World Trade Organization

SPECIAL STUDIES

OPENING MARKETS IN FINANCIAL SERVICES AND THE ROLE OF THE GATS

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I. Introduction

All branches of economic activity today are fundamentally dependent on access to financial services. In fact, it is the diversified intermediation and risk management services provided by the financial system which have made possible the development of modern economies. A healthy and stable financial system, underpinned by sound macroeconomic management and prudential regulation, is an essential ingredient for sustained growth. Conversely, macroeconomic instability emanating from weaknesses in the financial sector can undermine the process of development.

Trade is playing a growing role in the financial services sector in many countries through cross-border transactions, and even more so through foreign direct investment. As economic activities become more globalized through increased trade and investment flows, the need for internationalized intermediation and risk management services has also grown. Significant potential exists for further expansion in financial services trade, as economies continue to be opened and technological developments present new trading opportunities. The continuing globalization of economic activity, and the challenge of attracting productive investment in a competitive international environment, accentuate the need to maintain a healthy and efficient financial sector.

International cooperation in financial matters is hardly new, but the General Agreement on Trade in Services (GATS), which emerged from the Uruguay Round, represents the first multilateral effort to establish rules governing services trade, including financial services, and to provide a framework for multilateral negotiations on improved market access for foreign services and service suppliers. This effort was a significant step forward in international economic cooperation. It reflected a growing realization of the economic importance of trade in services, as well as the need for closer cooperation among nations in a world of growing interdependence.

The GATS negotiations in the financial services sector covered all financial services, including banking, securities, and insurance. Governments were unable to reach full agreement on a package of market opening commitments in financial services at the end of the Uruguay Round in 1993. Extended negotiations in 1995 resulted in an interim agreement, which effectively expires in December 1997. It is in this context that WTO Members are currently engaged in a further attempt to reach a permanent agreement based on the most-favoured-nation (MFN) principle - that is, the obligation to refrain from discriminating among trading partners. The negotiating deadline is 12 December 1997.

The negotiations offer a valuable opportunity for governments to make a shared commitment to progressive liberalization, thereby creating enhanced opportunities for trade that will benefit both producers and consumers of financial services and strengthen the financial sector. The purpose of the present study is to explore some of the issues surrounding the financial services negotiations, and to analyze what is at stake. The study does not, however, seek to prescribe a specific course of action for any country. Rather, it attempts to clarify the potential benefits and challenges which arise in the context of financial services trade liberalization.

The financial services sector is complex and a number of confusions and misconceptions can arise regarding the consequences of liberalization and the obligations assumed by Members in the context of negotiations under the GATS. This study places a good deal of emphasis on disentangling and clarifying these issues. It argues that the benefits of trade liberalization arise primarily from more competition and better financial intermediation. However, what distinguishes the financial services sector, especially its banking component, from other service activities is its close links with the economy at large. Strong interdependence exists between macroeconomic management, financial regulation and supervision, and the trade regime.

For these reasons, the economic gains of trade liberalization must be underpinned by appropriate supervisory and regulatory regimes domestically. The study shows that macroeconomic instability, and inadequate regulation and supervision can undermine the benefits of liberalization. At the same time, liberalization of financial services trade can in some circumstances exacerbate preexisting financial sector difficulties. The crucial question is how liberalization and accompanying reforms should be carried out so as to maximize the benefits. It is important to note, that the GATS allows Members to take prudential measures to protect investors and to ensure the integrity and stability of the financial system. The GATS also permits the use of temporary non-discriminatory restrictions on payments and transfers in the event of serious balance-of-payments and external financial difficulties. Thus the benefits from participating in the multilateral negotiating process under the GATS, through market access and national treatment commitments, can accrue to countries without in any way compromising their ability to pursue sound macroeconomic and regulatory policies. Indeed, there are circumstances where forward commitment to liberalization may help to support the development of better macroeconomic and regulatory policies.

A particular advantage of the GATS negotiating process is that the rules of the system are based on the principle of non-discrimination among WTO Members. This principle — the MFN principle — provides a framework for defining predictable and transparent conditions for international trade, establishing the foundation for rules-based, as opposed to power-based, international trade relations. The existing structure of the GATS, however, allows Members to seek exemptions from MFN, which several Members have chosen to do in financial services. A basic objective of the current negotiations is to secure an MFN-based result.

The study is divided into six sections. Section II explains the role of the GATS in the process of trade liberalization. Section III presents available statistics on financial services trade and on some of the characteristics of the sector. Section IV discusses the benefits that can accrue from trade liberalization. Section V then looks at the interaction between trade liberalization in the financial services sector and aspects of macroeconomic and regulatory policies. Section VI concludes. It should also be noted that Appendix I contains a description of the coverage, level and type of commitments that governments have already made in previous negotiations covering financial services.

II. The Role of the GATS in Financial Services Liberalization

This section discusses the role of the GATS in financial services liberalization, starting with an explanation of how rights and obligations under the GATS, and commitments made in negotiations, fit into the broader policy framework relevant to the financial services sector. It then proceeds to explain the nature of commitments made under the GATS, and to consider some reasons that favour undertaking market access and national treatment commitments in the GATS.

The GATS touches upon some but not all policy interventions affecting the financial sector

A four-fold distinction can be made between different types of government intervention that could have an impact on the financial services sector.[1] First, there is macroeconomic policy management in general. When a central bank conducts open market operations, for example, conditions in the financial sector could be affected through the impact of such interventions on the money supply, interest rates or exchange rates. These types of interaction fall entirely outside the ambit of the GATS.

Second, governments maintain prudential regulations in order to protect the financial sector, and ultimately the stability of the economy and the welfare of consumers. Typical prudential measures might include capital adequacy ratios and solvency margin requirements, restrictions on credit concentration or portfolio allocation, requirements for preserving asset quality, liquidity ratios, controls on market risk, management controls, and disclosure and reporting requirements. As with macroeconomic policy management, GATS commitments do not in any way curtail the scope for prudential regulation. Paragraph 2(a) of the Annex on Financial Services states that:

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

The same paragraph goes on to say that where prudential measures do not conform with other provisions of the GATS, they must not be used as a means of avoiding commitments or obligations under the Agreement. Prudential measures need not be inscribed in Members' schedules of specific commitments, as they are not regarded as limitations on market access or national treatment.

Third, governments may maintain other regulations, which are not prudential in nature, but which nevertheless can affect the conditions of operation and competition in a market. Such measures could include, for example, a requirement to lend to certain sectors or individuals. Such lending might also be mandated on the basis of preferential interest rates. The use of the financial system in this fashion — as a political instrument or a tool of industrial policy — has been criticized by many economists as a relatively inefficient means of achieving particular objectives, as well as a risk to financial stability if pursued to excess. But it is important to note that these policies are not necessarily subject to commitments made under the GATS. Whether they are or not depends on a judgement as to whether they constitute limitations on market access or national treatment. If they are neither discriminatory, nor intended to restrict the access of suppliers to a market, then such non-prudential domestic regulatory measures fall within the ambit of GATS Article VI disciplines.

Article VI seeks to ensure that domestic regulations involving qualification requirements and procedures, technical standards and licensing requirements do not constitute unnecessary barriers to trade. Article VI requires that these elements of domestic regulation are based on transparent and objective criteria, are not more burdensome than necessary to ensure the quality of the service, and in the case of licensing procedures are not in themselves a restriction on the supply of a service. Article VI does not, however, question the right of Members to pursue the public policy objectives in respect of which qualification requirements and procedures, technical standards, and licensing requirements are applied.[2]

The fourth area of policy intervention mentioned above deals with trade liberalization. Governments often impose trade restrictions aimed at preventing or inhibiting the domestic establishment of foreign service suppliers or the foreign supply of services on a cross-border basis. It is the reduction and elimination of these measures that constitute the primary focus of the trade liberalization efforts of the GATS. As explained briefly in

[1] Government measures to protect public morals or to maintain public order as well as national security measures may also have an impact, but are not discussed here as they are treated as general exceptions in the GATS.

[2] As discussed in Appendix 1, some Members appear to have inscribed prudential measures and other regulatory interventions in the schedules of specific commitments. This has led to a certain ambiguity in the distinction between those measures that restrict market access and/or national treatment, and therefore should be included in schedules, and those that pursue public policy objectives of a non-protectionist nature and should therefore be excluded from schedules.

Box 1, Members make market access and national treatment commitments, which may be subject to certain limitations. Any limitations must be indicated according to each of the four modes of supply — cross-border trade, consumption abroad, commercial presence and movement of natural persons.

Market access limitations under Article XVI must be expressed in terms of an exhaustive listing of six kinds of measures. These are: a) limitations on the number of service suppliers; b) limitations on the total value of service transactions or assets; c) limitations on the total number of service operations or on the total quantity of service output; d) limitations on the total number of natural persons that may be employed in a service sector or which a service supplier may employ; e) restrictions or requirements on the types of legal entity or joint venture permitted; and f) limitations on the participation of foreign capital. National treatment limitations under Article XVII must also be clearly indicated, but these are not subject to any exhaustive listing or system of classification, as is the case with Article XVI measures. A scheduling convention specified in Article XX requires that measures inconsistent with both Article XVI and Article XVII must be inscribed in the column of the schedule reserved for market access limitations.

Whether or not particular sectors or activities are entered in Members' schedules depends on the outcome of negotiations. It is thus unsurprising that considerable variance is encountered in the nature, scope and coverage of individual Members' specific commitments. A basic precept of the GATS, contained in Article XIX, is the principle of progressive liberalization, to be attained through successive rounds of negotiations. Progressive liberalization aims to reduce or eliminate over time the adverse effects of government measures on trade in services, in order to provide increased market access and national treatment. The liberalization process is to take place with a view to promoting the interests

Box 1: Financial Services in the GATS

The General Agreement on Trade in Services (GATS) emerged as part of the Uruguay Round package as the first multilateral trade agreement on services. The GATS covers all services sectors including financial services, except services supplied in the exercise of governmental authority. The financial services sector in the GATS includes any service of a financial nature (see the GATS Annex on Financial Services paragraph 5 in Appendix 2).

Trade in financial services, like in other services, is defined in terms of four modes of supply: (1) Cross-border supply, whereby, for example, domestic consumers take a loan, purchase securities, or take insurance cover from an financial institution located abroad; (2) Consumption abroad, whereby consumers purchase financial services while travelling abroad; (3) Commercial presence, whereby a foreign bank or any other financial institution establishes a branch or subsidiary in the territory of a country and supplies financial services; and (4) Movement of natural persons, whereby natural persons supply a financial service in the territory of a foreign Member country.

The GATS aims at negotiating a legally binding set of commitments to enhance predictability and provide transparency under the principle of progressive liberalization. The GATS framework consists of: (i) rules and obligations specified in the Articles of the Agreement; (ii) annexes on specific sectors and subjects including an annex on financial services; and (iii) national schedules of market access and national treatment commitments and lists of MFN exemptions. The most important of the general obligations under the GATS are MFN (most-favoured-nation) (Article II) and transparency (Article III). They apply across the board to all services sectors, although exemptions to the MFN obligation in specific sectors are permitted, provided that the measures are listed in the list of MFN exemptions and that such exemptions, in principle, should not extend beyond 10 years. Specific obligations are related to market access and national treatment (Articles XVI and XVII, respectively). They apply only to services that are inscribed in the Schedules of Commitments of countries where specific commitments on market access and national treatment are listed in the form of limitations or measures applicable. Such limitations may be either horizontal (cross-sectoral) or sector-specific, and are listed for each of the four modes of supply. Moreover, Article XVIII offers the possibility for countries to inscribe additional commitments not dealt with under the two previous articles. Some countries have made their specific commitments in accordance with the Understanding on Commitments in Financial Services, an optional text containing a "formula" approach to the scheduling of commitments.

In addition to the provisions of Articles XVI, XVII and XVIII, specific commitments in financial services are made in accordance with the Annex on Financial Services that complements the basic rules of the GATS. Paragraph 2 (a) of the Annex recognizes that countries may take measures for prudential reasons, including for the protection of investors, depositors, policy holders and for preserving the integrity and stability of the financial system. Such measures shall not be used as a means of avoiding a country's commitments or obligations under the GATS. These measures do not need to be inscribed in the Schedules of Specific Commitments of countries regardless of whether they are in conformity with any other provisions of the GATS, including Articles XVI and XVII. Furthermore, Article XII of the GATS allows Members to introduce restrictions of a temporary nature in the event of serious balance-of-payments and external financial difficulties subject to consultations with WTO Members.

of all participants on a mutually advantageous basis, and to securing an overall balance of rights and obligations.

Article XIX also stipulates that the process of liberalization shall take place with due respect for national policy objectives and the level of development of individual Members, both overall and in individual sectors. Appropriate flexibility is to be given to individual developing countries to open fewer sectors, liberalize fewer types of transactions, and progressively extend market access in line with their development situation.

In addition, Article IV of the GATS entreats Members, through negotiated specific commitments, to help developing countries strengthen their domestic service sectors, and improve their access to distribution channels and information networks. Priority should also be accorded to liberalization in sectors and modes of supply of export interest to developing countries. Developed countries are required to establish enquiry points to facilitate access to information concerning commercial and technical matters, registration, recognition and obtaining of professional qualifications, and to the availability of services technology. The provisions of Article IV are to be applied to the least-developed countries on a priority basis, and particular account is to be taken of the serious difficulties facing these countries in accepting commitments in view of their special economic situation and their development, trade and financial needs.

The GATS offers a vehicle for securing progressive liberalization on a non-discriminatory basis and reaping the benefits of a more efficient, stable and diversified financial sector

At least four reasons can be adduced for undertaking market access and national treatment commitments in the GATS. First, a multilateral commitment has the effect of tying in the degree of liberalization attained under the existing policy regime, or of tying in future liberalization commitments. In both cases, because these are multilateral commitments, national policies become more predictable and certain. Multilateral commitments weaken the power of domestic interest groups who may seek to maintain privileged positions regardless of a government's commitment to enhancing the welfare of the population at large. Trade liberalization within the European Union, for example, was facilitated by a credible commitment to future liberalization in the form of the Single European Act, and an adjustment period between its announcement and implementation (Schuknecht, 1992).

Second, the possibility of making commitments to future financial service trade liberalization can help to shape and underpin essential macroeconomic and regulatory reforms. As discussed in Section V of the study, in order to avoid undesirable destabilizing effects, trade liberalization needs to be combined with appropriate macroeconomic policy and adequate regulation. It is in this context that commitments under the GATS to future trade liberalization can make a contribution, by setting a time frame for essential macroeconomic policy and regulatory reforms, and by infusing an additional sense of purpose, coherence and urgency into the reform process.

Third, commitments under the GATS provide a signal of policy stability and intent to potential foreign investors. Offering additional security to foreign investors can give countries an edge as they seek to attract foreign capital. Countries can thereby benefit not only directly from increased foreign investment, but they can also reduce costs that might otherwise be incurred in an effort to attract capital by offering various kinds of fiscal incentives.

Fourth, a willingness to make commitments in the context of a multilateral negotiation may induce other countries to do likewise, in a virtuous circle of mutual benefits. Certain risks are attached to this argument, however, since it can divert attention from the reality that liberalization typically benefits most the countries that undertake the reforms. This is even more true for smaller countries, which are likely to encounter greater difficulty than larger ones in extracting reciprocity from their trading partners. This difficulty is perhaps mitigated in circumstances where broad-based negotiations generate greater opportunities for trade-offs than negotiations which focus on a narrower range of sectors or issues. But even in the latter negotiating context, active participation may contribute to a more propitious atmosphere in future negotiations.

Policy commitments which mirror the actual, historical level of liberalization in the market do not immediately further the declared GATS objective of progressive liberalization. But they do have the advantage of setting a bench-mark of actual openness that prevents "policy slippage," and which can serve as the basis for future liberalization undertakings. Commitments which either reflect liberalization measures adopted in the context of a negotiation, or which involve commitments to future liberalization, contribute directly to the progressive liberalization objective. It is noteworthy that many, if not a majority, of the participants in the recently concluded negotiations on basic telecommunications made commitments of one kind or another to future trade liberalization (Low and Mattoo, 1997).

The benefits of participation in the GATS negotiations are more limited if governments choose to make market access and national treatment commitments that in reality reflect less than the policy *status quo* in terms of market openness. Although below *status quo* commitments set a minimum guaranteed level of market access, they deny trading partners contractual certainty under the GATS with respect to their existing levels of market access. While such commitments may be based on the premise that governments need to retain policy flexibility to deal with unforeseen situations arising from scheduled commitments, it should be borne in mind that the GATS permits Members to take additional prudential measures and measures to protect the balance-of-payments should these become necessary, notwithstanding the binding nature of market access and national treatment commitments.

III. The Growing Importance of Financial Services Trade

Financial services constitute a large and growing sector in virtually all economies, developed and developing alike. The growth of the sector is particularly high in those economies that are experiencing rapid modernization. Trade in financial services is also increasing at a fast pace, owing to a combination of new and growing markets in developing and transition economies, financial and trade liberalization, the use of new financial instruments and rapid technological change. However, the financial services sector is far more important than its direct share in the economy implies. Financial services are the backbone of modern economies. It is difficult to think of any economic activity, except perhaps those that remain largely outside the money economy in less well-off countries, that does not depend in a significant way (either directly or indirectly) upon services provided by the financial sector.

Given the fundamental importance of financial services and the role of trade in the sector, the current lack of reliable and detailed data on financial service trade is remarkable.[3] Measurement of production and trade in financial services is perhaps even more complex than in a number of other service sectors. Financial services trade flows, for example, often cannot be identified directly, and so the value of transactions has to be inferred from the service charges levied by financial institutions. The estimation of trade in banking services, for example, relies upon intermediation charges, such as the spread between lending and deposit taking, fees associated with letters of credit, bankers' acceptances and foreign exchange transactions, to name only a few. Trade in securities is estimated from fees on brokerage, underwriting, derivatives and so on. Trade in insurance services is valued as the difference between gross premiums and disbursements on claims (IMF, 1993a).

This section pulls together some of the more readily available statistics on financial services trade, in order to provide an indication of the value of transactions in the sector, their relative importance in relation to other economic activities, and the pace of change in the sector. For the purpose of the GATS and the discussion that follows, the financial services sector has been divided into banking, securities, and insurance services. Historically, government regulation has often segmented the sector into these categories, for example, for prudential reasons. Although these distinctions are still conceptually useful, they are increasingly less helpful in identifying different kinds of financial institutions, as regulatory barriers are dismantled and companies seek to expand their activities. Some national regulatory regimes continue to impose structural separation on different kinds of activities in the financial sector, such that individual financial enterprises may be restricted from engaging in the full range of financial activities. However, many companies provide services in more than one category, and some global players cover the full range of financial service products (White, 1996).

The financial services sector is a major player in modern economies, as a producer of financial intermediation services and as an employer

Tables 1 and 2 illustrate the important role of the financial services sector, as reflected by its share in total employment and GDP, for a number of countries for which data were available. Employment in the financial services sector, for example, ranges from about 3 per cent of total employment in France, Canada and Japan to 5 per cent in Singapore, Switzerland and the United States. Moreover, employment in the sector is growing in many countries. Between 1970 and 1995, the share of financial services in total employment increased by between 25 per cent and 100 per cent in the countries identified in Table 1.

Value-added in the financial services sector as a share of GDP has also grown considerably over the 1970-95 period.[4] All industrialized countries for which data are available reported a value-added share of about 2-4 per cent of GDP for this sector in 1970. By the mid-1990s, the United States and Switzerland reported value-added shares of 7.3 and 13.3 per cent respectively, the highest among industrialized countries. Other industrial countries recorded value-added shares of 2.5 per cent to 6 per cent of GDP in the same period. Amongst developing countries, financial services are the most important in Singapore and Hong Kong (China).[5]

The vital role of the financial services sector in national economies can be illustrated by two other indicators. Chart 1a shows the size of the banking sector in a number of industrialized, and developing and transition countries. Total banking assets in Japan, the European Union and the United States amounted to about US$10 trillion

[3] Data deficiencies in the sphere of services are well recognized by governments, and efforts are under way to improve the collection of statistics both at the national and international levels. See, for example, the discussion in Karsenty and Mattoo (1997).

