Trade accord in financial services: some pros and cons

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Abbreviations

APEC  Asia Pacific Economic Cooperation
CPC  Central Product Classification
CTS  Council for Trade in Services
GATS  General Agreement on Trade in Services
GATT  General Agreement on Tariffs and Trade
GNS  Group of Negotiations on Services
MFN  most-favoured-nation
NAFTA  North American Free Trade Area
SSC  Schedule of Specific Commitments
WTO  World Trade Organisation
Trade in financial services: an Asian perspective

At the end of the Uruguay Round of multilateral trade negotiations in 1993, negotiations on trade in financial services remained incomplete. An interim agreement was concluded in July 1995 and negotiations were reopened in April 1997. A new and improved set of commitments regarding financial services under the General Agreement of Trade in Services (GATS) was agreed on 12 December 1997. Being a new international agreement, the GATS has limitations and shortcomings. Although these have been enumerated, this paper aims to provide a wide-ranging analysis that traces the road to the GATS accord, analyses the impact of market liberalisation in financial services and the role of the GATS in it, and undertakes a detailed analysis of the structure and performance of the GATS. I argue that trade in financial services is a vital area of the global economy and I hope to provide readers with a comprehensive background knowledge of trade in services and the GATS to enable them to ask relevant questions which in turn would trigger future research.

The accord on financial services

Ambiguity persisted for some time regarding the definition of trade in financial services, therefore the first task of the negotiators was to construct a clear definition. Article I, paragraph 2 of the GATS defines trade in services as ‘supply of services (a) from the territory of one member to any other member, (b) in the territory of one member to the service consumer of any other member, (c) by a service supplier of one member, through commercial presence in the territory of any other member, and (d) by a service supplier of one member, through presence of natural persons of a member in the territory of any other member’.

Thus viewed, the GATS distinguishes four different modes of supply when categorising trade in services. Mode 1 involves cross-border (also called ‘arms-length’ or ‘long distance’) trade, mode 2 is consumption of services abroad, mode 3 is commercial presence and mode 4 entails the movement of natural persons. A General Agreement on Tariffs and Trade (GATT) document, Scheduling of Initial Commitments in Trade in Services, states that these ‘modes are essentially defined on the basis of the origin of the supplier and consumer, and the degree and type of territorial presence which they have at the moment the service is delivered’ (GATT 1993:163–4). In mode 1 the consumer and the service supplier each remain in their respective territories. In mode 2 the consumer moves to the territory of the supplier. In modes 3 and 4 the service supplier moves to the consumer and delivers the service either through commercial presence or through presence as a natural person (Figure 1).
## Figure 1   Modes of supply

<table>
<thead>
<tr>
<th>Supplier presence</th>
<th>Criteria</th>
<th>Mode</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Service supplier not present within the territory of the Member</td>
<td>1. Service delivered within their territory of the Member, from the territory of another Member</td>
<td>1. Cross-border supply</td>
</tr>
<tr>
<td></td>
<td>2. Service delivered outside the territory of the Member, into a service consumer of the Member</td>
<td>2. Consumption abroad</td>
</tr>
<tr>
<td>2. Service supplier present within the territory of the Member</td>
<td>3. Service delivered within the territory of the Member, through the commercial presence of the supplier</td>
<td>3. Commercial presence</td>
</tr>
<tr>
<td></td>
<td>4. Service delivered within the territory of the Member, with supplier present as a natural person</td>
<td>4. Presence of natural person</td>
</tr>
</tbody>
</table>

**Source:** General Agreement on Tariffs and Trade (GATT), 1993. Scheduling of Initial Commitments in Trade Services, MTN.GNS/W/163, Geneva

In the annex on financial services in the text of the GATS, financial services are defined as any service of a financial nature offered by a financial service supplier of a member country. Financial services include ‘all insurance and insurance-related services’ and ‘all banking and other financial services’. Of these two, banking and other financial services are more broadly defined and include

- money market instruments (checks, bills, certificates of deposits)
- foreign exchange
- derivative products including futures and options
- exchange rate and interest rate instruments, including products such as swaps and forward rate agreements
- transferable securities
- other negotiable instruments and financial assets, including bullion.

