of December 31, 1999)
Coverage	<p><i>Services.</i> Trade (imports) in all services through all modes, including cross-border trade, commercial presence, movement of persons and consumption of services abroad.</p> <p><i>Capital movements.</i> The liberalization of the following capital movements is required:</p> <ul style="list-style-type: none"> <li>- any capital inflow that is related to establishment, <u>or</u></li> <li>- any capital inflow or outflow that is part of service itself, <u>and</u></li> <li>- refers to services that are subject to specific commitments.</li> </ul> <p><i>Payments and transfers.</i> The liberalization is required only where specific liberalization commitments are made.</p>
Obligations	General obligations are limited. During multilateral negotiations countries make specific commitments not to introduce new restrictions on market access or national treatment where there are none, or not to add further restrictions other than those listed.
Standards of liberalization	<p><i>National treatment</i> of foreign service providers (i.e., foreign services and services providers and their domestic counterparts are treated alike).</p> <p><i>Market access</i> for foreign services and foreign service providers (i.e., foreign services providers can enter and establish premises in a given country or provide services across border).</p> <p><i>MFN treatment</i> (i.e., similar treatment and nondiscrimination among different foreign services and services providers). The following exemptions apply:</p> <ul style="list-style-type: none"> <li>- national lists of MFN exemptions (Annex on Art. II Exemptions);</li> <li>- economic integration and labor markets integration agreements (Art. V bis);</li> <li>- recognition of licensing or certification standards, and prudential measures (Art. VII; para. 3, Annex on Financial Services).</li> </ul>
Transparency	<p>Transparency involves the following:</p> <ul style="list-style-type: none"> <li>- publication of measures relating to trade in services at the national level;</li> <li>- notification to the WTO of measures in sectors for which specific commitments made;</li> <li>- publication by WTO of schedules of liberalization commitments;</li> <li>- restrictions are listed as limitations in sectors where specific commitments are made.</li> </ul>
Enforcement	Council for Trade in Services monitors implementation. Regular country reviews are conducted as part of general trade policy reviews. Provisions are enforced through legally binding dispute settlement procedure. The procedure starts with efforts for amicable settlement. Retaliation is possible at the end of procedure.

Source: Authors' assessment based on WTO (1995).

Table 3. Measures Covered by the General Agreement on Trade in Services

Measures	Coverage in the GATS
Market access restrictions	Yes, including: <ul style="list-style-type: none"> <li>- limitations on the number of service suppliers;</li> <li>- limitations on the value of transactions or assets;</li> <li>- limitations on the number of operations;</li> <li>- limitations on the total number of natural persons that may be employed;</li> <li>- measures that restrict or require specific types of legal entity or a joint venture;</li> <li>- limitations on the participation of foreign capital.</li> </ul>
National treatment restrictions	Yes, for example: <ul style="list-style-type: none"> <li>- nationality or residency requirements on managers;</li> <li>- restrictions on the acquisition of land by foreign providers;</li> <li>- tax privileges or subsidies granted to domestic providers only;</li> <li>- restrictions applying only to branches or operations of foreign providers.</li> </ul>
Capital controls	Yes, but only controls on <ul style="list-style-type: none"> <li>- inward direct investment in services</li> <li>- capital flows that are essential part of provision of a service itself,</li> </ul> and only if capital flows refer to services with respect to which specific liberalization commitments have been made.
Balance of payments restrictions	Yes, subject to approval.
Prudential measures	Yes, subject to "prudential carve-out" – in the presence of specific commitments Members are allowed to keep prudential measures in place even if they constitute market access or national treatment restrictions.
Measures for monetary and exchange rate management	No, subject to the determination of the nature of measures.
Measures for national and international security reasons	No, subject to the determination of the nature of measures.

Source: Authors' assessment based on WTO (1995).

## Country Experiences in the Liberalization of Financial Services Trade

### *Chile*<sup>25</sup>

In Chile the financial sector reform took place in two episodes (1974–80 and 1982–99) separated by a severe banking crisis in 1981–82. The focus of this paper is on the first episode, which is more relevant for the purposes of the paper. During that time, the financial sector has been reformed in the context of macroeconomic stabilization and economic liberalization following a severe recession. Early in the reform interest rates and credit controls were liberalized and indirect monetary instruments developed starting in 1974. Privatization of state-owned banks was also an important part of early reforms. The liberalization of financial services started in 1976, when foreign banks were allowed to establish affiliates, although their activities remained heavily restricted. The entry of foreign banks clearly facilitated technology transfer and encouraged competition in the financial sector. At the same time Chile started to liberalize cross-border trade in financial services first by allowing nonfinancial enterprises to obtain trade credits from abroad. Banks' ability to borrow abroad was liberalized later in the decade along with the partial liberalization of the capital account. During early years of reform the capital account remained tightly controlled for fear of capital flight.

Although prudential rules were strengthened prior to financial liberalization, their enforcement remained inadequate, and this encouraged concentration of ownership with close ties between financial and industrial enterprises. High interest rates owing to a tight monetary policy gradually led to a build up of nonperforming loans and rollovers of existing debt. A lax implementation of prudential rules and widespread expectations of implicit government guarantees fueled excessive domestic and foreign borrowing. This, coupled with increasing macroeconomic imbalances and exchange rate overvaluation, led to a banking crisis in the early 1980s. Clearly, deficient prudential controls were a key reason for the unsuccessful liberalization of financial services trade in Chile. After the crisis, the liberalization of financial services trade was preceded by a more rigorous strengthening of prudential regulation and supervision and proceeded without major interruptions.