[4] It should be noted that the accounting of financial services in GDP is based on service charges. This overstates the contribution of financial services in inefficient markets (as costs and charges are high) and understates the importance in efficient markets.

[5] The data for a few developing countries, however, overstate the share of financial services as they also include business services.

Table 1: Share of Employment in Financial Services

(In per cent of total employment)

COUNTRY	1970	1980	1985	1990	1995
Canada[1]	2.4	2.7	2.9	3.0	3.2
France	1.8	2.6	2.9	2.8	2.7
Germany (former Fed. Rep.)	2.2	2.8	3.0	3.1	----
Japan[2]	2.4	3.0	3.2	3.3	3.1
Singapore[3]	----	2.7	----	----	5.0
Switzerland[4]	----	----	4.6	4.8	4.7
United Kingdom	----	3.0	3.5	4.6	4.3
United States[4]	3.8	4.4	4.7	4.8	4.7

Source: WTO (1996a), OECD (1996a).

[1] 1992 instead of 1995
[2] 1994 instead of 1995
[3] 1978 instead of 1980
[4] 1993 instead of 1995

Table 2: Share of Value-Added in Financial Services

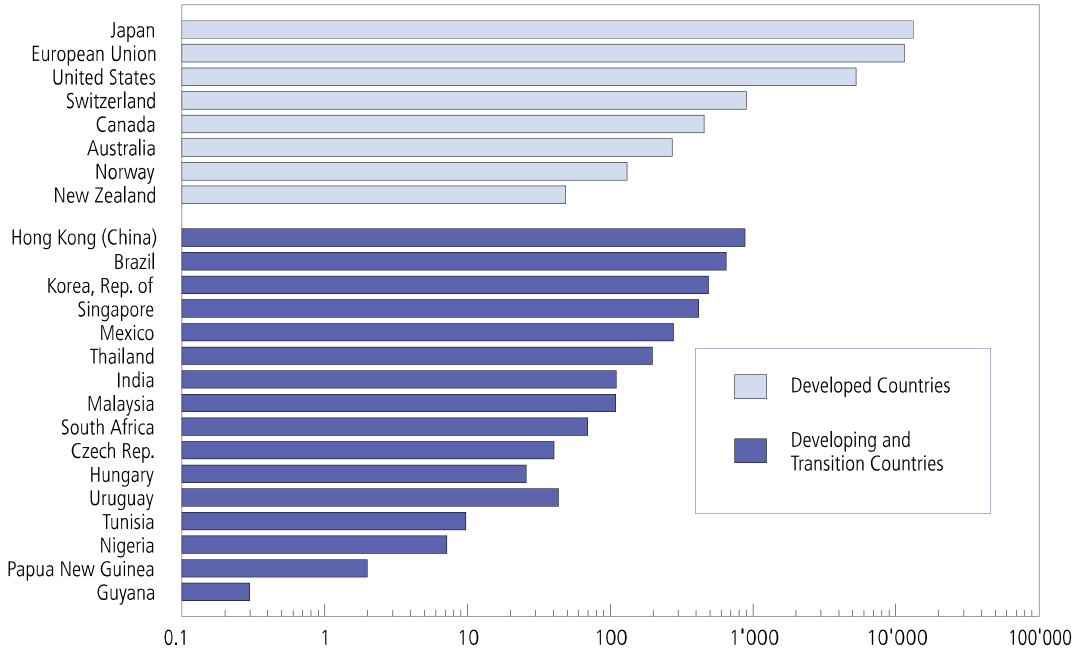
(In per cent of GDP)

COUNTRY	1970	1980	1985	1990	1995
Industrialized Countries:					
Canada	2.2	1.8	2.0	2.8	2.5
France	3.5	4.4	4.8	4.4	4.6
Germany[1]	3.2	4.5	5.5	4.8	5.8
Japan[2]	4.3	4.5	5.5	4.8	5.8
Switzerland[3]	----	----	10.4	10.3	13.3
United States[3]	4.0	4.8	5.5	6.1	7.3
Developing Countries:					
Colombia[4]	----	----	----	2.9	2.9
Ghana[5]	5.5	----	8.7	9.2	----
Hong Kong (China)	----	6.9	6.1	6.6	9.4
Mauritius[6]	----	----	----	4.4	5.2
Singapore[7]	----	5.0	----	----	12.0
Sri Lanka[8]	----	----	----	4.6	6.8
Thailand[9]	----	----	-----	4.0	7.8

Source: Hong Kong Census and Statistics Department (1997), Kapur *et al.* (1991), OECD (1996a), WTO (1995a, 1995b, 1995c, 1996, 1996a).

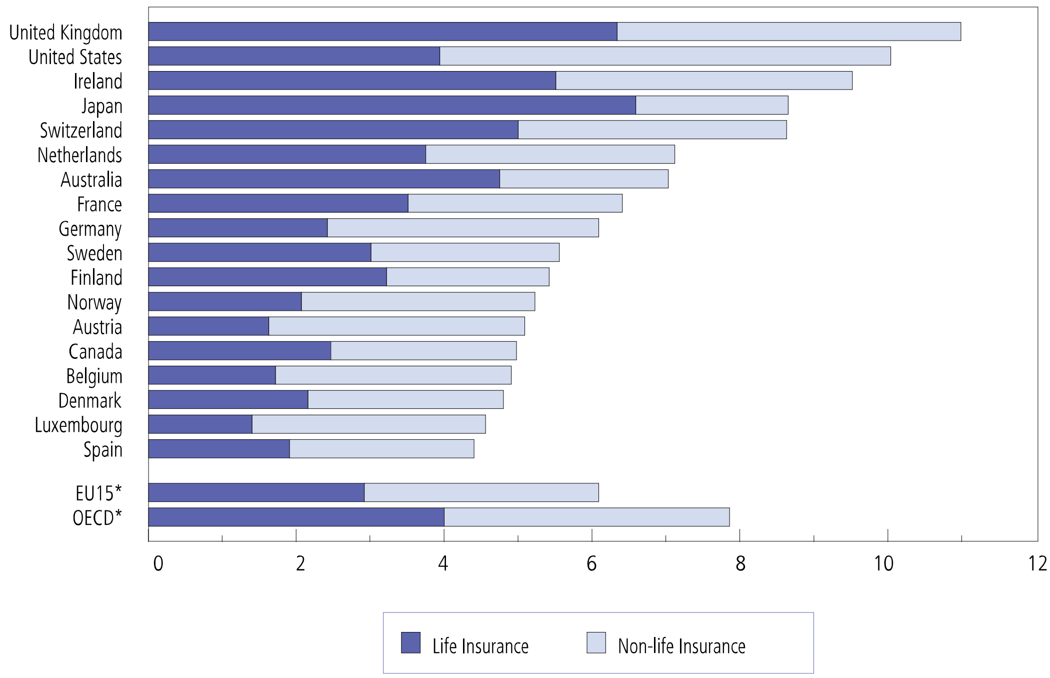
[1]Figures until 1990 refer to the former Federal Republic of Germany.
[2]1994 instead of 1995.
[3]1993 instead of 1995.
[4]1992 instead of 1990; 1994 instead of 1995.
[5]1971 instead of 1970; 1983 instead of 1985; includes business services.
[6]1987 and 1993 respectively; includes business services.
[7]1978 instead of 1980.
[8]1994 instead of 1995; includes real estate services.
[9]Excludes insurance services.

Chart 1a. Total Banking Assets, 1994 (US$ billion - logarithmic scale).



Sources: IMF (1997), Sorsa (1997).

Chart 1b. Insurance Premiums as Percentage of GDP, Average 1987-1994



Source: OECD (1996).

*Weighted average by size of insurance market, EU15 = European Union with 15 members.

each in 1994. Together these countries accounted for three quarters of global banking assets. Moreover, some smaller countries such as Switzerland reported banking assets of near US$1 trillion in 1994. Banking assets typically far exceed GDP in these countries. The size of financial markets in developing economies was mostly between US$10 and US$100 billion in 1994, with the exception of Brazil, Korea, Mexico and Thailand, which reported banking assets of between US$100 billion and US$1 trillion. By contrast, countries with the smallest banking sectors and banking assets of less than US$ 1 billion are also amongst the least well-off in the world. In these countries, banking assets are typically much smaller than GDP. This points to the presence of a large informal and subsistence economy which does not have access to the formal financial sector.

Chart 1b shows the importance of the insurance sector in industrialized economies. Total insurance premiums, for example, averaged 8 per cent of GDP for OECD countries during the 1987-94 period. In the United Kingdom, every ninth pound is spent on life or non-life insurance, and in the United States, Ireland, Japan or Switzerland the share is not much lower. The fact that the lower-income OECD countries, such as Greece, Mexico or Turkey spend only 1-2 per cent of GDP on insurance, suggests that growth in this sector is likely to be very buoyant in the future as these countries become richer.

Financial markets have become increasingly globalized

The growth of international financial activities has been even more rapid than the growth of domestic markets. Charts 2a and 2b demonstrate that international securities and derivatives transactions have grown particularly strongly over the past 10 years. The value of securities issues increased from about US$100 billion in 1987 to over US$500 billion in 1996, making this activity more important than international lending, which reached US$ 400 billion in 1996. Over the past decade, derivatives transactions have increased more than ten-fold. Outstanding futures and options in interest rates, currencies, and stock market indices (the so-called exchange-traded derivatives) amounted to US$ 10 trillion at the end of 1996. This amounts to almost twice the total value of world trade in 1996. The value of outstanding swaps and swap-related derivatives (or over-the-counter derivatives) reached US$25 trillion in the same year (BIS, 1997a).

Although much of the activity in international financial markets centres on industrialized countries, developing and transition economies have become increasingly important players. A recent World Bank study (World Bank, 1997) found that half of the 60 developing countries examined had attained a medium to high degree of financial integration in the early 1990s. This represents a 50 per cent increase compared to the mid-1980s. By way of illustration, Chart 3 shows that Latin America, East Asia, and Central and Eastern Europe increased their recourse to international capital markets considerably in the first half of the 1990s. Latin American countries relied mainly on bond financing during this period, whilst East Asian economies received financing both through bonds and loans.[6] Access to international capital markets for transition economies has also grown rapidly, although the amounts involved are still relatively small.[7] The growing importance of shares as a means of financing in developing and transition economies also suggests that companies and markets have become more open and more sophisticated.

Significant potential exists for further dynamic growth in financial services trade

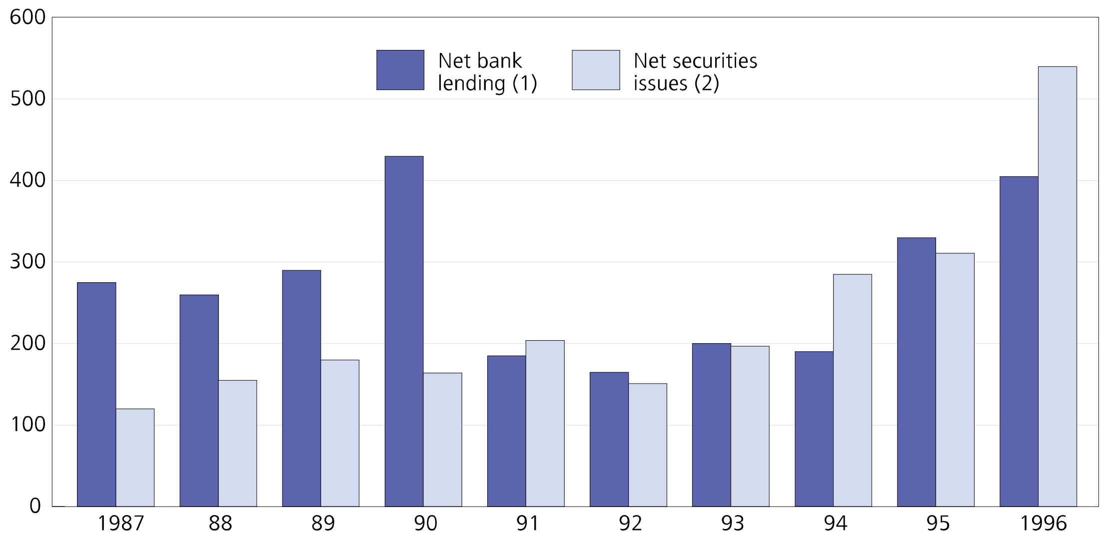
Financial services trade has experienced rapid growth in recent years in tandem with the deepening of international financial sector activities. Several factors help to explain this growth. First, technological progress has increased the scope for financial services trade, not least with the advent of electronic data processing and transmission, improved computer technology, automatic teller machines, and telebanking. Furthermore, a new era of Internet-based banking services has arrived (see Box 2). Independently of the liberalization efforts of governments under the GATS, these technologies add a new dimension to the workings of the financial sector. They offer new opportunities for enhanced efficiency and pose additional regulatory challenges. The potential gains associated with these new technologies are more likely to be reaped under an open financial services regime.

Secondly, the opening of today's transition economies in Europe and Asia, plus growing international trade, have extended markets and increased demand for international financing of both trade and investment activities. Third, liberalization of financial services trade and globalization have mutually reinforced each other as increased competition has forced companies to seek cheaper and better ways to finance their activities. The NAFTA signatories and the European Union, in particular,

[6] This pattern is probably a consequence of the debt crisis in the 1980s, when financial institutions had extended considerable loans to Latin American countries. Bonds put less risk into the hands of financial institutions, which may only mediate the issue of bonds. The more balanced financing structure in East Asia, on the other hand, may reflect the better credit history of the region.

[7] While this is true in general and regarding the amounts of financing involved, access to foreign capital was significant for a number of transition economies including the Czech Republic, Hungary and Poland.

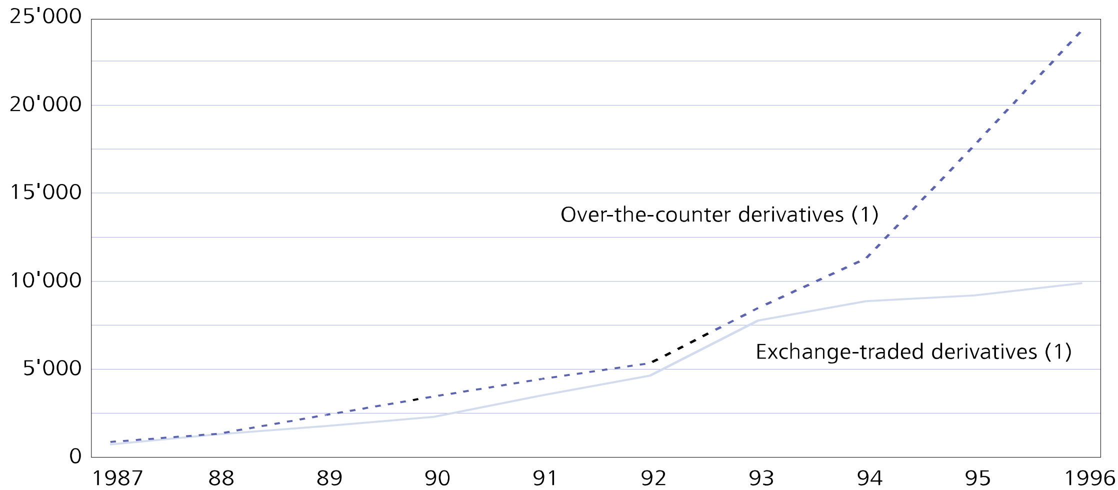
Chart 2a. Activity in International Financial Markets
(a) The International Banking and Securities Markets
(In US$ billion)



Sources : BIS (1997a).

(1) Changes in amounts outstanding, excl. exchange rate valuation effects and interbank redepositing.
(2) Net issues (excl. exchange rate valuation effects) of international bonds and euronotes.

Chart 2b. Activity in International Financial Markets
(b) Global Derivative Markets
(In US$ billion)



Sources : BIS (1997a).

(1) Notional amounts outstanding at end-year.

Box 2: Financial Services Trade on the Internet

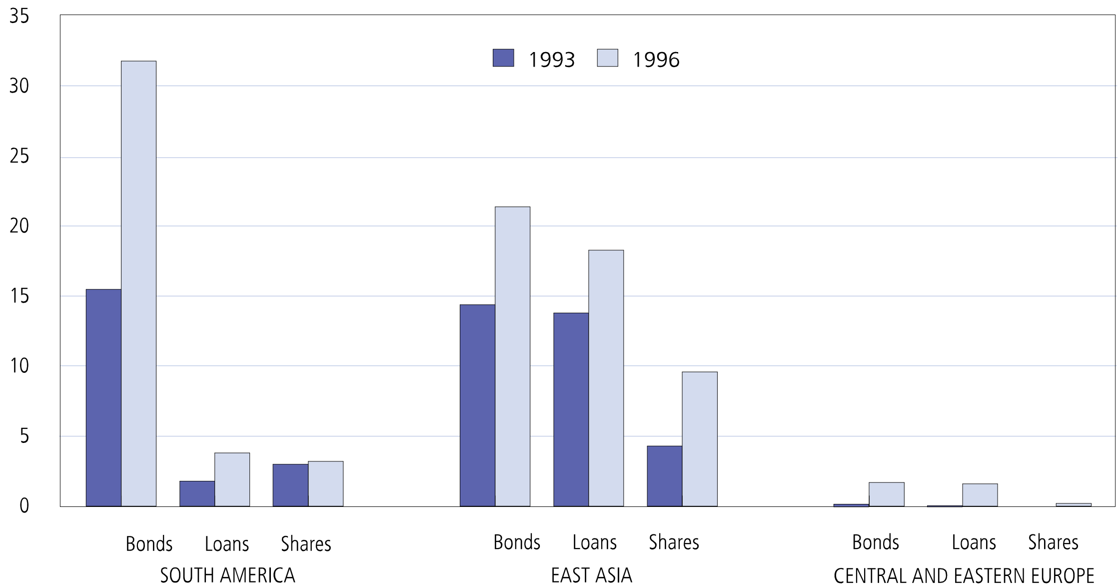
The Internet is likely to transform dramatically the way business is conducted in many areas, including financial services. The Internet cuts transaction costs, provides new channels for commercial transactions and lowers barriers to entry for smaller, geographically remote, competitors. Businesses have a direct link to consumers worldwide, who can order practically anything, from airline tickets to cars, without leaving their homes. The value of goods and services traded on the Internet is expected to increase from US$10 billion in 1996 to perhaps as much as US$200 billion by 2000.

The Internet will also have a profound effect on the financial services industry. The global reach of the Internet means that banking, insurance and brokerage services can be purchased from anywhere in the world. In fact, the Internet is likely to boost strongly international trade in financial services at the retail level—an area which has so far been little affected by globalization. The cost of an average payment transaction on the Internet, for example, is as low as one US cent, compared with 27 cents for an automatic teller machine, 54 cents for a telephone banking service and US$1.07 for a transaction conducted via a traditional bank branch. A growing number of banks have, therefore, begun offering banking services on the Internet, such as on-line bill payments and checking account statements. Recent studies suggest that there are already more than 1,200 banks maintaining a "Web" presence, and 60 per cent of banks in OECD countries will offer Internet transactions by the year 1999. Brokerage firms are offering on-line securities trading as well as access to "real time" market data and sophisticated investment management tools. In the United States alone, there are some 1.5 million on-line stock broker accounts, and this figure is growing by 50-150 per cent each year. In the insurance sector, many companies have started to use the Internet as a new delivery channel for their products. Electronic insurance purchases are projected to increase from zero in 1996 to several billion US dollars in 2000.

Despite its great potential, the future of financial services trade on the Internet will depend largely on the ability to ensure the security of on-line transactions and information. Sophisticated encryption systems, plus the use of digital certificates that verify the parties to a transaction, will play an important role in establishing the security of on-line transactions. Moreover, there have been calls for multilateral rules towards establishing a free trade zone on the Internet. Discussions on a framework for governing Internet transactions feature, for example, customs and taxation issues, electronic payments methods, commercial code-related issues, intellectual property protection, privacy and security.