This leaves no ambiguity regarding the coverage and scope of trade in financial services.

The GATS, like the World Trade Organisation (WTO), is squarely founded on the twin principles of non-discrimination and transparency. Articles I and III of the Articles of Agreement of the GATS provide for most-favoured-nation (MFN) treatment and transparency. Accordingly, each member is obliged to accord immediately and unconditionally to services and service suppliers of any other member treatment no less favourable than that it accords to like services and service suppliers of any other country. In addition, in the context of the GATS, the national treatment principle also works as a non-discrimination principle. Each member is also obliged to publish promptly all relevant measures of general application which pertain to or affect the operation of the GATS. These are known as two ‘general obligations’ of the GATS and a member country is required to honour them for all services sectors, including financial services. These and other Articles of Agreement bring trade in financial services within a framework of multilateral discipline. The GATS does, however, allow a country to take exemptions from the general MFN obligation and these must be taken upon entry into force of the agreement and, in principle, should not exceed a period of ten years.

During the Uruguay Round, some 82 countries (counting the twelve member states of the European Union (EU) at that time individually) had commitments in financial services listed in their schedules of specific commitments. But, there was a view among some members that the commitments in a number of schedules were not sufficient to conclude the negotiations. The United States announced at the end of 1993 a broad most-favoured-nation
exception in financial services unless the schedules of commitment of other countries were improved. Following the United States, other large traders in financial services took similar positions or withdrew their previous best offers. The Uruguay Round of the GATT ended in December 1993, without an agreement to liberalise trade in financial services.

In order to avoid a breakdown in the negotiations, trade ministers of the member countries agreed at the Marrakesh meeting of April 1994 that negotiations on schedules of commitments in financial services should be continued after the WTO Agreement came into being. The interim accord was undermined by the withdrawal of the United States. According to the US trade representative, market-liberalisation offers of several Asian countries were inadequate. With the United States not eager to accede to an agreement, the EU was left to cobble together a stopgap agreement which expired in December 1997. This makeshift arrangement was helpful in maintaining the momentum of negotiations, and encouraging countries like India to grant more licenses to foreign, essentially western banks. After the interim accord was signed, several large developing countries (including Turkey and South Africa) sent their improved market liberalisation offers to the WTO, along with Japan, the EU and the United States. Later on, Brazil and India also improved their offers.

The negotiations on financial services concluded successfully on 12 December 1997. The accord was an important milestone in multilateral trade negotiations and was made possible by a clear shift in attitude among developing countries, which comprised the bulk of the 70 signatories. The shift in attitude came about for two reasons. First, many developing countries desperately needed foreign capital. Second, industrial economies showed willingness to let poorer developing countries open up their financial markets gradually over time.

The idea of foreign direct investment in manufacturing appeals to most developing economies. But they have a long history of shunning foreign participation in their banking, insurance and securities markets. Many governments continued to coddle their homegrown institutions. Some of the culprits were in East Asia, where countries like India, Malaysia and South Korea stringently restricted the activities of foreign banks, stockbrokers, fund managers and insurers. Consequently, most developing countries had inefficient financial systems, the shortcomings of which are at the root of Asia’s 1997–98 financial crises. The lack of foreign competition made financial companies bloated, inefficient and costly. The problems of East Asia’s financial firms were not due to too much competition but to over-protection and cronyism, which encouraged shoddy lending practices and poor cost controls. It is significant that financial institutions in Hong Kong and Singapore, both of which have wide open financial services industries, have been able to withstand the regional turmoil much better than other East Asian economies.