### *Kenya*<sup>26</sup>

Kenya is one of the largest and most dynamic financial markets in Africa. The financial sector reform in this country started in the late 1980s and continued in a wake of a financial crisis to the second half of the 1990s, when the government undertook a program of financial rehabilitation and restructuring of distressed banks and non-financial institutions.

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<sup>25</sup> See Bisat, Johnston, and Sundararajan (1992); and Diaz-Alejandro (1992). For more details on Chile's capital controls, refer to IMF (forthcoming).

<sup>26</sup> See Berthélemy and Varoudakis (1996).



The program was supported by strengthening prudential regulation and the creation of a deposit protection system. Credit ceilings and interest rate controls were abolished, and indirect monetary instruments were put in place. Financial sector liberalization was closely linked to the liberalization of the foreign exchange market, with exchange and capital controls liberalized during 1991-95.<sup>27</sup>

Trade in financial services, including both commercial presence and cross-border supply of services started during colonial times, before the domestic liberalization of the financial sector. After independence Kenya preserved the relatively liberal trade regime in financial services, and foreign banks maintained their traditional markets. In the 1980s, these banks weathered the financial crisis relatively well in part owing to their access to parents' capital and targeting activities toward locally-operating multinationals. Prior to liberalization, however, financial repression policies discouraged activities of foreign banks, and the liberalization of interest rate and credit ceilings, and exchange and capital controls created incentives for a more active and diversified participation of foreign institutions in the provision of financial services. Financial liberalization helped promote the development of financial services markets and encouraged entry of new foreign (and domestic) banks in Kenya.

#### *Korea*<sup>28</sup>

Three periods could be distinguished in the history of Korea's financial reform: 1980s, 1990-97 and 1998 to present, with a financial crisis separating the latter two periods in 1997. Since the early 1960s Korea's financial system was characterized by a relatively high degree of government intervention, including restrictions on interest rates, credit allocation, and entry and activities of financial services providers. Financial sector liberalization started in the early 1980s and proceeded gradually and selectively. The partial and gradual nature of liberalization allowed the government to continue to maintain a significant control over the financial system during reforms, but this also allowed the government to postpone dealing with key structural weaknesses and distortions. Most interest rates and credit controls were lifted gradually, and the capital account was partially liberalized. Entry and activities of foreign financial services providers were liberalized, albeit selectively and with some reversals in response to changes macroeconomic conditions.<sup>29</sup>

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<sup>27</sup> For more details on capital account liberalization in Kenya, see IMF (forthcoming).

<sup>28</sup> See Bisat, Johnston, and Sundararajan (1992); Kochar, Loungani and Stone (1998); Park (1998); Dobson and Jacquet (1998); Johnston and others (1997, 1999); Baliño and Ubide (1999).

<sup>29</sup> During balance of payments difficulties of the early 1980s, for instance, the authorities encouraged entry of foreign branches in expectation that this would stimulate foreign exchange inflows. Advantageous treatment of foreign branches was scaled back when the

At the same time, prudential surveillance failed to match the challenges posed by liberalization, and transparency and market discipline remained weak. Cross-border trade in financial services was limited to certain instruments and maturities. The regulatory system (in particular, the approval requirement for credits from nonresidents to non-bank residents) has created incentives for excessive foreign borrowing through commercial banks. The financial crisis in 1997 induced the government to formulate a comprehensive program of financial sector restructuring. The opening of the financial sector to foreign competition by allowing the establishment of subsidiaries became an important element of the program. All in all, one important lesson that could be drawn from Korea's experience with the liberalization of financial services trade is the role that a faster opening of the financial sector to foreign competition could play in fostering transparency, international risk assessment practices and prudential rules.

### *Portugal*<sup>30</sup>

Portugal liberalized its financial sector gradually over a decade from 1983 to 1993. In the 1980s, macroeconomic imbalances were corrected to set the stage for the financial sector reform. The banking system was gradually opened up to domestic and private foreign entrants. The range of the financial services that banks could provide gradually widened. From 1986 onwards capital movements were progressively liberalized in the context of Portugal's accession to the European Union. This external liberalization was undertaken concurrently with domestic reform. The latter comprised, on the one hand, a major deregulation of banking and monetary systems and, on the other, the introduction of new prudential regulations and other requirements that prevented banks from undertaking excessive risks in the newly liberalized market. Finally, in the early 1990s, the nationalized banks were privatized, the legislation necessary for the development of capital markets was introduced, and the remaining capital controls were lifted. The liberalization of cross-border trade in financial services also started during this time.

In Portugal's case, gradual reform has been successful with cross-border services trade and the capital account being liberalized later in the reform process, after some competition had been initiated in the domestic market. The unique feature of financial services trade liberalization in Portugal is that national reform took place in the context of the country's accession to the EU. This helped ease political economy pressures and provide a template for the sequencing and content of financial sector reforms, in particular, the strengthening of prudential regulations. The liberalization of financial services trade with EU members has been completed. Another lesson suggested by Portugal's experience is that the liberalization of cross-border trade in financial services became possible after the capital

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current account deficits were reversed in the second half of the 1980s (Dobson and Jacquet, 1998).

<sup>30</sup> For more details, see Decressin (1998).

account had been liberalized. Capital account liberalization, in turn, had been induced partly by the erosion of capital control effectiveness as the economy became more closely integrated with the EU.

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