Sources: Financial Times (2 July, 1997), Clinton and Gore (1997).

Chart 3. Recourse to the International Capital Market: Selected Regions
(US$ billion)



Source: BIS (1997a).

Table 3: Cross-border Trade in Financial Services - Receipts and Expenditure
(US$ billion)

COUNTRY	1985	1990	1995
Receipts (Exports)			
Austria	0.3	0.7	2.5
Belgium-Luxembourg	0.6	4.9	5.6
France[1]	...	...	8.1
Germany	0.3	4.5	11.1
Japan	0.0	0.1	0.6
Singapore	0.1	0.1	0.4
Switzerland	1.8	4.2	6.9
United Kingdom[2]	7.3	6.1	9.1
United States	3.0	5.0	7.5
Expenditure (Imports)			
Austria	0.3	0.6	3.1
Belgium-Luxembourg	0.6	3.8	4.0
France[1]	...	...	8.2
Germany	0.2	4.8	9.4
Japan	0.5	1.4	3.0
Singapore	0.1	0.8	1.0
Switzerland[3]	0.1	0.2	0.2
United Kingdom[2, 3]	0.4	0.7	0.7
United States	2.5	4.4	6.2

Source: IMF (1996).

[1]1996 instead of 1995.
[2]1986 instead of 1985.
[3]Excludes expenditure on banking and securities-related services.

have gone a long way towards reducing trade barriers in this sector (Harris and Pigott, 1997).

As stated earlier, data on financial services trade are relatively scarce. Table 3 reports some information on cross-border trade for selected countries in the 1985-1995 period. As indicated in the table, Belgium, France, Germany, Luxembourg, Switzerland, the United Kingdom and the United States are the biggest exporters of financial services. Total cross-border exports in financial services exceeded US$50 billion in 1995 for the countries in Table 3 as a whole, which compares to less than US$15 billion 10 years earlier.

Table 3, however, does not include all financial services trade as defined in the GATS.[8] The GATS distinguishes four different modes of supply when categorizing trade in services. As explained in Section II and Box 1, mode 1 involves cross-border trade, mode 2 is consumption abroad, mode 3 is commercial presence, and mode 4 entails the movement of natural persons. The cross-border trade data discussed in the previous paragraph, gleaned from balance-of-payments statistics, refer to mode 1 and to elements of other modes where transactions take place between "residents" and "non-residents". No comprehensive source of data exists on mode 3 and mode 4 trade — that is, on the sales of foreign enterprises or natural persons that are established in the territory of another Member and are treated as "residents". Sales through commercial presence is sometimes referred to as "establishment trade"

It is noteworthy, however, that the United States provides detailed statistics on trade under mode 3 (USITC, 1997). These data are presented in Table 4, along with data from balance-of-payments statistics which approximate cross-border trade. Table 4 indicates that the United States is a strong net exporter of banking and securities services, both through cross-border trade and commercial presence. Exports exceed imports by a ratio of three to one. For insurance services, the United States appears to be a net importer, via both cross-border trade and commercial presence. Table 4 allows a comparison to be made between cross-border trade and establish-

[8] The statistical base of financial services trade is still evolving and data need to be interpreted with caution. In recent years, many countries have adopted the methodology of the IMF Balance of Payments Manual in measuring financial services trade. This has led to greater harmonization in the data but it also explains some breaks in the series.

Table 4: United States Financial Services Trade by Modes of Supply (1995)[1]
(US$ billion)

	Mode 1: Cross-border Trade[2]		Mode 3: Commercial Presence[3]	
	Exports	Imports	Exports	Imports
Insurance Services	1.40	4.50	30.90	48.70
Banking and Securities Services	6.10	1.70	14.00	5.90

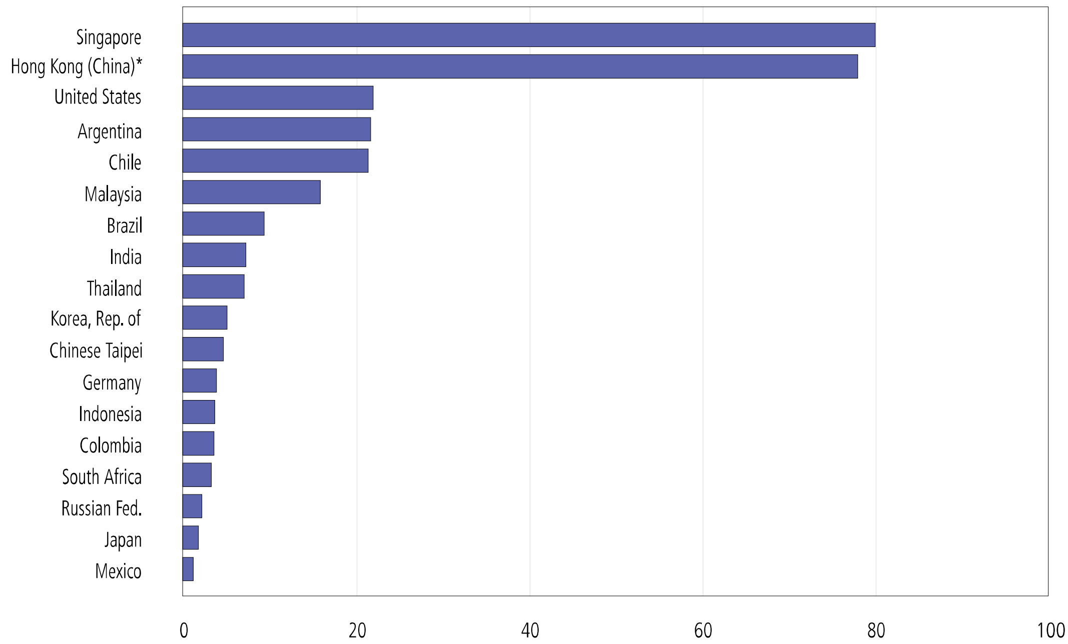
Source: USITC (1997).

[1]These statistics only provide an approximation to trade through the different modes of supply defined in the GATS.

[2]All cross-border trade figures for insurance services are presented on a net basis, i.e., imports comprise premiums paid for foreign insurance coverage, minus claims received from foreign insurers. Exports comprise premiums received from foreign policyholders, minus payments for claims.

[3]Affiliate trade of insurance services (via commercial presence) are not net of insurance claims paid, as these are unknown. Because of the differences in accounting and measurement, comparisons across modes and sectors are not very useful.

Chart 4. Share of Foreign-owned Assets in Total Banking Assets
(Percentage share of total assets)



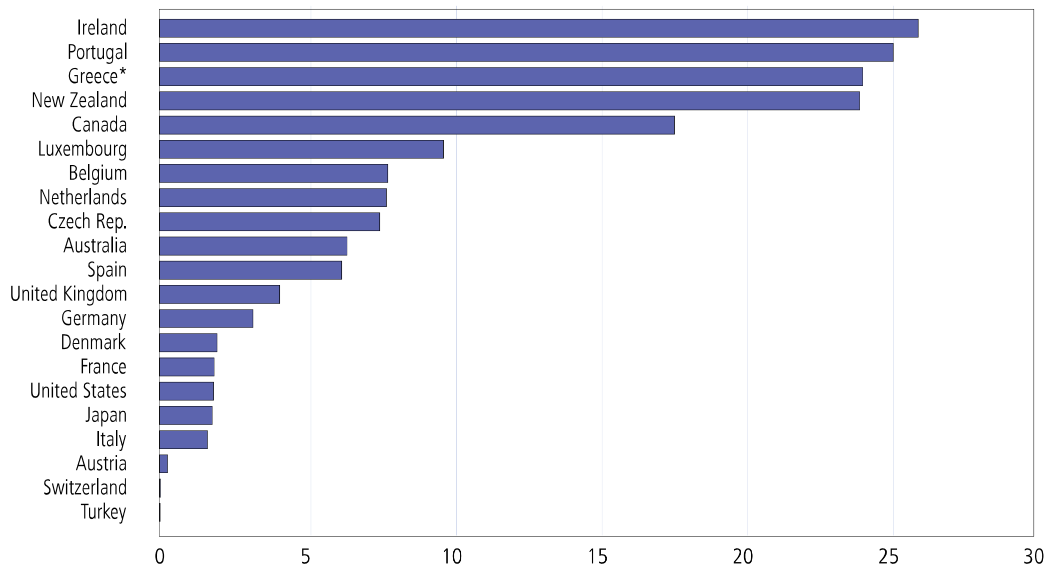
Source: Goldstein (1997).

*Refers to all overseas-incorporated authorized institutions.

Note: Figures refer to the latest available year (typically first half of 1990s).

Chart 5a. Foreign Market Share in Life Insurance Services, OECD Countries, 1987-1994 Average

(Percentage share).

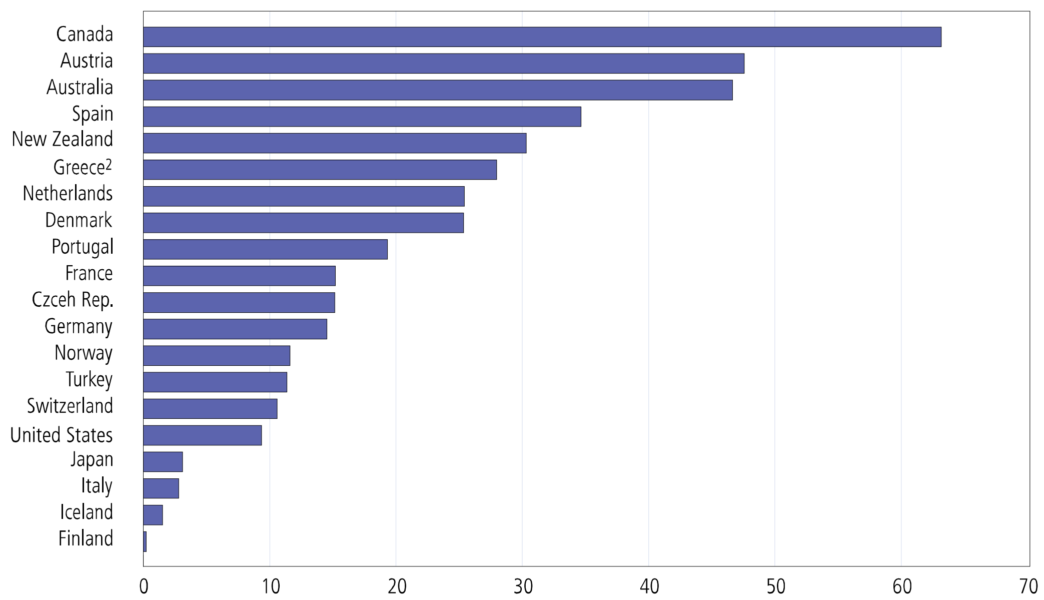


Source: OECD (1996).

*Net written premium basis.

Chart 5b. Foreign Market Share in Non-Life Insurance Services, OECD Countries, 1987-1994 Average[1]

(Percentage share).



Source: OECD (1996).

[1] Excludes social security.
[2] Net written premium basis.

ment trade in banking and securities services. Thus, in regard to expenditure (imports), establishment trade is over three times greater than cross-border trade. On the receipts side (exports), establishment trade is more than twice as large as cross-border trade. A similar comparison is not possible for insurance services. While cross-border trade figures are on a net basis, that is, include premiums received net of claims paid, establishment trade figures are on a gross basis with no deduction of claims paid.

The growing importance of commercial presence in foreign markets via subsidiaries, branch offices, or equity participation can be inferred to some extent from other indicators, without specific data on the modes of supply. The degree of foreign market penetration is highly variable among countries. Foreign ownership of banking assets, an indicator of commercial presence in this sector, fluctuates between zero and 80 per cent, with the latter share registered for Hong Kong (China) and Singapore (Chart 4). Foreign banks are also prominent in the United States, Argentina, and Chile, accounting for more than 20 per cent of banking assets. The banking sectors of many developing and some industrialized countries do not, however, feature high shares of foreign ownership. In the cases of Germany, Indonesia, Colombia, South Africa, the Russian Federation, Japan and Mexico, for example, foreign ownership of banking assets is less than 5 per cent of the total.

In the insurance sector, the share of foreign companies in the life and non-life insurance markets is a useful indicator of insurance services trade via commercial presence (Charts 5a and 5b). Judging from Chart 5a, the life-insurance market appears relatively closed. Only in Canada and in the relatively small industrialized countries of Ireland, Portugal, Greece or New Zealand, does market penetration by foreign suppliers exceed 10 per cent. The industry in most bigger industrialized countries is dominated by domestic companies, accounting for more than 90 per cent of total business. The market share of foreign firms is typically much higher for non-life insurance (Chart 5b). In Canada, almost two thirds of activity is in foreign hands, and in many other countries, the market share of foreigners exceeds 10 per cent. Very limited foreign penetration has occurred, however, in the non-life insurance markets of Japan, Italy, Iceland and Finland. To the extent that the large differences observed in levels of foreign penetration of the banking and insurance sectors among seemingly similar countries can be attributed to trade restrictions, there seems to be significant scope for increased trade in financial services following liberalization. But even if the observed differences in levels of foreign penetration cannot be explained by trade restrictions, trade may nevertheless expand over time as national economies become more integrated.

Liberalization of financial services trade is likely to affect all sectors, albeit not necessarily in a proportionate manner. Securities trade, wholesale banking and insurance, and reinsurance have already started to become “internationalized” and much of the anticipated trade growth is expected in these sectors. In retail banking and insurance (particularly life insurance), personalized business relations with domestic suppliers still predominate. The European Union, for example, has reported only slow progress in cross-border retail banking after liberalization (Financial Times, 1 July, 1997).

IV. The Benefits from Liberalization of Financial Services Trade

The magnitude of benefits from trade liberalization can be significant. This has been shown convincingly in the area of trade in goods. Sachs and Warner (1995), for example, found a positive correlation between openness and economic growth amongst developing countries. Other studies have shown that in the area of services, liberalization has resulted in significant economy-wide gains. Large price reductions in air transportation and certain telephone services, for example, have been associated with liberalization (Hoj, Kato and Pilat, 1995). It is by now well accepted that the multilateral trading system has played a key role in increasing income and growth via trade liberalization (Marvel and Ray, 1983; Moser, 1990; Francois, McDonald and Nordstrom, 1995 and 1996; Petersmann, 1997).

From an economic perspective, trade in financial services is no different from trade in other goods or services. Liberalization of trade in financial services can have strong positive effects on income and growth, driven by the same factors as in other sectors — specialization on the basis of comparative advantage, dissemination of know-how and new technologies, and realization of economies of scale and scope.[9] Moreover, liberalization improves financial intermediation, enhancing efficient sectoral, inter-temporal and international resource allocation.

A number of empirical studies have demonstrated that liberalization of the financial services sector, sometimes in conjunction with other reforms, can boost income and growth. Improved investment quality is often the main link between liberalization and growth. Levine (1996 and 1997) and King and Levine (1993) show that both developed and developing countries with open financial sectors have typically grown faster than those with closed ones. Jayaratne and Strahan (1996) find that deregulation of intrastate branching in the United States stimulated growth by 0.3-0.9 per cent of GDP for the 10 year-period following deregulation and 0.2-0.3 per cent thereafter.

The growth-stimulating effect of liberalization, however, is likely to be largest in the developing economies with less sophisticated financial systems (World Bank, 1997). In Ghana, for example, a combination of macroeconomic and structural reforms, including in the financial sector, boosted growth from minus one per cent in the 1970s to over 5 per cent in the 1983-90 period (Kapur *et. al.,* 1991). The economic success of Hong Kong (China) and Singapore has also been facilitated by internationally-oriented financial services sectors (Bercuson, 1995). The ranking of financial sector development in 53 industrialized and developing countries covered by the World Economic Forum (1997), which includes proxies for the opening and stability of financial systems, tends to confirm these findings. Whilst the 10 countries with the highest ranking grew, on average, by more than 4 per cent during 1990-95, the 10 countries with the lowest ranking posted an average growth rate of zero.

A. Assessing the Benefits From Financial Services Trade Liberalization

Trade liberalization can make the financial services sector more efficient and stable

There are a number of ways financial services liberalization can enhance the efficiency of the sector and reduce costs. Financial institutions can take advantage of economies of scale and specialize according to their comparative advantage. The emergence of specialized institutions in certain market segments, such as reinsurance, is a case in point. On the other hand, financial institutions can also broaden their spectrum of related services to take advantage of economies of scope. A number of financial institutions have, in fact, become global players, offering a broad range of financial services, not unlike department stores, where consumers can cover all their financial service needs.

Competition, including competition from international sources, forces companies to reduce waste, improve management and become more efficient. Costly rent-seeking activities, intended to gain or maintain preferential credit access or other privileges, are also less feasible in a liberalized environment. All these changes can reduce the operational costs of providing financial services. Competition then forces institutions to pass on cost-savings to consumers, and the spreads between lending and deposit rates, commissions or insurance premiums go down.

Liberalization can also improve service quality. With increased competition, financial institutions are more likely to be attentive to the needs of consumers, and to advise clients on how best to tailor financing packages to meet their specific needs. In large insurance projects, for example, support services for prevention, engineer-

[9] This encourages resources to move into the most productive activities, and improves productivity and the investment climate. Economies of scale allow lower average costs through the production of greater quantities of goods and services of the same type. Economies of scope allow cost reductions through the production of related goods or services.

ing and risk management can be very valuable, and competition is likely to improve such services (Carter and Dickinson, 1992). Depositors are also likely to benefit from better advice on investment strategies as financial institutions compete for their savings.

International trade can create significant benefits from the transfer of knowledge and technology. This includes knowledge on best practices in management, accounting, data processing and in the use of new financial instruments. Such benefits largely depend on the commercial presence of foreign banks and insurance companies (Zutshi, 1995; Agosin, Tussie and Crespi, 1995).

The range of available services is likely to increase with more open markets, as consumers seek out ways of optimizing their financing and insurance packages. The emergence of many new financial instruments should be seen from this perspective. In a liberal environment, companies can more easily choose the optimal combination of equity, bonds or loans to finance their activities. Derivatives allow economic agents to hedge against the risk from interest or exchange rate fluctuations. Edey and Hviding (1995) report that banks have started making more money from securities trade relative to traditional bank credits, as they have ventured into new areas of business. Companies switched to bond financing when this was cheaper than traditional credit-financing, and small savers started investing in various types of funds to benefit from higher returns than in classical savings accounts.

Trade in financial services can also reduce the systemic risk for small financial markets which are less able to absorb large shocks. Liberalization can help to deepen and broaden financial markets by increasing the volume of transactions and the spectrum of services, thus reducing volatility and the vulnerability to shocks. Shocks to the domestic market can also be absorbed more easily through the multinational "parents" of local branches or through reinsurance in international markets (USITC, 1993). Goldstein and Turner (1996) report that relatively high shares of foreign ownership have helped to maintain stable banking systems in Hong Kong (China), Chile and Malaysia.

Empirical evidence for OECD countries shows significant positive effects on financial sector efficiency associated with liberalization. Liberalization by the United States and other NAFTA signatories, and between European Union Member States is often quoted in this context (Harris and Piggot, 1997); and Box 3 illustrates the European Union experience in detail. Financial reform in OECD countries' banking sectors has resulted in improvements in most indicators of operational efficiency (Hoj, Kato and Pilat, 1995; Levine, 1996). Table 5 illustrates that interest margins have been constant, despite a likely increase in the average riskiness of bank lending (as liberalization eliminated the bias towards low-risk lending in many OECD countries). This suggests that risk-adjusted lending-deposit spreads have declined (Edey and Hviding, 1995). The same table shows that competition squeezed the ratio of gross income to capital. Competition forced companies to rationalize. Staff costs as a percentage of gross income have declined from an average of 40 per cent to 34 per cent between the early 1980s and the early 1990s. Lower costs and competition have also driven down

Table 5: Indicators of Operational Efficiency, Selected OECD Countries[1]
(In percent unless otherwise indicated)

	1979-1984	1985-1989	1990-1992
Net interest margin[2]	2.57	2.58	2.61
Gross income to capital[3]	0.76	0.73	0.65
Staff costs to gross incomes[3]	0.40	0.35	0.34
Average commissions[4]	0.50	0.33	0.25
Bid-ask spreads[5]	0.32	0.13	...
Automatic teller machines[6] (per million inhabitants)	*95*	*186*	*379*

Sources: Edey and Hviding (1995), Piggott and Harris (1997).