The December 1997 accord on financial services covers more than 95 per cent of the world’s multitrillion dollar financial services market. According to the US trade representative and WTO estimates, it covers US$18 trillion in global securities assets, US$38 trillion in international bank lendings and US$2.5 trillion in gross insurance premiums (Williams 1997). No significant trading economies have been left out. Under the agreement, which will come into force in March 1999, 102 countries—of the 132 member countries of the WTO—have pledged to open their banking, insurance and securities markets to varying degrees to foreign competition. The biggest achievement of the new agreement is to make these pledges binding. During the pre-accord period, a country that allowed foreign banks to run majority-owned subsidiaries was free to reverse that decision. Arriving at an agreement implies that GATS members agree to subject financial services to legally binding fair-trade rules and disciplines. In the post-accord period, a government changing its decision on foreign banking would be answerable to a dispute-settlement panel with sweeping powers. Thus, multilateral
discipline is expected to soothe investors and promote investment. It should make policies in the financial services industry more predictable, and decision-making more efficient.

Some of the high points of the accord on financial services are

- the United States and the EU will, with minor restrictions, be fully open to foreign banks, insurance and securities companies
- Japan has opened its banking and securities markets more widely to foreigners and ‘multilateralised’ its bilateral insurance deal with the United States
- East and Southeast Asian economies have made important market liberalising concessions.

All except Malaysia have agreed to respect existing foreign investment of up to 100 per cent in the insurance industry, while Malaysia will allow foreign insurers to hold a majority (51 per cent) stake in locally incorporated companies. Malaysia has not resolved the issue of what to do with the incumbents. Nor has it found an answer to the question, ‘Should the new entrants be accorded what was accorded to the incumbents?’ This issue was debated in the WTO, but so far no conclusion has been reached. The results of the latest round of agreement on trade in financial services are part of a protocol that will be open for governments to accept until January 1999. Under the terms of the WTO’s so-called ‘built-in agenda’ (agreed at the Uruguay Round’s conclusion in Marrakesh in December 1993), a comprehensive set of negotiations under the GATS is scheduled to resume no later than 1 January 2000.

The role of trade in financial services

Scanning the literature on trade in financial services reveals a lack of consensus on views regarding the significance of this trade in an economy. Economists have held starkly opposite opinions. For example, Walter Bagehot and John Hicks assigned financial services pride of a place in the economy and argued that they played a crucial role in igniting industrial revolution in England. Leading this group of thinkers, Joseph Schumpeter argued that a well-functioning financial services industry spurs technological innovation by identifying and funding those entrepreneurs with the best chances of successfully implementing the most innovative, functional and profitable ideas. In contrast, other economists argue that financial services play a secondary role in an economy. The latter group includes Joan Robinson, Robert Lucas and Nicholas Stern. They contend that the role of financial services have been over-emphasised.

Astonishingly, Adam Smith, who propounded the concept of gains from the division of labour, viewed all services as being ‘unproductive of any value’. A more muted recent view is that services tend to get left behind as the technological level of an economy advances. Several noted development economists have expressed skepticism about the role of financial services in economic growth. Contemporary researchers have attempted to come to a categorical conclusion in this regard through various rigorous theoretical and empirical methods. A growing body of empirical analyses, including firm-level studies, industry-level studies, individual country-studies and broad cross-country comparisons, demonstrate a strong positive link between the expansion of financial services and long-term economic growth. King and Levine (1993), in a seminal piece of work, convincingly demonstrated that links between growth and financial services are strong and that better development of financial sector precedes faster growth. They took cross-country data of 80 countries and controlled for a variety of factors, including income, education, political stability, and monetary, fiscal, trade and exchange rate policies. A fundamental fact worth emphasising here is that financial services have economy-wide externalities. All the branches of economic activity depend on access to financial services; therefore they are far more important than
their direct share in the economy implies. Little wonder they are considered the brain of an economy.