[1]Weighted average of commercial banks in United States, Japan, Germany (all banks), France, Italy, Canada, Belgium, Denmark (all banks), Finland, Greece, Luxembourg, Norway (all banks), Portugal (all banks), Spain (all banks), Sweden and Switzerland.

[2]Also including United Kingdom.

[3]Gross income defined as net interest revenues plus fee income. Income from "net interest and fees" is expressed as a ratio to capital rather than assets in this table because asset growth understates the growth of the total banking business.

[4]UK equities (per cent).

[5]Eurocurrency deposits (percentage points). Simple average of US dollar, pound sterling, French franc, Deutsche mark and Japanese yen. Average of daily spreads.

[6]Average of the United States, Japan, Germany, France, Italy, United Kingdom, Canada, Belgium, Denmark, Finland, Netherland, Norway and Sweden.

Box 3: Liberalization of Financial Services Trade in the European Union

The liberalization of financial services in the European Union (E.U.) has been part of the E.U.'s broader strategy to create a single market for goods, services, labour and capital. First efforts to create a single European financial market date back to the 1970s. At that time, some countries already removed their restrictions on capital movements. In the late 1980s, the creation of a single market was put at the top of the policy agenda of the then European Community. Meanwhile, a series of directives has completed liberalization of trade in banking, insurance and investment services.

Liberalization in the E.U. is based on three fundamental principals: first, minimum harmonization of standards at the E.U. level; second, mutual recognition of national laws and regulations between E.U. Member States; and third, supervision of companies in their (E.U.) country of registration (home country control). The regulatory framework has been completed by the entry into force of the Second Banking Directive in 1993, the Third Life and Non-Life Insurance Directives in 1994, and the Investment Services Directive in 1996. These directives are complemented by a series of other directives defining key concepts and establishing essential prudential requirements. This framework grants E.U. companies and incorporated foreign subsidiaries in the E.U. the right of operation in all E.U. countries when they are registered in just one ("Single Passport").

The single market initiative has strongly influenced the financial sector in the E.U. It has had its greatest impact on wholesale and corporate markets, whereas the impact on retail business in banking or insurance has been relatively small (until 1997). Cross-border branching by E.U. banks and credit institutions increased by 50 per cent between 1993 and 1996, with institutions taking advantage of the Single Passport. Third-country financial institutions branched out their activities from existing (E.U.-incorporated) subsidiaries rather than from their parent firms. Between 1993 and 1996, 43 foreign banks from 12 non-E.U. countries notified their intention to establish subsidiaries in the E.U. The single market has also intensified competition within the E.U. This has encouraged consolidation within the sector and a growing number of cross-border mergers and acquisitions. Profit margins have been squeezed and consumers have benefitted from lower prices.

The process of market integration, however, is still continuing. In the insurance sector, for example, a 1995 survey shows that considerable further benefits from liberalization are yet expected. Three quarters of the surveyed insurance companies expect better services and better value for money for corporate customers in the future. Sixty per cent also expect private customers to benefit from further market integration. Products will become more customized and flexible, with companies offering more complementary financial services. Telecommunication-based trading is on the increase. Consolidation in the financial service sector is likely to continue with positive effects on costs and efficiency. A new impetus to financial service trade within the E.U. can be expected from the introduction of the single currency. This will further lower transaction costs and improve transparency to the benefit of consumers.

Sources: Loheac, (1991); WTO, (1995 and 1997); Weidenfeld, (1996); and Financial Times, 1 and 9 July, 1997.

commissions by over 50 per cent during the same period. Automatic teller machines have become a common means of banking in all industrialized countries over the past decade. After liberalization of United States intrastate branching, the share of non-performing loans declined by 12-38 per cent, and the share of loans to "insiders" (connected lending) decreased by 25-40 per cent (Jayaratne and Strahan, 1996).

It must be recognized that there are going to be adjustment costs from liberalization, at least in the short-term. Less efficient financial institutions with high operating costs are likely to suffer from competition. Companies and sectors which previously benefitted from preferential access to credit may also lose. Some political costs to government are, therefore, likely to arise from resistance by these groups to liberalization. The transition period may also involve some economic costs as output declines in the previously privileged sectors and resources are reallocated. These factors suggest that it may be desirable to create safety nets to help firms and individuals deal with the costs of adjustment, but they should not put at risk the considerable benefits that flow from financial sector liberalization.

An open financial sector increases the incentive for better macroeconomic policies and regulation

There are strong reasons to believe that liberalization of financial services trade promotes better macroeconomic policies and government regulation. First, monetary policy is likely to improve. Credit and interest ceilings often serve as monetary policy instruments to control credit expansion and inflation in a closed financial system. Liberalization requires the replacement of such controls by indirect policy instruments, such as open market operations, to control liquidity. Indirect monetary policies are considered less distortionary and they help develop financial markets. Liberalization in the financial sector also puts pressure on governments to pursue prudent monetary, fiscal and exchange rate policies. By the same token, it may be argued that liberalization strengthens the incentive for governments to eliminate

Box 4: Singapore: Developing Towards an International Financial Centre

Financial sector development has been a key element in Singapore's impressive economic success over the past three decades. Since the late 1960s, the government has implemented a number of far-sighted policies and regulations to promote Singapore as an international financial centre. In 1968, the introduction of an international banking facility (Asian currency unit) initiated the rapid development of the Asian Dollar Market and Singapore's financial services sector. Extensive liberalization measures were taken in the late 1970s. Reserve requirements, credit guidelines, minimum cash ratios, interest-rate setting and exchange controls were either streamlined or abolished. In 1984, the Singapore International Monetary Exchange (SIMEX) became the first futures exchange in Asia. Tax concessions have helped, in particular, the development of the offshore market.

Singapore's attractiveness as a financial centre has been aided by its strategic location in a fast growing region, political and financial stability, a skilled labour force, and a strong commitment to openness. Consequently, the contribution of the financial services sector to the economy has increased from 5 per cent of GDP in 1978 to 12 per cent in 1995. Its contribution to employment has increased from 2.7 per cent of the total labour force to almost 5 per cent over the same period. The productivity of the financial services sector is about three times the national average.

Commitment to macroeconomic stability has been one of the most important factors explaining Singapore's success in building its financial sector. Gross domestic product has grown steadily at an average rate of 7 per cent over the past decades. Inflation, averaging 4 per cent, has been low and relatively stable over this period. The government budget has been in surplus, with moderate levels of expenditures and taxation. At the same time, the Monetary Authority of Singapore has balanced the need to liberalize and to maintain financial stability via a tight regime of prudential regulation and supervision. Today, Singapore has evolved into one of the world's most important financial centres and the fourth largest centre for foreign exchange trading.

Sources: Bercuson, (1995); Economist Intelligence Unit, (1996); Euromoney, (1994); Financial Times, (1996 and 1997); SICC, (1996); WTO, (1996a).

distortionary interventions and to introduce adequate prudential regulation and supervision of financial institutions. As discussed in more detail in Section V, financial institutions can be quite vulnerable to macroeconomic instability and inappropriate government regulation.

Much emphasis has been placed on the dangers for the financial system emanating from failures in the macroeconomic and regulatory sphere. The opportunities arising from using financial services trade liberalization as a pre-commitment device for complementary reform in these areas have been less well publicized. Pre-commitment to simultaneous financial services trade liberalization, and macroeconomic and regulatory reform can help bring about the benefits from more trade as well as from more financial and macroeconomic stability. In fact, credible policy pre-commitments to good and stable policy making are now considered key in explaining rapid growth and development (see, e.g., Borner, Brunetti and Weder, 1996; World Bank, 1997a). Moreover, there is evidence of beneficial links between open markets and economic stability. In Indonesia, for example, open financial markets are often credited with a beneficial effect on macroeconomic stability in the past decades (World Bank, 1997). It is reported that in Hong Kong (China) and Singapore (Box 4), a rapidly developing, open and well-regulated financial services sector, in tandem with macroeconomic stability, have together strengthened the economy and promoted growth.

Other benefits typically arise as distortionary domestic regulation is removed in the context of liberalization. Highly regulated financial markets, for example, often feature interest rate controls and credit ceilings for individual institutions. Lending interventions by governments funnel resources into priority sectors or the financing of government deficits. This can lead to distortions, especially when interest rates are below market level and require cross-subsidization from other lending. The inefficient use of scarce capital in some sectors results in credit-rationing and shortages in others. Some potentially profitable investments are, therefore, not undertaken. Alternatively, investors can seek financing in the informal economy from money lenders or relatives. This is often very costly and the scope of investments becomes relatively limited.

Liberalization of the financial services sector requires a reduction of these kinds of direct financial market interventions, especially when they do not address market imperfections. Their reduction (or elimination) changes relative funding costs, and capital is redirected away from previous "priority" sectors into investments with the highest (risk-adjusted) return. As a result, loan costs rise in sectors which previously benefitted from cross-subsidization. In other sectors, however, borrowing costs fall and a broader spectrum of investments can be financed. Small or less well-connected investors are likely to attain better access to the financial system when previously they could only borrow informally. This can have positive effects on income distribution.[10]

Liberalization may improve inter-temporal and international resource allocation

Open and more efficient financial markets affect savings and investment and improve the inter-temporal allocation of resources. Competition among financial institutions, the liberalization of interest rates, and the emergence of new savings instruments are likely to increase the returns to investments. This stimulates aggregate savings and higher investments which, in turn, boost growth. However, easier availability of credit, particularly consumer credit, can have the opposite effect and reduce aggregate savings. The empirical evidence is mixed. Hoj, Kato and Pilat (1995) do not find a significant effect from liberalization on aggregate savings in OECD countries. King and Levine (1993), however, report that the quantity of investment is strongly correlated with financial sector development. Data from the World Economic Forum (1997) also suggest a positive link between a strong financial sector with high-quality financial intermediation and the level of savings and investment in developing countries. The top ten countries in the Forum's ranking in terms of the quality of the financial sector record average levels of savings and investment of over 33 per cent of GDP, while countries figuring among the lowest ten have average ratios of 22 per cent.

Even if aggregate savings and investment are not always affected, liberalization of the financial services sector can have beneficial effects on individual income streams. Consumer credits, for example, facilitate more stable consumption over time ("consumption smoothing"). This can be a valuable choice for people with volatile incomes or for those hit by unemployment (Edey and Hviding, 1995). The rapid development of life insurance and private retirement insurance in recent years allow consumers to make their own provisions for old age, accidents and sickness (Skipper, 1996). Given rapidly aging populations in many countries, especially the industrialized countries, the beneficial effect which financial market liberalization has on opportunities for individual consumption smoothing and insurance should not be underestimated.

Liberalization of the financial services sector improves the potential for risk management and insurance. With access to international markets and know-how, financial institutions can provide the best possible investment strategies. Investors can, therefore, hedge or insure against many risks much better than in a closed financial market, and they are likely to adjust their portfolios accordingly. Very large and risky projects which promise a high expected rate of return can, nonetheless, go ahead more easily. The small trader who can receive better or cheaper insurance for his trade or investment activities, or who can hedge the related currency or interest rate risk may also be better off.

A further benefit of international trade in financial services is that it facilitates the flow of capital from countries with capital surpluses to those with shortages. This reduces the interest costs of investments in the latter countries.[11] Countries with high savings rates and relatively low returns to investment can export capital and thereby raise their returns. Financial services trade and the related capital flows should then equalize interest rates across countries. In fact, this seems to have happened in the E.U. in recent years (Edey and Hviding, 1995).

B. Why Trade Protection Is Not The Best Means to Attain Certain Policy Objectives

A number of reservations are sometimes expressed about trade liberalization and its effects, leading to the argument that liberalization should be arrested or even reversed. One concern is that foreign financial institutions will end up dominating the domestic market after liberalization and will abuse this position. If foreign suppliers are much more efficient than domestic ones, they will certainly be effective in penetrating a liberalized market. But there is no reason to assume that foreign suppliers will always be more efficient than domestic ones; their presence will in fact promote the efficiency of the domestic sector.

To the extent that domestic firms need time to adjust to new competition, trade liberalization can be phased in over time. Alternatively, if a government wishes to maintain a certain national presence in the domestic market, or wishes to provide temporary support to national suppliers, then from an efficiency perspective these objectives are better attained through fiscal incentives rather than through restrictions on trade, provided that the necessary fiscal resources can be raised through less distortionary means.

As for the question of the abuse of market dominance, competition between incumbent suppliers, both domestic and foreign, combined with the openness of the market for new entrants, should minimize the danger of abuse. If this were to prove insufficient, governments could deploy competition policies to help secure competition.

[10] It may be noted that similar positive distributional effects are likely to arise with more stable macroeconomic policy. This is because, in an inflationary environment, the less well-off are more likely to hold their assets in liquid form and are less able to hedge effectively against rising prices.

[11] Opening to foreign direct investment can, however, place domestic investors at a disadvantage compared to foreign investors in the same sector, on account of higher financing costs they may face in their operations.

Another concern relates to the potential for selective servicing by foreigner suppliers. It is feared that the latter will only service profitable market segments referred to as cherry-picking and that the resulting underprovision of retail banking in rural areas, for example, could then have detrimental effects on the economy. A question to be asked is whether underprovisioning is the result of government regulation, or the absence of certain underlying conditions, which makes certain market segments unprofitable. Some have argued, for example, that the absence of a well-functioning judiciary which can enforce claims makes lending to certain market segments very risky (World Bank, 1997a). If other reasons account for a need to promote financial service provisioning in certain markets, such as the cost of services in certain geographical regions or in relation to the purchasing power of low-income consumers, then alternative measures, such as fiscal incentives, would seem more appropriate than keeping financial markets closed. It is also possible to impose certain requirements, such as universal service obligations, on foreign as well as domestic financial institutions to ensure that social objectives are met without sacrificing the efficiency benefits of competition.

The presence of too many financial institutions is sometimes cited as an argument against liberalization in financial services trade. It is argued that the entry of more foreign firms would aggravate the problem of "overbanking" or "overinsuring". "Overbanking," for example, suggests that there are already too many banks trying to attract business in a given financial market. To the extent that this reflects concern about the viability of individual financial institutions, it is best addressed through prudential measures and measures to facilitate orderly exit from the market. In some countries, the licensing or liquidation regime for banks is deficient. This leaves the economy with a crowded banking sector featuring unsound banks. The right response, however, would be to permit an orderly consolidation in the financial system rather than protectionism. In Russia, for example, 450 out of 2,150 banks were wound down in 1995 and 1996. In Argentina, one quarter of the country's 200 banks were liquidated in 1995 and 1996. In Malaysia and Korea, mergers have been encouraged in recent years, to facilitate consolidation and increase the competitiveness of the financial sector.

Finally, it has been argued that liberalization of financial services trade worsens a country's balance-of-payments position. In principle, however, better access to international capital should ease payment pressures on countries. Initially, capital flows into the country as foreign financial institutions establish themselves. The resulting effects on growth and income are likely to generate income which more than pays, for example, for the remitted profits of foreign financial institutions.

V. The Challenges in Financial Services Trade Liberalization

A. Realizing the Full Benefits From Liberalization

It is by now well-known that liberalization of financial services trade requires careful preparation (Johnston, 1994; Goldstein and Turner, 1996; World Bank, 1997; BIS, 1997; UNCTAD, 1996). This section, therefore, tries to identify some key ingredients for the successful opening of markets in financial services. These ingredients include macroeconomic stability, and a constructive role by government in the regulation and supervision of the financial system.

Liberalization of financial services trade itself does not cause financial crises but, in the presence of inadequate macroeconomic and regulatory policies, it can exacerbate problems

A number of developing, transition and industrialized countries have experienced banking sector problems after deregulation and liberalization in the past 15 years. This has led some to conclude that it is liberalization that causes such problems. The anxiety is understandable if one considers the high costs of banking crises in some countries, which have burdened the government and the economy in the past (Table 6). The costs for government largely arise from bailing out banks so that depositors do not lose their money. Financial crises can also worsen unemployment and lower growth as the disruption in financial intermediation, at least temporarily, affects real economic activity. The most costly crises have been reported for Argentina and Chile in the early 1980s. But industrialized countries have not been spared. The United States savings and loan crisis of the late 1980s, for example, cost several per cent of GDP.[12] Furthermore, big losses in international trading incurred by well-known financial institutions have not helped to build confidence in open international financial markets.

What are the links between financial services liberalization and financial stability? The key causes for financial sector problems lie in unsound macroeconomic policies, inadequate government regulation and supervision, and inappropriate intervention in financial markets (Galbis, 1994; Harris and Piggot, 1997; Jacquet, 1997; various BIS publications). However, liberalization can increase the likelihood or the magnitude of financial sector difficulties. Excessively easy monetary policies, for example, can result in imprudent lending or encourage excessive foreign exchange exposure of banks, especially when "easy" money from capital inflows is not "sterilized" (neutralized) by monetary authorities. Inappropriate political interventions into lending decisions or the terms of loans can also work to undermine financial institutions, and render them ill-equipped to cope with the competitive pressures created by liberalization. These policy and management errors can cause a loss of confidence, and thereby ignite a crisis. Without adequate prudential regulation and supervision, financial institutions are more likely to act imprudently. Liberalization reduces the ability of institutions to "survive" poor performance, as rising competition reduces the rents and profitability of the sector. There may, therefore, be a need to improve macroeconomic management and to enhance the regulatory and supervisory capacity of governments with liberalization.

Financial services trade liberalization can also affect financial stability indirectly via its effect on capital flows. To the extent that trade liberalization stimulates capital inflows, the reversal of such capital flows in a period of confidence loss can worsen the situation of financial institutions and, thereby, magnify the adverse effects of poor macroeconomic and regulatory policies on financial stability. In developing countries, in particular, where the size and depth of financial markets is limited, capital outflows and confidence loss can be magnified by "herding" behaviour on the part of investors, still unfamiliar with these relatively new markets (World Bank, 1997). Speculative pressure can also exacerbate this situation. However, it may be noted that such capital movements typically respond to, rather than cause initial imbalances in economic and financial variables, hence strengthening the case for sound macroeconomic and regulatory policies (World Bank, 1997). Moreover, it is clear that policy predictability contributes to stability of capital flows.

It is important to note, however, that financial services trade liberalization and the opening of the capital account are two distinct issues. The GATS focuses upon seeking improvements in the terms and conditions of market access and non-discriminatory treatment for foreign suppliers of financial services, and not on the question of how far and how fast a government liberalizes capital account transactions. It is, of course, true that Members are required to allow international transfers and payments for transactions relating to their specific commitments under the GATS, some of which may involve capital account transactions. However, as discussed elsewhere, the GATS permits Members to take prudential measures aimed to ensure, among other things, the integrity and stability of the financial system. Moreover, in the case that a Member faces serious balance-of-payments and external financial difficulties or the threat thereof, it is entitled under Article XII of the GATS to maintain temporary restrictions

[12] Problems typically affect banking and securities rather than insurance. However, even in the insurance sector, four per cent of life insurance and two per cent of non-life insurance companies were "struggling" in the United States in the period 1990-95 (Desiata, 1996).

Table 6: The Public Resolution Costs of Selected Banking Crises

Country	Period of Crisis	Cost as percentage of GDP
Industrialized countries		
Finland	1991-93	8
Norway	1987-89	3-4
Sweden	1990-93	4-6
United States	1984-91	2-5
Transition economies		
Estonia	1992-94	1-2
Hungary	1991-95	10-11
Kazakstan	1991-95	3-6
Developing countries		
Africa		
Benin	1988-90	17
Côte d'Ivoire	1988-91	25
Ghana	1983-89	6
Senegal	1988-91	17
Asia		
Indonesia	1992-94	2
Malaysia	1985-88	5
Philippines	1981-87	3
Latin America		
Argentina	1980-82	55
Chile	1981-83	32-41
Columbia	1982-87	5
Uruguay	1981-84	7
Venezuela	1994-95	13

Source: Caprio and Klingebiel (1996a).

on trade in services in respect of which it has assumed commitments, including on payments and transfers for transactions related to such commitments.

More generally, it is a widely held view that capital account liberalization should not be introduced prematurely in the reform process of countries (Johnston, 1994; World Bank, 1997; BIS, 1997; Helleiner, 1997). A careful timing of capital account liberalization should also reduce the risk that capital controls will need to be reintroduced. The re-introduction of such controls can prevent rapid capital outflows in the short run but it undermines investor confidence and raises the risk premium required by investors, and hence increases the costs of capital in the long run (IMF, 1993). It may be noted that the effectiveness of capital controls should be carefully assessed, not only because of the capacity of economic agents to circumvent them, but also because they do not address the underlying problems that prompt their introduction. The International Monetary Fund is taking the lead in advising countries on policies relating to the capital account.[13]

Volatility of financial markets does not rise with well-conceived liberalization

It is sometimes claimed that liberalization has increased the volatility of capital flows, and thereby undermined the stability of the macroeconomy and the financial system. The above discussion has shown that after liberalization, capital flows can indeed become more volatile if optimism by investors first stimulates capital inflows which are later reversed when policy errors occur and expectations are disappointed. On balance, however, this claim is not supported by empirical evidence. Most indicators of financial volatility have decreased over the past decade in both industrialized and developing countries, even though during this period, many countries have liberalized financial markets and financial services trade. After an increase in exchange rate volatility in the mid-1980s (related to the strong appreciation of the U.S. dollar), real effective exchange rates have become more stable in most industrialized countries. Similarly, long term interest rates and stock prices have largely become less volatile (Edey and Hviding, 1995; Harris and Piggot, 1997). In developing countries, there is particularly strong concern about the volatility of capital flows and reserves. However, according to the World Bank (1997), volatility of capital flows decreased in the 1980s and 1990s, most notably in Asia and Africa. Foreign currency reserves have on average become more stable as well. Only Latin America has recorded a small increase in the volatility of private capital flows (World Bank, 1997).

[13] A detailed discussion of IMF activities in this field can be found in its publications.

Trade in derivatives is sometimes singled out as a particularly hazardous area. First, it should be noted that derivatives have allowed a considerable reduction in the risk and exposure of participants in the financial system. The hedging behaviour they permit helps reduce many risks, for example, regarding future exchange rates or interest rates.[14] Second, banks still face a much larger exposure to risk from their traditional activities than from derivatives (Harris and Pigott, 1997; Economist, April 27, 1996).

As mentioned before, liberalization in an inadequate policy environment can exacerbate the potential effect of shocks. However, liberalization also improves the ability to absorb them. Volatility of the terms of trade, international interest rates and exchange rates can put enormous pressure on the domestic economy and the foreign debt burden (Goldstein and Turner, 1996). Caprio and Klingebiel (1996) demonstrate that terms of trade shocks have exacerbated financial sector problems in many developing countries. "Contagious" or "domino" effects, with crises spreading from one country to the next, can become a concern. Whilst such concerns are very important, they cannot be solved by insulating the financial sector from trade. Interest and exchange rate fluctuations can be hedged better in an open international environment. A liberal trade regime allowing freer capital flows can ease short-term balance-of-payments problems. Furthermore, it has been argued above that the risks for the financial system (e.g., from a terms--of-trade shock) can be "insured" internationally with the help of foreign institutions. Goldstein and Turner (1996) have found, for example, that the presence of foreign institutions helped to stabilize financial systems in several countries in the wake of the 1994/95 Mexican crisis, and to prevent the spread of its effects to other countries.

B. The Importance of Macroeconomic Stability

Liberalization of the financial services sector requires a stable macroeconomic environment in order to yield its full benefits (USITC, 1993; Johnston, 1994; Edey and Hviding, 1995; Goldstein and Turner, 1996; World Bank, 1997).[15] Adverse effects of inflation, large budget deficits or unsustainable exchange rates on the macroeconomy and the financial sector can be compounded by international financial flows. The transition period to an open financial system is particularly critical. Policy errors are more likely, and more harmful, when financial markets are still under-developed, confidence in the new policy regime is still weak, and experience with the proper management of the macroeconomy and the financial sector is more limited. Commitment to disciplined macroeconomic management is, therefore, of great importance for successful liberalization.

Liberalization requires stability-oriented monetary policies

If financial institutions are to perform their role of intermediation adequately, they require an environment of low and stable inflation. This is best secured by predictable and stability-oriented monetary policies. Two of the main dangers from expansionary monetary policies for the financial system lie in imprudent lending and asset price inflation.[16] The typical transmission mechanism is as follows: monetary expansion permits banks to provide easy credit to companies or to the real estate sector at relatively low interest rates. This permits risky lending and inflates asset prices, for example, for land and buildings. With some delay consumer prices are likely to rise as well. To regain price stability, the monetary authorities then have to pursue more restrictive policies via higher interest rates. This dampens demand. Rising interest rates and slowing demand create a gap between credit costs and the return to investments. Asset prices then have to come down as returns on assets no longer cover the rising costs of credits any more. Oversupply (for example, as a result of overbuilding) can increase the necessary correction. If this correction takes place after a "bubble" has already emerged, banks may find themselves with a considerable share of non-performing loans in their portfolios. Foreclosure may then be of little help as the amount of credit exceeds the value of the asset.

The problem of bad loans is likely to be greater, the more "recklessly" banks have been lending beforehand. In an extreme case, banks can become insolvent and, if much of the banking sector is affected, a banking crisis can emerge. In fact, a number of developed and developing countries have experienced these so-called "macroeconomic banking crises". Such banking crises can create further dilemmas for policy makers. If the latter use the central bank to deal with problems in the banking sector by extending credit, price stability can be undermined further. A vicious cycle between loose monetary policies stimulating inflation, and banking sector problems stoking further inflation can develop. If policy makers let banks fail, this will often be extremely unpopular. It should be noted, however, that imprudent lending is unlikely to arise from inadequate macroeconomic policies alone. Typically, inadequate banking supervision is involved as well, an issue discussed below.

[14] Of course, they can also result in considerable losses if not used properly. This has been shown by the collapse of the Barings Bank or the troubles of Orange County, California.

[15] This is particularly important for banking and securities where the links with the macroeconomy are relatively close.

[16] Inflation can also raise exchange rate volatility, or discourage long-term lending.

Sound fiscal and exchange rate policies support financial stability

Sound fiscal policies are essential for stable monetary policies, and hence support financial sector stability. Large fiscal deficits, on the other hand, put pressure on monetary policies. High deficits drive up real interest rates and crowd out private investment from the capital market. High interest rates attract capital inflows and put upward pressure on the exchange rate. This, in turn, affects the competitiveness of producers, and depresses economic activity and growth. Temptations rise to cut interest rates in the short run and to finance the deficit via credit expansion. And the chain of events which can then follow is outlined above.

Exchange rate policies are also key in maintaining a stable financial system. A fixed exchange rate is sometimes used as an anchor for macroeconomic stability. It aims to increase the credibility of domestic policies and break inflationary expectations. However, monetary policies have to be kept very tight to avoid inflation and an overvalued exchange rate. If monetary policies are relaxed and if this causes inflation to rise and the international competitiveness of producers to decrease, problems can arise from the external side as well. Overvaluation hurts the export sector and thus depresses growth. This puts pressure on companies' balance sheets and also, indirectly, on the financial sector. More importantly, the exchange rate may have to be realigned when the currency is overvalued. Devaluation, in turn, raises the costs of external debt, as the value of obligations rise in domestic currency terms. If banks or companies have not hedged against their future foreign exchange liabilities in the faith that the exchange rate will remain stable, they may incur considerable losses.

A more flexible exchange rate policy may help to avoid some of these problems, but it too has its costs. Exchange rate volatility can quickly undermine confidence in domestic monetary policies and price stability. However, there is no universal recipe for appropriate exchange rate policies in the context of financial services trade liberalization, and much depends on individual country circumstances.

Macroeconomic stability helps to build confidence but caution is needed particularly during the transition period

The most important cost of inadequate macroeconomic policies and resulting financial sector problems is probably the weakening of confidence in government policy making and in economic liberalization. Liberalization of financial services trade is likely to be mentioned as a cause for financial sector problems, and liberalization is then made even more difficult to achieve in the future. This is a further argument why macroeconomic stability should be given a high priority in the context of financial services liberalization.

Macroeconomic management, however, is particularly difficult during the transition period. When liberalization commences, new investment opportunities and optimism about the future typically attract capital inflows. If not neutralized ("sterilized"), these can boost the money supply via deposits of financial institutions. As noted above, this can lead to imprudent lending and sow the seeds of a future crisis. Monetary management during liberalization is also complicated by structural changes in monetary aggregates. For example, better financial services will induce people to put more money into banks instead of holding cash. Savers may move out of savings accounts into long term deposits or other financial instruments. Such changes make monetary aggregates difficult to interpret and monitor. And if the wrong indicators are monitored, early-warning signals of monetary expansion might be missed.

A number of policy measures and institutional changes have been recommended to enhance macroeconomic stability and policy credibility. Measures to "sterilize" the impact of capital inflows on the money supply, and careful observation of several monetary aggregates should help to improve monetary management (Edey and Hviding, 1995; Johnston, 1994). An independent central bank and sound budgetary institutions are recommended to strengthen prudent monetary and fiscal policies (Eygffinger and de Haan, 1996; Moser, 1997 on central bank independence; Milesi-Feretti, 1996; World Bank, 1997a on sound budgetary institutions).

C. The Importance of Structural Reforms

Structural reforms are crucial in three areas for building an efficient and stable financial sector.[17] A first challenge is to prevent the use (and abuse) of the financial system for unrelated policy objectives. Secondly, government can play an important role in preparing financial institutions for a more competitive environment, and in creating a level playing field among institutions. Finally, government can contribute to the broadening and deepening of financial markets. Trade liberalization in the financial services sector can play a supportive role in relation to these structural reforms, through pre-commitment to market opening.

The financial system will suffer if governments rely upon quasi-fiscal interventions

Governments often burden the financial system with costs which should normally be borne by the budget. An example of such policies is directing credits to priority

[17] The efficiency-enhancing effect of some of these measures have been discussed in the previous section. Here the focus is on financial sector stability.

firms and individuals. This includes so-called "political lending" to public or private enterprises or to individuals. Banks may also be induced to set artificially low interest rates for such credits (Folkerts-Landau *et. al.,* 1995).

A related type of intervention aims at reducing government debt servicing costs. The most popular means is financial repression when financial institutions are forced to hold government debt at below market interest rates. Tanzi (1995) reports that some governments have reduced interest expenditure by several per cent of GDP via financial repression. Certain monetary policies can also raise central bank profits, which are then transferred to the budget and help reduce the deficit. Goldstein and Turner (1996) report that Mexico used reserve requirements to finance a considerable share of its fiscal deficit in the 1980s.

Such interventions can have adverse consequences. First, they can distort credit allocation and thereby reduce the growth potential of the economy. Secondly, they can undermine the stability of the financial sector. The costs of lending interventions have to be met by earnings from other lending activities. This increases the capital costs for investors and is, in effect, a tax on lenders. If financial institutions are unsuccessful in making a compensatory profit elsewhere, or are not allowed to do so, they can encounter financial difficulties. This undermines the stability of the financial system. Government may then have to bear the costs of its interventions indirectly, by paying for non-performing loans and rescuing failing banks (Johnston, 1994). In other words, burdening the financial system with quasi-fiscal tasks may only delay the costs for the budget. Alternatively, the central bank can bail out banks through extending credits. But this can undermine monetary stability. If governments want to pursue certain policy objectives and promote priority sectors, it is better to make the costs explicit in the budget rather than to "tax" the financial system.

Third, the elimination of such interventions creates a level playing field between domestic and foreign financial institutions. If trade in financial services is liberalized and such interventions continue, the burden is likely to fall disproportionately on domestic institutions (although in some circumstances the opposite can be true as well). If foreign institutions are better able to fend off pressure for political lending than their domestic counterparts, the latter are more prone to problems and weaker in the face of competition, even if they are well managed.

Governments can help in preparing financial institutions for a more competitive environment and in facilitating financial market deepening

Banks and other financial institutions may need to deal with their "inheritance" from the time of closed markets in the context of liberalization. Government can encourage institutions to reduce their operating costs, for example, through improving efficiency or investment in updated technology. Banks burdened by bad debt may require a partial or full takeover of such debt by government, especially if it has political origins. In addition, the merger or even closure of banks should not be hindered if this improves the efficiency and stability of the sector (BIS, 1997a). Such adjustments make financial institutions less vulnerable in a competitive environment. Privatizing state-owned financial institutions (and dismantling monopoly rights) may also be helpful in improving the competitive environment.

Regulations sometimes provide incentives for imprudent behaviour by financial institutions and distort incentives between different types of financial institutions (Harris and Piggot, 1997). This can be particularly damaging when financial markets are liberalized. Tax incentives, for example, can induce banks and investors to pour too much capital into one particular sector or to hold too much debt (e.g., in real estate). Perverse incentives have contributed to financial sector problems in a number of industrialized countries. In the Nordic countries, for example, real after-tax interest rates were very low or even negative at the time when the financial sector was liberalized. This fuelled a lending boom which, in turn, contributed to a later banking crisis (Drees and Pazarbasioglu, 1995).

Government can also promote a more stable and competitive environment by facilitating financial market deepening. One of the principal means of doing so is through selling treasury bills with different maturities. Permitting secondary markets and conducting open market operations further deepen financial markets, and provide both investors and government with valuable information on financial market trends. Financing public investment projects through financial markets or the regular commercial activity of pension and life insurance funds have similar effects. Holzmann (1996) found that such reforms deepened financial markets considerably in the first half of the 1990s in Chile.

D. Prudential Regulation and Supervision of Financial Institutions

In order to strengthen the stability of the financial sector, any financial institution that performs financial intermediation and manages risk needs adequate prudential regulation and supervision. Prudential regulation and supervision are particularly important for banks, as the failure of one or a few institutions can trigger a systemic crisis via the loss of confidence and spark a "run" on banks. This, in turn, can undermine macroeconomic stability and economic activity. Adequate prudential regulation and supervision become particularly important in open financial markets. The interdependence between macroeconomic and financial stability increases in a liberalized environment. At the same time, competition erodes the rents which have helped the sector absorb management or policy mistakes in the past. With liberalized financial services trade, effective supervision helps to improve the governance of financial institutions and detect problems at an early stage. This permits more timely corrective measures and thereby limits the probability and degree of financial sector difficulties.

Many studies have found that proper prudential regulation and supervision increase the stability of the financial system (Goldstein and Turner, 1996; Caprio and Klingebiel, 1996; UNCTAD, 1996). Experience also shows, however, that appropriate rules alone are not enough. They must also be implemented effectively. An interesting comparison can be made between Denmark and the other Scandinavian countries. All four of these countries experienced similar macroeconomic developments in the late 1980s. Good supervision coupled with stringent and enforced prudential standards prevented a crisis in Denmark, but deficiencies in this area contributed to financial sector difficulties in Finland, Norway, and Sweden in the early 1990s (Edey and Hviding, 1995). Improving prudential regulation and supervision (together with structural and macroeconomic reforms) has been key to resolving financial sector difficulties in many countries (Box 5).

Commitment to core principles for effective supervision puts liberalization on the right track

A number of core principles have been developed (the so-called "Basle principles") to promote effective banking supervision.[18] The Basle Committee on Banking Supervision (Basle Committee) has been instrumental in this task (Box 6). The core principles propose minimum standards for licensing, ownership transfer and liquidation. They also suggest prudential rules and requirements, supervision methods, and information and disclosure requirements for both domestic and cross-border activities. Although the principles have been tailored to banks, they basically apply to all types of financial institutions.[19] The core principles have the blessing of many governments and central banks in industrialized and developing countries. They are also fully consistent with multilateral obligations and commitments. Market-based and international monitoring can complement government supervision (see also BIS, 1996, 1997, 1997b, and Crockett, 1996).

Adequate entry and exit rules strengthen the health of the financial sector

Licensing, transfer of ownership and bankruptcy rules are very important in keeping unfit companies out of the financial sector. If banks are not licensed properly or if they cannot go out of business, unsound institutions are likely to emerge. This can create a "moral hazard" problem; to protect depositors, governments are tempted to bail out problem institutions which in turn can encourage such institutions to be less vigilant in their business.

Licensing rules should allow supervisors to reject potentially unsound market entrants. The Basle Committee supports a thorough scrutiny of shareholder suitability, financial strength, the legal and operational structure, and the expertise and integrity of bank management when considering license applications. Adequate information and prior approval from the home country supervisor should be secured for applications made by foreign banks. Supervisors should be able to prevent licensed banks from being transferred to unsuitable shareholders. Furthermore, major acquisitions and investments should not expose a bank to undue risk.

If banks or other financial institutions are in difficulties, corrective measures or, in the worst case, liquidation must be regulated. Supervisors must be able to request corrective measures which protect depositors and creditors. If internal measures and reforms do not succeed, and the institution is no longer viable, supervisors must be able to require a takeover, merger, or final closure of the institution.

Prudential rules and disclosure of information should encourage "good" banking

Prudential rules help financial institutions to measure and manage their exposure to risk. A number of important rules and indicators have been developed to measure such exposure. The most well-known is the minimum capital adequacy ratio of 8 per cent recommended by the Basle Committee. Many observers argue, however, that this ratio should be much higher in certain developing countries with high market volatility and political uncertainty (Goldstein, 1997). Table 7 shows that minimum capital adequacy ratios are typically 8 per cent or higher. It should be noted that actual risk-based capital ratios exceed the 8 per cent level considerably in many industrialized and developing countries, and reach almost 20 per cent in Argentina or Singapore.

[18] The Basle principles are voluntary minimum standards which allow for considerable diversity. They can be tailored to meet country circumstances and to permit a degree of experimentation on "what works best" (Lewis, 1993). The pros and cons of international regulation versus mutual recognition or "regulatory competition" are discussed in White (1996).
[19] Similar efforts are being made by the International Organization of Securities Commissions (IOSCO) and by the International Association of Insurance Supervisors (IASA) in the areas of securities and insurance.

Box 5: Five Case Studies in Banking Crisis and Reform

A number of countries in all stages of development have experienced financial sector crises in the past two decades. Liberalization itself has not been the cause of these difficulties, but sometimes has exacerbated them. Responsibility typically lies with an inadequate policy framework featuring poor macroeconomic management, excessive government interventions, ineffective prudential supervision, or a combination of these factors. At times, external shocks exacerbate the crisis. Many countries, however, have overcome their difficulties and stabilized their financial system through the implementation of sound polices.

(a) Chile (1981-83) Macroeconomic policies coupled with inadequate supervision had facilitated rapid credit expansion and excessive risk-taking by financial institutions after financial liberalization in the 1970s. A large share of loans went to undercapitalized and highly indebted enterprises. Rapid lending growth also caused share and asset prices to increase between 1977 and 1981. Towards the end of this period, a strong appreciation of the real effective exchange rate and high interest rates started to undermine the private sector's ability to repay its debt. When the debt crisis emerged in 1981, world interest rates increased, copper prices collapsed, capital inflows declined, and asset prices dropped. The economy went into a deep recession and a financial crisis unfolded. The government supported troubled banks with subsidies and recapitalizations, and liquidated three of them. Improvements in prudential regulation and supervision included a risk classification and early-warning system for prudential standards, a new banking law, and a streamlined deposit insurance scheme. Today, Chile features an open and stable financial system which has contributed significantly to its economic success.