International trade in services is currently the subject of intense scrutiny among academics and policymakers alike. The Uruguay Round of multilateral trade negotiations drew the attention of academics and the policymaking community towards financial services and trade in them, thus it has only recently become an area of systematic intellectual inquiry. The first question that needs to be considered is whether the theory of comparative advantage—in its Ricardian or Heckscher-Ohlinian form—and the empirical evidence on the benefits of openness of an economy developed for trade in goods applies to trade in services, including trade in financial services. Is trade in financial services, in this respect, similar to that in goods? A number of researchers (Sapir and Lutz 1981; Walter 1988) have answered this query in the affirmative. Sapir and Lutz (1981) considered data from the insurance industry and Walter (1988) took data for banking and securities industries to conclude that the two trade theories, classical and neoclassical, applied to goods as well as to trade in financial services.

The classical concept of trade based on comparative advantage, as propounded by Smith, Mill and Ricardo, is premised on international differences in production functions. Since production technology in financial services sector varies from country to country, this concept is as applicable to trade in goods as it is to financial services. The fact that production technology in the financial services sector is not uniform worldwide, gives institutions in some countries a competitive edge over those based in others in the Ricardian sense of what drives international trade. Subsequently, the Heckscher-Ohlin-Samuelson model emphasised the differences between countries in the availability and cost of productive factors, clearly an important determinant of trade in financial services as well. This theory attempts to explain the pattern of international trade in the context of interindustry differences in factor intensities and intercountry differences in factor endowments. The availability and cost of productive factors is an important determinant of trade in financial services as well, particularly if we take into account human capital along with physical capital. Both theories, when they are applied to trade in goods, assume there are human and physical resources or characteristics that are not mobile between countries. This leads to countries having comparative advantage in producing certain goods and comparative disadvantage in producing others.

Countries with abundant capital have a comparative advantage in trade in financial services because they have large domestic banking systems and capital markets. In all the major financial service exporting countries, international banking grew out of domestic banking which had developed in rich cities like Florence, Amsterdam, Paris, London, New York and Zurich. Here the sources of comparative advantage were first, a cost advantage due to abundance of capital, and second, a large domestic market for financial services and consequent economies of scale. The major sources of scale economies are the possibility of clearing debits and credits and of centralised decision-making through modern telecommunications technology. Specialisation, whether or not based on product differentiation, yields further scale economies and promotes the development of a wide range of specialised skills, without which comparative advantage cannot be attained.

The empirical results of a cross-sectional analysis indicates that like manufactured goods, financial services are subject to the same underlying factors which have given the industrial economies a comparative advantage over developing economies (Moshirian 1994). These results show that the size of banks’ international assets, physical and human capital, level of information technology as well as the amount of R&D are the main determinants of supply of international financial services. These results indicate that the industrial economies’
financial institutions are likely to continue to be the major suppliers of financial services in the international financial markets.

Several conceptual studies (Arndt 1994; Glaessner and Oks 1994; and Levine 1996) have concluded that as opening trade in goods promotes production on the lines of comparative advantage and improves economic efficiency in the system, so does trade in financial services. Opening trade in financial services leads to both static and dynamic gains. Foreign investment in financial services leads to improvement in the standard and functioning of domestic financial systems. There are three direct and indirect channels of benefit. First, foreign trade and investment in financial services provides better access to foreign capital, which in turn contributes to financing a higher level of investment. Second, they also result in expansion and strengthening of the domestic financial infrastructure, which in turn promotes improvement in regulation and supervision. These are two direct benefits. The third, indirect benefit, is improvement in the quality of domestic financial services.

To focus on the third benefit, competition with foreign financial institutions and more liberal conditions governing foreign entry can produce efficiency gains and promote technology transfers, thus leading to a modernisation of domestic financial systems and an improvement in the quality of investment. To be sure, the most important benefit conferred by an open financial system stems from the positive spillover effects on savings and investment and on the allocation of productive resources. By increasing the efficiency of financial intermediation, greater openness heightens the ability of the financial system to direct funds where the marginal efficiency of capital is the highest. Increased competition lowers the costs of financial services faced by households, businesses and governments. Increased competition also eases access of firms, particularly small and medium-sized enterprises, to sources of external finance and to the newest financial innovations. Thus, a more competitive financial sector raises the overall competitiveness of the real sector.