(b) Estonia (1992-94) Liberal licensing policies after Estonia's independence allowed the proliferation of commercial banks without appropriate capital, banking skills, accounting methods, and internal control procedures. The lack of market discipline and effective banking supervision in the new economic environment increased the scope for risk-taking behaviour, unsound lending policies and fraud. A first crisis in 1992 to some extent had external roots, as the assets of Estonia's two most important banks were frozen abroad. In 1994, another crisis unfolded, triggered by the collapse of the second largest Estonian bank. The government responded decisively. The banking sector was consolidated with a mixture of liquidations, mergers, and some limited rescue operations. In order to restore public confidence in the banking system, depositors received some compensation, and supervision and enforcement capabilities were strengthened.

(c) Ghana (1983-1989) Government intervention in the form of negative real interest rates, credit controls, and political lending had created severe financial repression and disintermediation in the banking system up to the 1980s. Serious shortcomings in banking legislation and supervisory capacity contributed to the build-up of bad loans and bank losses. Macroeconomic instability and weak export prices put pressure on the enterprise sector and, indirectly, the financial system. With assistance from the World Bank and other sources, financially distressed banks were restructured. Banks adopted new prudential reporting systems and accounting standards, including internationally accepted auditing standards for external audits. Macroeconomic stability was restored by narrowing the public sector deficit, and by tightening monetary policies which helped reduce inflation.

(d) Malaysia (1985-1988) Malaysia experienced a considerable equity and property boom in the early to mid-1980s. Large fiscal deficits and monetary tightening put pressure on real interest rates and the exchange rate. When the asset price bubble burst in 1985, the financial sector incurred heavy losses, non-performing loans increased much beyond provisions for bad debt, and a number of financial institutions became insolvent. Weak management and internal controls had previously disguised the extent of the problem. Declining export prices and rising debt-servicing costs from the subsequent devaluation exacerbated the difficulties of financial institutions. The government responded by recapitalizing troubled banks. Prudential regulation and supervision were substantially strengthened, and fiscal retrenchment and currency depreciation helped to restore macroeconomic stability.

(e) Nordic Countries (late 1980s - early 1990s) Financial crises emerged after deregulation of the financial system without adequate strengthening of the regulatory and supervisory framework. This, coupled with inadequate risk management, tax incentives, and low-interest policies, resulted in imprudent lending and an asset and real estate bubble. In all three Nordic countries, the governments recapitalized or took over a number of large banks, issued guarantees, and improved internal controls and management. The regulatory framework was also strengthened: Norway, for example, tightened disclosure rules and prudential supervision, and developed prudential and macroeconomic early-warning indicators of potential problems.

Sources: De Castello Branco *et al.* (1996); Drees and Pazarbasioglu, (1995); Flemming *et al.*, (1996); Lindgren *et al.*, (1996); Sheng, (1996 and 1996a); Sheng and Tannor, (1996); Velasco, (1992).

Box 6: The Basle Core Principles for Effective Banking Supervision and the Role of the BIS

A large number of banking crises in both developed and developing countries since the 1980s have prompted central bankers and other supervisory authorities to improve the quality of banking supervision by establishing international banking standards. The Bank for International Settlements (BIS) has played a key role in this process, which culminated in the endorsement of the Basle Core Principles for Effective Banking Supervision by BIS members and a number of other supervisory authorities from developing countries.

The BIS was founded in Basle, Switzerland, in 1930, as an international financial organization to settle the problem of German reparation payments after the First World War. The BIS evolved into a forum for central bankers to discuss and coordinate banking regulations and to promote international financial stability in the 1970s and 1980s. Since the BIS is owned and controlled by central banks, it is often referred to as the "central bank of central bankers". Until recently, the BIS had 32 members, including the industrialized economies, most East European countries, Turkey and South Africa. In recognition of the growing importance of developing countries, the BIS invited 9 additional central banks including those from Russia and a number of Asian and Latin American economies to participate as shareholders in 1996. Apart from being a forum for international financial cooperation, the BIS is also a bank which held 7-8 per cent of global gold and currency reserves in 1997.

The Basle Committee on Banking Supervision (Basle Committee) was established by the central bank Governors of the G-10 in 1974 in the aftermath of serious disturbances in international currency and banking markets. Its objective was to formulate broad supervisory standards and guidelines in order to close gaps in the supervisory net, and to improve supervisory understanding and the quality of banking supervision. With the onset of the debt crisis in the early 1980s, its role became more prominent. In 1983, the Basle Committee issued the Basle Concordat on how to share the supervisory responsibility for banks whose activities cross national borders. In 1988, it established (voluntary) standards for capital adequacy, known as the "Basle capital ratios" or the "Basle Accord". In 1992, a first set of minimum standards for cross-border supervision were developed.

In October 1996, the Basle Committee and the Offshore Group of Banking Supervisors (which comprises supervisors of major offshore centres) released a report on the Supervision of Cross-Border Banking. It contains 29 recommendations for improving the supervision of banks operating beyond their national borders by home and host-country banking authorities. The report (building on the 1992 minimum standards) addresses, in particular, the need for home supervisory authorities to have full access to relevant information. It lays out procedures for the conduct of cross-border inspections by home-country supervisors at branches or subsidiaries of banks headquartered within their country of jurisdiction. Furthermore, the report aims at making home and host country supervision of all cross-border banking operations more effective. Recommendations for determining the effectiveness of home-country supervision, monitoring of supervisory standards in host countries and for dealing with corporate structures which create potential supervisory gaps are also included.

In April 1997, the Basle Committee, in close collaboration with supervisory authorities from 15 developing countries from Eastern Europe, Latin America and Asia, released the Basle Core Principles for Effective Banking Supervision. They are intended to serve as a basic reference point for supervisory authorities in all countries to apply to the supervision of banks within their jurisdictions. The document sets out 25 principles that represent the basic elements of an effective supervisory system, covering seven broad topics: (1) the preconditions for effective banking supervision; (2) the licensing and structure of institutions; (3) prudential regulations and requirements; (4) methods of ongoing banking supervision; (5) information requirements; (6) the formal powers of supervisors; and (7) cross-border banking. The Core Principles are minimum requirements and in many cases, may need to be supplemented by other measures to address particular conditions and risks in the financial systems of individual countries. They are expected to be endorsed by supervisory authorities around the world by October 1998.

Sources: Bank for International Settlements, (1996, 1997a and 1997b).

Table 7: Required and Actual Bank Capital Ratios, 1995

(Percentages)

Country	Capital adequacy ratio (national requirements)	Actual risk-based capital ratio
Hong Kong (China)	8[a]	17.5[b]
India	8	9.5[c]
Indonesia	8	11.9
Korea, Rep. of	8	9.3
Malaysia	8	11.3
Singapore	12[d]	18.7[d]
Chinese Taipei	8	12.2
Thailand	8	9.3
Argentina	12	18.5
Brazil	8[e]	12.9
Chile	8[f]	10.7
Colombia	9	13.5
Mexico	8	11.3
Israel	8	10.5[g]
South Africa	8[h]	10.1
Japan	8	9.1
United States	8	12.8

Source: Goldstein and Turner (1996).

[a]12 per cent for some banks, and 16 per cent for some nonbanks.
[b]Relates to locally incorporated authorized institutions and is on a consolidated basis.
[c]Relates only to public-sector banks.
[d]Based only on Tier 1 capital.
[e]Plus 1.5 per cent on national value of swap operations.
[f]Legislation now before Congress.
[g]1994.
[h]Higher ratios for some banks.

Note: Several European countries have significantly higher capital ratios. Definitions sometimes differ from those applied by the Basle Committee.

Another important element of prudential regulation is the assessment of and provisioning for non-performing loans. Even the best bank cannot guarantee that all loans are serviced fully at all times. Once non-performing loans are discovered, adequate reserves to cover them must be established. In many countries, however, guidelines on how to assess and make provisions for such loans are unclear or non-existent (Goldstein, 1997). Table 8 shows that many countries with relatively well-developed and liberal financial markets have a healthy coverage ratio of around parity (one). This means that provisions cover all identified non-performing loans.[20]

Excessive exposure to single borrowers can also cause difficulties for financial institutions. If exposure to one particular borrower is large and if this borrower becomes insolvent, a domino effect can then occur, causing insolvency of the bank itself. As a result, many countries have introduced rules limiting maximum exposure to one borrower. The limit is typically equal to or less than 25 per cent of capital but it is as low as 5 per cent in Chile (Table 9). Lending to related parties like bank managers or employees (so-called "connected lending") is restricted as well. Goldstein and Turner (1996) report that "connected lending" has been one of the reasons for financial sector problems in a number of developing and industrialized countries.

The supervision of multinational institutions poses particular challenges both in the home and host countries of such institutions. Normally the "home country rule" should be applied, where supervision of all operations worldwide is overseen from the country of registration. Global consolidated supervision, therefore, requires the application of prudential norms to both the domestic and foreign operations of financial institutions. In the host country, foreign operations should be subject to similar prudential inspection, and reporting requirements as domestic institutions, recognizing obvious differences such as branches not being separately incorporated. Contact and exchange of information between the supervisory authorities in home and host countries is crucial to successful cross-border supervision (BIS,

[20] It should be noted, however, that in some countries the coverage ratio is significantly below 1. Moreover, in certain cases, the share of non-performing loans is underreported, hence providing an overly optimistic "official" picture of provisioning for non-performing loans (Goldstein, 1997).

Table 8: Provisioning Coverage for Non-performing Loans

Country	Loan loss reserves(A) (percentage of total loans)[a]	Non-performing loans(B) (percentage of total loans)[b]	Coverage ratio (A/B)
Hong Kong (China)	2.2	3.1	0.7
Korea, Rep. of	1.5	1.0	1.5
Malaysia	9.6	8.2	1.2
Singapore	-	-	1.2
Argentina	10.2[b]	10.5	1.0
Chile	3.5	1.0	3.5
Colombia	1.9	2.5	0.8
United States	2.7	1.6	1.7

Source: Goldstein (1997).

[a]Average 1990-94.
[b]Average 1994-95.

Note: These figures may not all be strictly comparable.

1996). Given the particular challenge of supervising the largest global institutions, the "Group of 30", a forum of bankers, government officials and academics, has developed a list of supervisory standards designed especially for this group of financial institutions.

Effective supervision requires reliable information on the financial condition of an institution. A number of key requirements have been identified by the Basle Committee (BIS, 1997b). These include the availability of records, and regular publication of financial statements on the basis of accepted accounting standards. The information presented must be "accurate, complete and timely." It must also represent a "true and fair view of the financial position" (BIS, 1997b). Internal controls and external audits should further facilitate the monitoring of exposure to risk.

Deposit insurance schemes can provide a safety net against banking failure

Failure of financial institutions can occur despite adequate rules and effective supervision. If one bank fails, depositors may lose confidence in other banks as well. This can result in a chain reaction and affect even those institutions which are healthy under normal conditions. A deposit insurance scheme can help prevent such a chain reaction. Deposit insurance also has the positive side effect that insolvent banks can be allowed to fail more easily.

Deposit insurance, however, can cause moral hazard problems. Depositors are less likely to scrutinize their banks, and banks could take on excessive risks if monitoring by customers weakens. "Co-insurance" schemes which still leave some risk with depositors could limit this problem. Examples include ceilings on coverage by the deposit insurance, or coverage of only a certain percentage of deposits (e.g., 90 per cent) (BIS, 1997b).[21]

Know-how and technology development strengthen the financial system

Liberalization of financial services trade may call for better management, supervision, and enhanced technical capacity. Upgraded skills include knowledge about new financial instruments and their effect on risk. Technical requirements in terms of electronic data processing or payments systems also increase. Payments systems, in particular, may need updating for smooth clearance and settlement of ever-growing international transactions (Johnston, 1994). In 1995/96, daily transactions amounted to about US$ 6 trillion worldwide (Economist, April 27, 1996). This is more than world merchandise and services trade for the whole of 1996. Supervisors need to have adequate knowledge and means in order to adapt supervision to a new environment. International technical assistance can be very useful in this regard, especially in terms of sharing country experiences.

Market-based and international monitoring can complement government supervision

Market-based monitoring of financial institutions can increase their stability and complement government supervision (Crockett, 1996). If, for example, banks are rated regularly by private rating agencies, this provides valuable information to customers and regulators on their soundness. Banks then have an incentive to improve their performance to maintain business. Ano-

[21] More sophisticated suggestions are summarized in Goldstein (1997). The central bank can also take on the role of lender of last resort if deposit insurance is unavailable (Edey and Hviding, 1995).

Table 9: Rules on Maximum Exposure to a Single Borrower

Country	Maximum Exposure to Single Borrower
Argentina	15% of net worth for non-affiliated clients (25% if collateralized)
Chile	5% of capital and reserves (up to 30% if in FOREX for exports and if guaranteed)
Germany	25% of capital (after transition to European Union standards)
Hong Kong (China)	25% of capital (group of connected borrowers is treated as single exposure)
India	25% of capital and free reserves
Indonesia	20% of capital for groups of affiliated borrowers; 10% for a single person
Japan	20% of capital (up to 40% including guarantees and exposure through subsidiaries)
Korea, Rep. of	15% of capital
United States	15% of capital (10-25% state-chartered banks)
Venezuela	10% of paid-up capital and reserves

Source: Goldstein and Turner (1996).

ther method could involve the regular issuance of bonds by financial institutions with the price of bonds reflecting perceived health. Global financial institutions could also agree voluntarily to more stringent standards for their operations to protect the stability of the world financial system. Peer pressure or even penalties could help to enforce such standards (Financial Times, June 6, 1997).

International monitoring and assistance are also beneficial. For example, IMF surveillance of member countries' macroeconomic and financial positions and the recent introduction of data dissemination standards increase transparency. These mechanisms facilitate "early-warning" of financial sector problems.

E. Choosing a Liberalization Strategy

Given the considerable benefits and challenges arising in the context of financial services trade liberalization, a question to be addressed is how liberalization and accompanying reforms should be phased to maximize the benefits. There is no universal rule for an optimal strategy. However, there are a few key principles which seem to be uncontroversial. Liberalization cannot proceed effectively during periods of major political and economic turmoil, such as military conflict or hyperinflation. As discussed previously, conditions for successful liberalization include sound macroeconomic management, an adequate basic system for banking supervision and its effective implementation, and the absence of major political lending and other abuses of the financial system.

The discussion on the relative merits of a "big bang" versus a more gradual approach to liberalization is worthy of interest. A big bang, in which all necessary reforms are introduced simultaneously, or with great speed, has a number of advantages. Incomplete reform is avoided, and special interests have no time to organize against reforms (Galbis, 1994). Countries with low savings and a small, poorly functioning formal financial systems may reap considerable benefits from rapid liberalization (Johnston, 1994).

More gradual reforms can also have important advantages. If domestic savings are high and the financial system is effective, the risks from a hasty liberalization may outweigh the benefits from faster reforms. Furthermore, time is provided to adjust to the new conditions. Social and political consensus can be built, raising the credibility of commitments to reforms and the prospects for their successful implementation. Liberalization of financial services trade within the European Union, for example, was successfully introduced over a number of years with much emphasis on public persuasion regarding its benefits.

The question of how much macroeconomic stability and effective prudential regulation and supervision is needed at what stage of the liberalization process also depends on individual country circumstances. Countries with a record of macroeconomic crises and a weak regulatory and institutional structure may want to put more emphasis on getting the preconditions right before starting major liberalization efforts. Other countries will probably prefer more simultaneity in reform. It may be noted, however, that external liberalization could actually speed up necessary reforms in domestic policies and regulations. As discussed elsewhere, pre-commitment to liberalization, including within the framework of the GATS negotiations, can make a useful contribution to a coherent and sustained domestic reform programme.

VI. Conclusion

Modern economies depend on well-functioning financial sectors. Over the past decades, the provision of financial services has been growing strongly in virtually all countries. Financial services trade has also been expanding rapidly. Furthermore, technological progress, the development of new financial instruments and liberalization have increased the potential for further growth of the sector both domestically and internationally. This trend is likely to continue in the future, especially if further market opening takes place.

Significant benefits are likely to arise from liberalization of financial services trade. First, enhanced competition will improve sectoral efficiency, leading to lower costs, better quality, and more choice of financial services. Second, liberalization will improve financial intermediation and investments opportunities through better resource allocation across sectors, countries and time, and through better means of managing risks and absorbing shocks. Third, the opening of the economy will induce governments to improve macroeconomic management, domestic policy interventions in credit markets, and financial sector regulation and supervision.

However, a number of challenges must be met if countries are to reap the full benefits from trade liberalization. Macroeconomic stability, structural policies which minimize distortionary interventions in the financial sector and prudential regulation and supervision are key, otherwise liberalization can exacerbate problems in the financial sector or the economy. There is no universally applicable liberalization strategy, and individual country circumstances should determine the specific timing and sequencing of reform.

The GATS provides a valuable opportunity to commit to liberalization in the multilateral context. Through the MFN principle, commitments made under the GATS have the particular advantage of guaranteeing non-discriminatory treatment to all WTO Member countries, small and large alike. Commitments which tie in current levels of market access and future liberalization create security and predictability. A more certain environment is conducive to increased trade and investment. Moreover, commitments at the multilateral level tend to weaken the power of entrenched interests and facilitate the pursuit of welfare-enhancing policies. Liberalization commitments can also help to discipline future macroeconomic, structural and prudential policies at home. Finally, commitments in the multilateral context not only yield benefits from more liberal trade at the domestic level, but may also yield additional benefits from more open markets in other countries.

Financial services negotiations are presently ongoing in the WTO, with 12 December 1997 as the deadline. Regardless of the outcome, Article XIX of the GATS foresees further rounds of multilateral negotiations aimed at liberalizing trade in services, including financial services. The next round is scheduled to begin in 2000. While broad-based negotiations are due to start in little more than two years, and this may seem to mitigate the urgency of making commitments now, two considerations might be borne in mind. First, any postponement of commitments, whether to immediate liberalization or future liberalization, delays the benefits that accrue from such action. A widening gap between the liberalization of financial services and the multilateral commitments made by Members would add to uncertainty in the financial services sector. Second, even though services negotiations are to commence in the year 2000, it is reasonable to expect that, in the context of complex and possibly broad-based negotiations covering liberalization as well as other aspects of WTO rules, they will take some years to conclude. New commitments are unlikely to be made in the intervening period. In the world of financial markets, five years or more is a very long time. Finally, lack of progress in this key sector is likely to have negative effects on the credibility of the multilateral trading system as a whole.

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Appendix 1: The Coverage, Level and Type of Current GATS Commitments in Financial Services

This Appendix examines the nature and extent of market access and national treatment commitments in financial services undertaken by WTO Members in the GATS so far, with a view to identifying in a general manner where scope might exist for further liberalization efforts. It will be recalled that in the Uruguay Round, although many governments undertook commitments in financial services, the results were judged unsatisfactory by some countries, and it was agreed to extend negotiations for a further 18 months. In 1995, forty-three Members improved on their earlier commitments, in some cases substantially, but it was again impossible to reach a permanent MFN-based agreement involving all major players. The interim agreement of 1995 terminates on 12 December 1997, and negotiations are again in progress, with the same objective of a permanent MFN agreement.

The WTO analytical database permits a more detailed examination of scheduled commitments than previously feasible, but cross-country and cross-sectoral analyses require interpretative assumptions

The analysis that follows examines commitments currently in force as a result of negotiating efforts to date, both in 1993 and in 1995. It uses information generated by an analytical database currently under development in the WTO Secretariat. The database is able to generate analytical information on the market access and national treatment commitments undertaken by Members in their national schedules. It can retrieve all entries in Members' schedules of specific commitments.

It must be emphasized that the interpretation of entries in the schedules is not always straightforward. Difficulties arise from the need to make cross-country or cross-sectoral analysis possible in a context where national schedules have not always been constructed in a uniform manner. Certain judgements have been necessary, and this should be borne in mind in interpreting the results reported below. For example, where Members have used their own classifications of financial services, it has been necessary to try to match these with the classification provided in paragraph 5(a) of the Annex on Financial Services (Appendix 2). Where Members have scheduled their commitments in accordance with the Understanding on Commitments in Financial Services, it was necessary to reformulate the content of the Understanding into a hypothetical schedule.[22] In taking account of horizontal measures in the schedules — that is, of measures applying to all sectors — the relationship between these measures and sector-specific entries was not always clear. A similar problem sometimes arose with respect to "sector-horizontal" measures applying to all financial services or to its major sub-sectors.

As noted earlier, limitations on market access should be scheduled in terms of one or more of the six measures specified in paragraph 2 of Article XVI.[23] Not all the entries of Members were explicit enough to be readily classified along these lines, and judgements had to be made. Moreover, some entries did not appear to fit any of the Article XVI limitation categories, so an additional category of "residual" measures was created. Some such measures were clearly of a prudential nature, and should not therefore have appeared in the schedules at all. The absence of an agreed list of what constitutes prudential measures, however, meant that such clarity was not always attained. More generally, a lack of legal clarity would appear to have been introduced where Article VI-type measures involving domestic regulation have been scheduled as Article XVI market access limitations.

In the case of national treatment limitations, a categorization of typical measures was developed, since Article XVII does not contain a statutory list of national treatment departures. A residual category was also established for other national treatment measures, and for entries that did not appear to constitute departures from national treatment. In some cases, adjustments were made where measures that seemingly should have been classified as national treatment limitations appeared in the market access column, and vice-versa.[24] It is noteworthy that the residual categories contain a very large number of measures. While to a degree this may suggest limitations in the analytical approach adopted, it also raises the question whether the approach by Members to scheduling may need to be revisited at some future date.

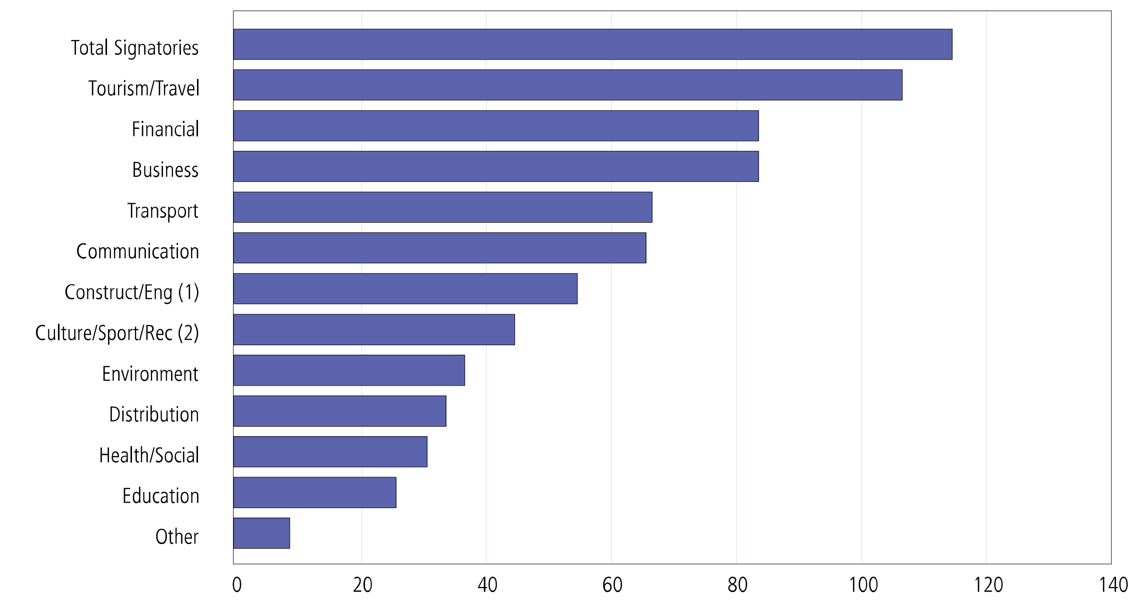
Given that the database is still at an early stage of development, and that closer examination may lead to revisions in the judgements applied, the analysis below

[22] Twenty-six Members made financial services commitments in accordance with the Understanding. The Understanding contains a series of explicit commitments that bear directly on the interpretation of the content of schedules.

[23] See page 4 for the list of restrictive measures on market access provided in Article XVI.

[24] As noted earlier, measures inconsistent with both Article XVI and Article XVII should be inscribed in the market access column of the schedule (Article XX:2).

Chart 6. Specific Commitments under the GATS, by Services Sector
(Number of countries)



(1) Construction and Related Engineering Services.
(2) Recreational, Cultural and Sporting Services.

has been conducted mainly on the basis of country groupings. Further analysis of the commitments of individual countries, and for that matter, a cross-country comparison of the commitments on a country-by-country basis, will need to wait until the data are further scrutinized.[25]

The schedules of commitments are analyzed in terms of sectoral coverage, the level of commitments and the types of limitations applied on market access and national treatment

The analysis of the sectoral and sub-sectoral coverage of the GATS schedules in financial services is relatively straightforward. Each Member is allowed to choose the service sectors and sub-sectors in which to make commitments, and these commitments can be then compared with the total population of all possible commitments. Even here, however, judgements are sometimes necessary as to the precise coverage of particular entries in the column of the schedule describing the sector or sub-sector to which a commitment applies. The analysis encompasses each of the four modes of supply, as these are entered separately in the schedule. Sectoral disaggregation in the analysis is not as detailed as the classification in the Annex on Financial Services.

In examining the level of commitments, three distinctions are made. These are between full bindings, designated as a "none" entry against a particular mode of supply in the schedule, "partial" bindings, which refer to those entries which are conditioned in some way by a limitation,[26] and no bindings, which are designated "unbound" against the relevant mode.

The analysis of the levels of commitment focuses a good deal on market access limitations. The reason for this is not only because of the importance of market access limitations for foreign service suppliers at the stage of entry (pre-establishment), but also because any measures inconsistent with both Article XVI (market access) and Article XVII (national treatment) are scheduled in the market access column of the schedule in

[25] The database has not been formally authorized or endorsed by WTO Members and therefore the responsibility for any errors or omissions lies entirely with the authors. Refinements that might be made to the database in the future include, for example, further analysis of residual categories and analysis of the relative restrictiveness of measures, including through quantification.

[26] The database attempts to categorize partial commitments into those that are partial by modal coverage, those that are geographically partial, those that are sectorally partial, and those that are fully bound in each of the above dimensions, but which carry other limitations, such as upon the number of suppliers permitted. For reasons of space, and because of the need to perfect analysis along these lines in the database, these categorizations have not been included in this study, except for a general categorization (i.e., partial, full or no commitments) within each mode.

accordance with Article XX:2. As a consequence of this scheduling convention, the entry "none" in the national treatment column may not necessarily be taken to mean a full commitment to national treatment in cases where market access limitations also constitute limitations on national treatment. This makes it difficult to assess the degree of commitment to national treatment.[27]

The examination of the types of limitation scheduled in the market access and national treatment columns of Members' schedules seeks to identify what types of restrictions are preferred by governments in what modes of supply and for which services. Once again, primary focus is upon market access measures, for the reasons noted above.

Some 25 Members (counting the European Union as one) have established schedules of MFN exemptions under Article II of the GATS.[28] MFN exemptions allow Members to discriminate among their trading partners in a manner that would otherwise be prohibited. Where such exemptions have been registered, the policy treatment indicated cannot be entered in the schedules of commitments, as market access and national treatment commitments offered in the schedules must be provided on an MFN basis. Twenty-five Members have taken MFN exemptions. In some cases, exemptions cover preferential treatment in regional sectoral agreements. In many cases, however, they are intended to secure, or permit a demand for, bilateral reciprocity with respect to market access. It should be noted, that the exemptions may be reconsidered in the context of the negotiations scheduled for completion in mid-December 1997.

The analysis that follows is accompanied by several summary tables. These tables (and Chart 6) have been extracted from a set of more detailed tabulations. For reasons of space, the latter tabulations could not be reproduced in this study. It should be noted that the simple descriptions of Members' commitments presented below in terms of coverage by sector, mode and measure provide a very partial picture. Among the reasons for this are differences in the relative importance of sub-sectors, differences in the relative significance of modes, and differences in the impact of particular limitations on market access and national treatment. These shortcomings could only be addressed in a systematic fashion if more detailed quantitative information were available.

Governments have made more commitments in financial services than in any other sector except tourism. However, the number of limitations maintained, on market access or on national treatment, is higher than in several other sectors and the level of commitments undertaken varies considerably, both as between Members and as between different sub-sectors of the industry

Eighty-four WTO Members had made commitments in financial services as of mid-1997 (Chart 6).[29] The number of Members making commitments in this sector was second only to tourism and travel related services.[30] Of the 84 Members making financial services sector commitments, 71 (or 85 per cent) made commitments in insurance services and the same number in banking and other financial services, with some countries making commitments in only one of those two major sub-sectors (Table 10).

A number of developing and least developed countries have been more willing to make commitments in banking and other financial services than in insurance services.[31] This may be due to the higher priority placed on opening the banking sector to foreign services and investment. On the other hand, many of the Caribbean countries and some other island economies with off-shore financial businesses (such as Bahrain and Malta) were more inclined to make commitments in insurance services. Most of the latter undertakings were in reinsurance, which is one of the most "internationalized" of all financial services.

The coverage of sub-sectors is variable (Table 10). In insurance services, life insurance was covered by 59 Members and non-life by 61 Members. Among the group of countries which made commitments in insurance services, only three had no commitments in life insurance, while one country had no commitments in non-life insurance services. Sixty-seven Members made commitments in reinsurance, while only 45 made commitments in insurance intermediation and 41 in services auxiliary to insurance.

In banking and other financial services, 67 countries made commitments in acceptance of deposits and other repayable funds from the public. The same number made commitments in lending of all types. This is in contrast

[27] It is not always evident from the entries in the market access column which measures simultaneously constitute limitations on national treatment and which do not. The extent to which a measure in the market access column inconsistent with national treatment would affect the commitment indicated in the national treatment column is also debatable. Given this ambiguity, the tables on the levels of commitment in national treatment are based on the actual entries in the national treatment column, and no account has been taken of the measures scheduled in the market access column. Clearly, this approach distorts the results of the analysis. For a discussion of these issues, see Mattoo (1997).

[28] The Members concerned are Australia, Brunei Darussalam, Canada, Colombia, El Salvador, European Union, Honduras, Hungary, India, Indonesia, Israel, Liechtenstein, Mauritius, Pakistan, Peru, Philippines, Singapore, South Africa, Swaziland, Switzerland, Thailand, Turkey, United Arab Emirates, United States, and Venezuela.

[29] For the present purposes, twelve of the fifteen European Union member states have been counted as one, while three other member states (Austria, Finland and Sweden) have been counted individually.

[30] In the analysis below, the results of the negotiations on basic telecommunications concluded in February 1997 have not been taken into account.

[31] A number of observations such as this one are not discernible from any of the tables presented with the text. As indicated above, the information upon which they are based is available from the WTO Secretariat in a statistical supplement to the present study.

with 39 countries making commitments in settlement and clearing services and 38 countries in trading in derivatives. Virtually all countries making commitments in financial services included undertakings on both acceptance of deposits and lending. A number of countries made commitments only in selected non-core businesses of banks or other financial institutions.

Of the 16 sub-sectors listed in the Annex on Financial Services, Members on average made commitments in about 10 of them. The coverage was more comprehensive among developed countries compared to other groups (transition, developing and least developed countries), but it is worth noting that some of the least developed countries (Gambia, Malawi and Mozambique) covered all banking and other financial services (excluding insurance). Sierra Leone covered all financial services in its schedule without exclusion.

In general, it can be expected that higher levels of commitment would be made in more "internationalized" financial services (such as reinsurance or services to the corporate sector), or the "core" services of banks and other financial institutions, compared to domestically-oriented or new services. This expectation is borne out by the observed pattern of commitments by Members.

In Tables 11 to 15, the level of commitment is characterized by the distinction between full, partial and no commitments in the total number of possible commitments for each sector or sub-sector, and in respect of each mode of supply. The percentage shares of the three levels of commitment are calculated on the basis of all sectors and sub-sectors which could be scheduled for each mode of supply, in respect of each Member or group of Members. In other words, the levels of commitment are calculated as the percentage shares of full, partial or no commitments in the total number of possible entries by service and by mode of supply for the 84 countries, regardless of whether certain sub-sectors were scheduled. For example, a Member which did not schedule "life insurance", would be considered as having entered "unbound" in its schedule in all four modes for this service category.

It should be emphasized that this distinction between "full" and "partial" bindings is a very crude one. Although simple sectoral comparisons suggest a relatively low share of "full commitments" in the financial services sector compared to some other sectors such as tourism, it is necessary to consider the nature of the limitations which have been maintained, and the reasons for them, before any conclusions can be reached about their real impact on market access or their implications for liberalization in this sector. It is not surprising, for example, that the schedules contain a large number of limitations or prescriptions on the type of legal entity financial services providers may establish, or on the participation of foreign capital (see Table 16). In a sector as heavily regulated and as politically sensitive as this, the number of countries ready to make commitments is much more striking than the fact that they have felt it necessary to maintain some specific controls on foreign suppliers.

The combined percentage share of full and partial commitments in mode 1 was the lowest among the modes, and mode 2 was the second lowest (Table 11). Mode 3 contained the highest combined share of full and partial commitments. However, the differences were relatively small. This pattern was generally observed across the various sub-sectors of financial services except for reinsurance and provision and transfer of financial information, for which the difference in the levels of commitment between the modes were even less significant. This would be expected, since the latter services are commonly supplied on a cross-border basis from the world's major financial centres.

It might be expected that stronger commitments would be made under mode 3 compared to mode 1 or mode 2 in financial services, due to relatively strong supervisory concerns on the part of financial regulators and the knowledge and technology transfers expected from such trade. Although prudential measures can be taken regardless of GATS obligations, imposing a requirement on foreign financial service suppliers to establish within the territory of the country might make it easier to exercise supervision and control over the supply of services. The observed distribution of commitments generally confirms the notion that governments prefer commercial presence to cross-border supply, but the differences are not very great.

As would be expected, developed countries on average have the highest levels of commitment, followed by transition countries, developing countries and least developed countries (Tables 12-15). An exception to this pattern is the banking and other financial services sectors of least developed countries. The highest proportion of "full" commitments was obtained across all modes in banking and other financial services in the case of this country group.

Most market access limitations that could be properly analyzed fell under mode 3, but many scheduled limitations could not be allocated according to the permitted categories

Tables 16-18 examine market access limitations in terms of the six types of limitations listed in Article XVI:2. A significant feature of this analysis is that a very large number of entries could not be allocated to one or other of the six categories of market access limitations. More than half of the limitations registered under modes 1 and 2, about one-fourth of mode 3 entries and a little less than half the mode 4 entries could not be

Table 10: Specific Commitments by Sub-sector

Sub-Sector	Number of countries[1]	Percentage share of countries
All insurance and insurance-related services	71	85
Direct insurance	62	74
Life	59	70
Non-life	61	73
Reinsurance and retrocession	67	80
Insurance intermediation	45	54
Services auxiliary to insurance	41	49
Banking and other financial services	71	85
Acceptance of deposits and other repayable funds	67	80
Lending of all types	67	80
Financial leasing	55	65
All payment and money transmission services	60	71
Guarantees and commitments	55	65
Trading for own account or for account of customers	59	70
Money market instruments	51	61
Foreign exchange	53	63
Derivative products	38	45
Exchange rate and interest rate instruments	42	50
Transferable securities	58	69
Other negotiable instruments and financial assets	40	48
Participation in issues of all kinds of securities (Underwriting)	55	65
Money broking	42	50
Asset management	53	63
Settlement and clearing services for financial assets	39	46
Advisory and other auxiliary financial services	57	68
Provision and transfer of financial information	46	55

[1]Maximum = 84 countries which made commitments in financial services.

Table 11. Financial Services Commitments as Compared to Other GATS Sectors

(In percent of commitments)

	Market Access Commitments		*National Treatment Commitments*	
	Financial services	Other services sectors[1]	Financial services	Other services sectors[1]
Mode 1				
Full[2]	9	8	11	7
Partial[3]	14	6	11	6
No[4]	77	87	78	88
Mode 2				
Full	15	11	16	10
Partial	18	8	15	7
No	67	81	69	83
Mode 3				
Full	6	5	5	6
Partial	37	16	37	12
No	57	79	59	82
Mode 4				
Full	1	0	0	1
Partial	40	20	39	17
No	59	80	60	82

[1]Includes unweighted average of business services, communication services, construction and related engineering services, distribution services, educational services, environmental services, health services, recreational, cultural and sporting services, transport services and other services not included elsewhere.

[2]"Full" means no limitations to market access or national treatment.

[3]"Partial" means that a country has made commitments to grant market access or national treatment, however, subject to certain limitations, either on the entire mode or a part of the mode.

[4]"No" means no commitments in market access or national treatment.

Table 12 - Commitments in Financial Services Under Mode 1, By Country Group

(In per cent of commitments)

		Developed countries	Transition countries	Developing countries	Least developed countries	Average for all countries
Market access:						
All insurance and related services	Full	13	11	14	10	14
	Partial	56	43	19	0	26
	No	31	46	67	90	60
Banking and other financial services	Full	0	8	11	58	12
	Partial	36	18	14	17	18
	No	64	74	75	25	69
National treatment:						
All insurance and related services	Full	9	38	18	10	17
	Partial	48	15	12	0	19
	No	43	46	70	90	64
Banking and other financial services	Full	2	22	13	58	15
	Partial	27	13	11	17	15
	No	71	65	75	25	70

Table 13 - Commitments in Financial Services Under Mode 2, By Country Group

(In per cent of commitments)

		Developed countries	Transition countries	Developing countries	Least developed countries	Average for all countries
Market access:						
All insurance and related services	Full	11	14	18	17	16
	Partial	52	40	20	0	26
	No	37	46	61	83	57
Banking and other financial services	Full	20	8	21	58	22
	Partial	74	39	13	17	26
	No	6	52	67	25	52
National treatment:						
All insurance and related services	Full	7	46	22	20	21
	Partial	44	15	11	0	17
	No	49	38	68	80	62
Banking and other financial services	Full	11	47	19	58	23
	Partial	65	12	11	17	23
	No	24	41	70	25	55

Table 14 - Commitments in Financial Services Under Mode 3, By Country Group

(In per cent of commitments)

		Developed countries	Transition countries	Developing countries	Least developed countries	Average for all countries
Market access:						
All insurance and related services	Full	1	9	7	0	6
	Partial	89	77	46	33	55
	No	9	14	47	67	39
Banking and other financial services	Full	7	8	4	25	9
	Partial	88	65	40	58	52
	No	5	28	51	17	39
National treatment:						
All insurance and related services	Full	0	10	9	10	7
	Partial	76	69	39	27	48
	No	24	21	52	63	44
Banking and other financial services	Full	0	10	6	25	6
	Partial	79	58	42	59	52
	No	21	32	52	17	42

Table 15 - Commitments in Financial Services Under Mode 4, By Country Group

(In per cent of commitments)

		Developed countries	Transition countries	Developing countries	Least developed countries	Average for all countries
Market access:						
All insurance and related services	Full	0	0	0	0	0
	Partial	91	86	48	33	58
	No	9	14	52	67	42
Banking and other financial services	Full	0	0	0	25	2
	Partial	95	72	43	59	56
	No	5	28	57	17	43
National treatment:						
All insurance and related services	Full	0	0	0	0	0
	Partial	77	79	45	33	53
	No	23	21	55	67	46
Banking and other financial services	Full	0	0	0	8	1
	Partial	80	67	43	75	55
	No	20	33	56	17	44

Table 16: Restrictive Measures on Market Access in Financial Services (GATS, Art XVI:2), by Mode of Supply)

	Mode 1	Mode 2	Mode 3	Mode 4
Total	249	352	3111	1454
Number of suppliers	12	39	346	4
Value of transactions or assets	10	10	327	34
Number of operations	6	20	142	4
Number of natural persons	0	0	51	559
Types of legal entity	0	0	602	0
Participation of foreign capital	0	0	387	26
Other market-access measure	151	217	759	633
National treatment limitation	70	66	497	194

properly categorized. In some cases, this was because of a lack of specificity in the description of the measure. In others, it was because the measure itself simply did not correspond to any of the categories. While a closer analysis might lead to a reduction in this large residual of unclassified measures, much uncertainty would remain.