With opening of markets and expansion of trade, the range and quality of financial services come closer to international norms. Skill accumulation, better disclosure regulations, general improvements in the legal and regulatory frameworks are some of the other consequences of expansion of trade in financial services. In addition, trade expansion, sometimes in conjunction with other reforms, can boost income and growth. With improvement in the general financial framework, the credibility of the system also enhances, and the financial sector can enter into international agreements and intensify linkages, with foreign regulators. This can lower the risk of policy reversals and reduce systemic risks. Also, the financial sector can gradually becomes part of the global financial system.

Another important benefit is improved liquidity in stockmarkets (Claessens and Glaessner 1998). All these various benefits can enter the economy in two ways: First, governments can consciously promote trade in financial services, where benefits move from the top downward. The second possibility is financial market initiative, as they absorb greater international norms and practices and become more efficient and competitive. Here the benefits move from the bottom to the top.

International trade in goods differs in two important respects from trade in services, particularly financial services. First, efficient trade in financial products generally requires the presence of the provider of services locally. This is because from the supply side the service providers need accurate information to tailor loans or other financial services to clients’ needs. They also need to have knowledge of local conditions and the business environment in the economy where they are providing services. Therefore, a commonly used mode of keeping the exporter of financial services out and protecting domestic firms from foreign competition, is erection of entry barriers against establishing a local branch or subsidiary. However, from the demand side, trade in financial services is difficult to monitor for the
importing economy, therefore, domestic regulators may prefer having local presence so that they are able to maintain some control over the exporting firm. In case of insurance, many countries have made it mandatory for the exporting firm to have a local branch.

The second difference between trade in goods and trade in financial services is the level of regulation. For monetary policy and fiduciary reasons, it is accepted practice to regulate the provision of financial services in most economies. The GATS also accepts domestic prudential regulatory measures. These regulations, however, affect the cost of trading in financial services. When financial services are traded, one set of service providers who are subject to one set of regulations compete with another set of service providers who are subject to another set of regulations. The competitors have different costs of complying with their regulations. Thus, differences in regulations between countries may affect competition in trade in financial services. More often than not, this impact is unfair for the exporter of financial services. This is essentially why it is contended that national markets for financial services cannot be internationalised until national regulatory systems are harmonised.

Value-added in the financial services sector is measured on the basis of service charges. Paradoxically, this overstates the contribution of financial services in inefficient markets and understates the contribution in the efficient markets because costs and charges are high in the inefficient markets and low in the efficient ones. As a proportion of GDP, value-added in the financial services sector has been increasing. Industrial economies, for which data are available, reported a value-added share of about 2 per cent to 4 per cent of GDP for this sector in 1970. By 1995, the United States and Switzerland reported value-added shares of 7.3 per cent and 13.3 per cent, respectively (WTO 1997a). These proportions are the highest among industrial countries. The proportions of other industrial countries increased from 2.5 per cent to 6 per cent of GDP on an average, over the same period (WTO 1997a). Among the developing economies, financial services are the most important for Singapore and Hong Kong.

The growing significance of trade in financial services

Over the last ten years, growth of international financial activities has been more rapid than the growth of domestic financial markets. International securities and derivative transactions recorded a particularly brisk growth. According to the Bank for International Settlements data, the value of international securities transactions increased from around US$100 billion in 1987 to over US$500 billion in 1996, making their dimension larger than that of international lending, whose level reached US$400 billion in 1996 (BIS 1997). Derivative transactions increased more than tenfold over the same period. Outstanding futures and options in interest rates, currencies and exchange-traded derivatives amounted to US$10 trillion at the end of 1996. This was as large as twice the value of world trade in 1996. The value of outstanding swaps and swap-related derivatives reached US$25 trillion in 1996 (BIS 1997a).