Turning to the measures that could be classified, a vast majority of them were inscribed in mode 3, followed by mode 4 (Table 16).[32] Almost 80 per cent of all limitations (excluding "other" measures) in market access were taken in banking and other financial services (excluding insurance) (Table 17). Furthermore, over 60 per cent of all measures were concentrated in mode 3. By contrast, there were very few limitations scheduled in modes 1 and 2, as countries have often kept those modes either fully bound or unbound.

Limitations on the type of legal entity predominated, followed by limitations on foreign equity participation

In view of the predominance of mode 3 limitations, the following comments apply only to that mode. Among the six types of measures limiting market access as listed in Article XVI:2, restrictions on the types of legal entity (branches versus subsidiaries, for example) were the most common (Table 16). This was followed by limitations on the participation of foreign capital, limitations on the number of suppliers, and limitations on the value of transactions or assets (such as limitations on the share of banking assets allowed to be held by foreign banks). Limitations on the number of service operations and on the total quantity of service output (such as numerical limits on the number of ATMs allowed) were relatively few.

The frequency of the types of measures did not differ by very much for the major sub-sectors of financial services. However, there was some difference in the measures preferred by country groups (Table 18). Developed and transition countries had a higher incidence of restrictions on the types of legal entity and lower incidence of limitations on participation of foreign capital. In contrast, developing countries had an almost identical number of restrictions on the types of legal entity and on participation of foreign capital. Least developed countries only employed restrictions on the types of legal entity. Limitations on the number of suppliers were equally frequent for developed and developing countries.

Among geographical regions (Western Europe, Eastern Europe, North America, Latin America, Africa and Asia),[33] Asia had the largest share of market access limitations in all modes followed by Western Europe. The percentage share of measures limiting the number of suppliers was highest for North America followed by Latin America. Restrictions on the types of legal entity were most common in Africa, followed by Western Europe. Limitations on the participation of foreign capital were also most common in Africa, but Asia was next in this type of measure. This may reflect policies to promote joint ventures in those countries.

[32] The analysis below takes into account the measures inscribed in the horizontal sections of the schedules applicable to all sectors.

[33] For the composition of country groups by geographical region and by level of development, see Appendix 3.

Table17: Restrictive Measures on Market Access, by Sub-sector and by Mode of Supply

	Mode 1	Mode	Mode 3	Mode 4
All Insurance and insurance-related services	106	94	683	391
Of which:				
Life	7	10	155	84
Non-life	28	25	166	86
Reinsurance and retrocession	31	29	153	98
Banking and other financial services	142	258	2409	1052
Of which:				
Acceptance of deposits and other repayable funds	7	17	196	85
Lending of all types	14	18	186	82
Trading for own account or for account of customers	35	81	760	322
Participation in issues of all kinds of securities (underwriting)	7	17	161	70

Authorization requirements were the most commonly encountered national treatment limitation, followed by ownership, nationality and residency requirements

Tables 19-21 break down national treatment limitations by a number of categories developed for the analytical data base. These different categories do not have any legal standing. The most ubiquitous national treatment limitation was "authorization requirements" (Table 19). This was followed closely by limitations on the ownership of property and land, and nationality requirements. A large majority of the measures were taken in mode 3, followed by mode 4 (Table 20). As with the market access limitations, a larger proportion of limitations was in banking and other financial services, and the frequency of the types of measures did not differ by very much for the major sub-sectors of financial services.

Limitations in developed countries tended to be more concentrated in residency rather than in ownership requirements, while the reverse was true for developing countries. Developed countries accounted for the bulk of tax-related national treatment limitations

Comparing the measures in mode 3 for the country groups, it is apparent that developed countries have a preference for residency requirements, while developing countries have more nationality requirements (Table 21). Developing countries also tend to have more restrictions on the ownership of property and land. More than 80 percent of all tax measures were concentrated in developed countries. Transition countries had a high proportion of restrictions on the ownership of land and property. The absence of tax measures in transition countries is also notable. All performance requirements and almost all technology transfer requirements were found in the developing country group.

Across geographical regions, Asia had a higher proportion of nationality requirements, while Latin America had a higher proportion of authorization requirements. All performance requirements were found in Asia. The absence of fiscal or financial measures (tax measures, subsidies and grants and other financial measures) for Africa was notable. Nationality and residency requirements occurred more frequently in Western Europe than in North America. The proportion of local content and training requirements was higher in North America than in Western Europe. They were absent in Latin America. Subsidies and grants and other financial measures were also somewhat more common for North America than for Western Europe.

The additional commitments column (Article XVIII) has been little used so far in financial services

The additional commitments column has very few entries in financial services, as only three countries (Brazil, Hungary and Japan) have inscribed additional commitments in their schedules. These were either commitments to introduce liberalization in the future without specifying the date of implementation (e.g. after the adoption of a law), or to remove a prudential restriction.

Table 18: Restrictive Measures on Market Access, by Country Group and by Mode of Supply

(a) All Insurance and Insurance-Related Services

Mode	Country group	Restrictive measures							
		Number of suppliers	Value of transaction or assets	Number of operations	Number of natural persons	Types of legal entity	Participation of foreign capital	Other market-access measures	National treatment limitations
Mode 1	Developed	5	2	4	0	0	0	14	25
	Transition	2	4	0	0	0	0	11	0
	Developing	0	2	0	0	0	0	23	14
	Least-developed	0	0	0	0	0	0	0	0
Mode 2	Developed	4	4	4	0	0	0	10	16
	Transition	2	4	0	0	0	0	7	1
	Developing	2	2	0	0	0	0	30	8
	Least-developed	0	0	0	0	0	0	0	0
Mode 3	Developed	16	20	6	0	45	10	55	48
	Transition	3	5	0	0	17	7	26	20
	Developing	44	45	8	15	68	67	105	45
	Least-developed	0	0	0	0	3	0	5	0
Mode 4	Developed	0	0	0	44	0	5	51	20
	Transition	0	5	0	9	0	0	27	6
	Developing	4	9	4	77	0	4	78	38
	Least-developed	0	0	0	5	0	0	5	0

(b) Banking and Other Financial Services

Mode	Country group	Restrictive measures							
		Number of suppliers	Value of transaction or assets	Number of operations	Number of natural persons	Types of legal entity	Participation of foreign capital	Other market-access measures	National treatment limitations
Mode 1	Developed	4	0	2	0	0	0	34	2
	Transition	0	0	0	0	0	0	5	15
	Developing	1	2	0	0	0	0	64	13
	Least-developed	0	0	0	0	0	0	0	0
Mode 2	Developed	31	0	16	0	0	0	101	12
	Transition	0	0	0	0	0	0	32	15
	Developing	0	0	0	0	0	0	37	14
	Least-developed	0	0	0	0	0	0	0	0
Mode 3	Developed	101	118	16	0	168	73	173	137
	Transition	23	6	21	0	63	15	77	39
	Developing	157	132	81	35	225	213	287	205
	Least-developed	0	0	0	0	8	0	26	0
Mode 4	Developed	0	0	0	156	0	17	168	88
	Transition	0	6	0	25	0	0	77	8
	Developing	0	14	0	212	0	0	196	33
	Least-developed	0	0	0	26	0	0	26	0

Table 19: Restrictive Measures on National Treatment in Financial Services (GATS, Art XVII), by Mode of Supply

	Mode 1	Mode 2	Mode 3	Mode 4
Total	193	318	3441	2027
Tax measures	28	38	161	14
Subsidies and grants	10	10	274	181
Other financial measures	1	1	76	0
Nationality requirements	4	1	411	255
Residency requirements	21	3	335	257
Licensing standards, qualifications	15	0	193	528
Registration requirements	21	113	165	47
Authorization requirements	44	23	494	192
Performance requirements	0	0	30	25
Technology transfer requirements	0	0	46	71
Local content/training requirements	6	21	76	77
Ownership of property/land	0	0	453	125
Other national treatment measure	24	106	378	231
Market-access limitation	19	2	349	24

Table 20: Restrictive Measures on National Treatment by Sub-sector and by Mode of Supply

	Mode 1	Mode 2	Mode 3	Mode 4
All Insurance and insurance-related services	19	60	794	488
Of which:				
Life	4	5	164	106
Non-life	30	13	175	107
Reinsurance and retrocession	28	19	184	115
Banking and other financial services	67	258	2622	1524
Of which:				
Acceptance of deposits and other repayable funds	4	15	201	119
Lending of all types	5	15	192	120
Trading for own account or for account of customers	18	90	150	469
Participation in issues of all kinds of securities (underwriting)	4	16	170	109

Table 21: Restrictive Measures on National Treatment, by Country Group and by Mode of Supply

(a) All Insurance and Insurance-Related Services

Mode of supply	Country group	Restrictive measures: Tax Measures	Subsidies & grants	Other financial measures	Nationality require-ments	Residency require-ments	Licensing, standards, qualifications	Registration requirements	Authorization requirements	Performance requirements	Technology transfer requirements	Local content & training req.	Ownership of property and land	Other national treatment measures	Market access limitation
Mode 1	Developed	26	4	1	1	18	15	2	18	0	0	6	0	7	2
	Transition	0	5	0	0	0	0	15	5	0	0	0	0	0	15
	Developing	2	1	0	3	3	0	4	21	0	0	0	0	17	2
	Least-developed	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Mode 2	Developed	36	4	1	0	1	0	97	1	0	0	21	0	89	0
	Transition	0	5	0	0	0	0	15	5	0	0	0	0	0	0
	Developing	2	1	0	1	2	0	1	17	0	0	0	0	17	2
	Least-developed	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Mode 3	Developed	134	137	75	181	210	72	51	193	0	0	22	117	196	178
	Transition	0	34	0	23	31	25	22	91	0	2	0	83	2	1
	Developing	27	103	1	207	94	96	92	210	30	44	54	253	168	170
	Least-developed	0	0	0	0	0	0	0	0	0	0	0	0	12	0
Mode 4	Developed	0	93	0	148	145	171	33	49	21	0	0	22	111	22
	Transition	0	34	0	25	29	104	0	31	0	0	0	63	0	0
	Developing	14	54	0	82	83	253	14	81	4	52	65	40	120	2
	Least-developed	0	0	0	0	0	0	0	31	0	19	12	0	0	0

(b) Banking and Other Financial Services

Mode of supply	Country group	Restrictive measures: Tax Measures	Subsidies & grants	Other financial measures	Nationality require-ments	Residency require-ments	Licensing, standards, qualifications	Registration requirements	Authorization requirements	Performance requirements	Technology transfer requirements	Local content & training req.	Ownership of property and land	Other national treatment measures	Market access limitation
Mode 1	Developed	2	0	0	0	0	0	2	2	0	0	2	0	2	0
	Transition	0	1	0	0	0	0	15	1	0	0	0	0	0	15
	Developing	0	0	0	0	0	0	0	13	0	0	0	0	12	0
	Least-developed	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Mode 2	Developed	17	0	0	0	0	0	97	0	0	0	17	0	85	0
	Transition	0	1	0	0	0	0	15	1	0	0	0	0	0	0
	Developing	0	0	0	0	0	0	0	12	0	0	0	0	12	1
	Least-developed	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Mode 3	Developed	99	102	64	136	158	55	40	159	0	0	17	85	149	152
	Transition	0	25	0	18	18	17	14	71	0	0	0	61	0	0
	Developing	18	80	1	154	68	77	61	167	25	29	48	181	130	134
	Least-developed	0	0	0	0	0	0	0	0	0	0	0	0	9	0
Mode 4	Developed	0	68	0	118	116	132	33	34	16	0	0	17	84	17
	Transition	0	26	0	21	21	77	0	23	0	0	0	45	0	0
	Developing	9	44	0	69	60	175	8	57	0	29	50	35	88	0
	Least-developed	0	0	0	0	0	0	0	26	0	17	9	0	0	0

Appendix 2: Definition of Financial Services in the GATS Annex on Financial Services

A financial service is any service of a financial nature offered by a financial service supplier of a Member. Financial services include all insurance and insurance-related services, and all banking and other financial services (excluding insurance). Financial services include the following activities:

Insurance and insurance-related services

(i) Direct insurance (including co-insurance):

- (A) life
- (B) non-life

(ii) Reinsurance and retrocession;

(iii) Insurance intermediation, such as brokerage and agency;

(iv) Services auxiliary to insurance, such as consultancy, actuarial, risk assessment and claim settlement services.

Banking and other financial services (excluding insurance)

(v) Acceptance of deposits and other repayable funds from the public;

(vi) Lending of all types, including consumer credit, mortgage credit, factoring and financing of commercial transaction;

(vii) Financial leasing;

(viii) All payment and money transmission services, including credit, charge and debit cards, travellers cheques and bankers drafts;

(ix) Guarantees and commitments;

(x) Trading for own account or for account of customers, whether on an exchange, in an over-the-counter market or otherwise, the following:

- (A) money market instruments (including cheques, bills, certificates of deposits);
- (B) foreign exchange;
- (C) derivative products including, but not limited to, futures and options;
- (D) exchange rate and interest rate instruments, including products such as swaps, forward rate agreements;
- (E) transferable securities;
- (F) other negotiable instruments and financial assets, including bullion.

(xi) Participation in issues of all kinds of securities, including underwriting and placement as agent (whether publicly or privately) and provision of services related to such issues;

(xii) Money broking;

(xiii) Asset management, such as cash or portfolio management, all forms of collective investment management, pension fund management, custodial, depository and trust services;

(xiv) Settlement and clearing services for financial assets, including securities, derivative products, and other negotiable instruments;

(xv) Provision and transfer of financial information, and financial data processing and related software by suppliers of other financial services;

(xvi) Advisory, intermediation and other auxiliary financial services on all the activities listed in subparagraphs (v) through (xv), including credit reference and analysis, investment and portfolio research and advice, advice on acquisitions and on corporate restructuring and strategy.

Appendix 3: Countries and Country Groups in the GATS Database

A. Country groups by region	Number of countries ( ) = Members with financial services commitments
1. Africa	42 (16)
2. Asia	23 (18)
3. Latin America	19 (15)
4. North America	2 (2)
5. Central and Eastern Europe	6 (6)
6. Western Europe	11 (11)
7. Other	
(a) Caribbean Islands	14 (12)
(b) Oceania	6 (4)
Total:	123 (84)

B. Country groups by level of development	Number of countries ( ) = Members with financial services commitments
1. Developed	15 (15)
2. Transition	7 (7)
3. Developing	78 (56)
4. Least developed	23 (6)
Total:	123 (84)

Note: Aruba and the Netherlands Antilles have financial services schedules separately from the European Union, but are not WTO Members independently.

A. Country list, by region[1]

Africa

1. Algeria*
2. Angola
3. Benin
4. Botswana
5. Burkina Faso
6. Burundi
7. Cameroon
8. Central African Republic
9. Chad
10. Congo
11. Côte d'Ivoire
12. Democratic Rep. of the Congo (former Zaire)
13. Djibouti
14. Egypt
15. Gabon
16. Gambia
17. Ghana
18. Guinea, Rep. of
19. Guinea Bissau
20. Kenya
21. Lesotho
22. Madagascar
23. Malawi
24. Mali
25. Mauritania
26. Mauritius
27. Morocco
28. Mozambique
29. Namibia
30. Niger
31. Nigeria
32. Rwanda
33. Senegal
34. Sierra Leone
35. South Africa
36. Swaziland
37. Tanzania
38. Togo
39. Tunisia
40. Uganda
41. Zambia
42. Zimbabwe

Asia

1. Bahrain
2. Bangladesh
3. Brunei Darussalam
4. China*
5. Cyprus
6. Hong Kong (China)
7. India
8. Indonesia
9. Israel
10. Japan
11. Korea, Republic of
12. Kuwait
13. Macau
14. Malaysia
15. Maldives
16. Myanmar
17. Pakistan
18. Philippines
19. Qatar
20. Singapore
21. Sri Lanka
22. Thailand
23. United Arab Emirates

Latin America

1. Argentina
2. Belize
3. Bolivia
4. Brazil
5. Chile
6. Colombia
7. Costa Rica
8. Ecuador
9. El Salvador
10. Guatemala
11. Guyana
12. Honduras
13. Mexico
14. Nicaragua
15. Paraguay
16. Peru
17. Suriname
18. Uruguay
19. Venezuela

North America

1. Canada
2. United States of America

Central and Eastern Europe

1. Bulgaria
2. Czech Republic
3. Hungary
4. Poland
5. Romania
6. Slovak Republic

Western Europe

1. Austria
2. European Community
3. Finland
4. Iceland
5. Liechtenstein

[1] Country lists A and B include countries without financial services commitments which were not subject to the analysis in Appendix 1. It also includes non-WTO Members which had submitted draft services schedules. (The names of Members with financial services schedules are underlined. "*" indicates non-Members.)

6. Malta
7. Norway
8. Slovenia
9. Sweden
10. Switzerland
11. Turkey

Other

(a) Caribbean Islands

1. Antigua and Barbuda
2. Aruba (Netherlands)
3. Barbados
4. Cuba
5. Dominica
6. Dominican Republic
7. Grenada
8. Haiti
9. Jamaica
10. Netherlands Antilles (Netherlands)
11. Saint Kitts and Nevis
12. Saint Lucia
13. Saint Vincent and the Grenadines
14. Trinidad and Tobago

(b) Oceania

1. Australia
2. Fiji
3. New Caledonia
4. New Zealand
5. Papua New Guinea
6. Solomon Islands

B. Country list, by level of development

Developed countries

1. Australia
2. Austria
3. Canada
4. European Community
5. Finland
6. Iceland
7. Israel
8. Japan
9. Liechtenstein
10. New Zealand
11. Norway
12. South Africa
13. Sweden
14. Switzerland
15. United States of America

Transition countries

1. Bulgaria
2. Czech Republic
3. Hungary
4. Poland
5. Romania
6. Slovak Republic
7. Slovenia

Developing countries

1. Algeria*
2. Angola
3. Antigua and Barbuda
4. Argentina
5. Aruba (Netherlands)
6. Bahrain
7. Barbados
8. Belize
9. Benin
10. Bolivia
11. Brazil
12. Brunei Darussalam
13. Cameroon
14. Chile
15. China*
16. Colombia
17. Congo
18. Costa Rica
19. Côte d'Ivoire
20. Cuba
21. Cyprus
22. Democratic Republic of the Congo (former Zaire)
23. Dominica
24. Dominican Republic
25. Ecuador
26. Egypt
27. El Salvador
28. Fiji
29. Gabon
30. Ghana
31. Grenada
32. Guatemala
33. Guinea-Bissau
34. Guyana
35. Honduras
36. Hong Kong (China)
37. India
38. Indonesia
39. Jamaica
40. Kenya
41. Korea Rep. of
42. Kuwait
43. Macau
44. Madagascar
45. Malaysia
46. Malta
47. Mauritius
48. Mexico
49. Morocco
50. Namibia
51. Netherlands Antilles (Netherlands)
52. New Caledonia
53. Nicaragua
54. Nigeria
55. Pakistan
56. Papua New Guinea
57. Paraguay
58. Peru
59. Philippines
60. Qatar
61. Saint Kitts and Nevis
62. Saint Lucia
63. Saint Vincent and the Grenadines
64. Senegal
65. Singapore
66. Solomon Islands
67. Sri Lanka
68. Suriname
69. Swaziland
70. Thailand
71. Trinidad & Tobago
72. Tunisia
73. Turkey
74. United Arabs Emirates
75. Uruguay
76. Venezuela
77. Zambia
78. Zimbabwe

Least developed countries

1. Bangladesh
2. Botswana
3. Burkina Faso
4. Burundi
5. Central African Republic
6. Chad
7. Djibouti
8. Gambia
9. Guinea, Republic of
10. Haiti
11. Lesotho
12. Malawi
13. Maldives
14. Mali
15. Mauritania
16. Mozambique
17. Myanmar
18. Niger
19. Rwanda
20. Sierra Leone
21. Tanzania
22. Togo
23. Uganda