To be sure, industrial countries overwhelmingly dominate activities in the international financial market. However, developing economies are increasingly integrating themselves into it and are slowly becoming important players. A World Bank study on the integration of developing economies into the private capital markets found that half of the 60 developing countries examined had attained a medium to high degree of financial integration by the early 1990s, up from 15 in the mid 1980s (World Bank 1997). During the first half of the 1990s, East and Southeast Asia, Latin America and Central and Eastern Europe internationalised their capital markets. Latin American countries relied mainly on bond financing during this period, while the Asian economies made use of both bonds and bank financing. The pattern of financing has evolved from the debt crisis of the 1980s, when large banks extended
massive loans to Latin American economies and lost heavily. Bond financing implies lesser risk for financial institutions, because they only mediate the issue of bonds. Due to better credit history, Asian economies had a balanced international financing structure. During the 1990s, stocks became a more popular means of financing in the developing and transitional economies. This suggests that firms and markets are becoming more open and sophisticated in the developing and transitional economies.

The foregoing exposition suggests deepening as well as widening of the international financial sector. Several factors are responsible. First, technological progress in communications, spread of computer technology and electronic data processing have given a fillip to expansion of trade in financial services. Together they have transformed the way financial business is performed. The next step is internet-based banking, which is currently spreading, albeit slowly. Second, under the aegis of the various rounds of the GATT, international trade has liberalised quickly, in turn leading to a brisk and significant expansion of the international financial market. Third, recent trends in economic liberalisation of transitional economies in Asia and Europe have increased demand for international financial services. Fourth, increasing globalisation and competition have forced firms to seek cheaper ways to finance their activities.

Value of exports and imports

In 1985, trade in the three financial services which are covered by the GATS was close to US$15 billion, it grew to over US$50 billion in 1995. It is one of the fastest growing segments of world trade. The largest traders in financial services are the United States, Switzerland, Germany, France and the United Kingdom. However, there are some problems with these data. In addition to general inadequacy of statistics on trade in financial services there are conceptual problems. For instance, the GATS definition of trade in services goes beyond the traditional notion of international trade, which refers to products crossing geographical boundaries, or to transactions between residents and non-residents. The definition of trade in services includes local sales by foreign entities who would be considered ‘resident’ by conventional statistical criteria and for whose activities relevant statistics are not available. Second, the scheduled commitments are in most part according to the GNS classification which is based largely on the UN Central Product Classification (CPC). However, the only statistics available follow the International Monetary Fund (IMF), *Balance of Payments Yearbook* classification. Statistical data on financial services presented in this paper (Tables 1 and 2) were compiled by the WTO (1997b) from the IMF statistics on cross-border trade in financial services for some selected, mostly industrial, economies.

According to the latest (1995) statistics, the United States is the largest exporter of banking and securities services (Table 1). Its exports were US$6,100 million, or 17.4 per cent of the total world exports in this category. Switzerland (US$5,627 million) and the United Kingdom (US$5,260 million), were fairly close with 16 per cent and 15 per cent of total exports, respectively. The three largest importers were Italy (US$4,454 million), Belgium-Luxembourg (US$2,755 million) and France (US$2,351 million), accounting for 23.6 per cent, 14.6 per cent and 12.5 per cent of total imports in this category. The top five exporters and importers of banking and other financial services in 1995 accounted for approximately 61 and 71 per cent of reported exports and imports, respectively. Statistics on exports of banking and other financial services need to be viewed with caution. Two major traders, Switzerland and the United Kingdom, report statistics only on a net basis, and not separately for exports and imports. Since each has a trade surplus, the two countries appear in Table 1 as exporters. The practice of reporting net figures leads to an underestimation of world exports and world imports and to a distortion in the ranking of countries.
Table 1  Top 20 exporters and importers of banking and other financial services, 1995 (US$ million)

<table>
<thead>
<tr>
<th>Exporters</th>
<th>Value</th>
<th>Share of total (%)</th>
<th>Importers</th>
<th>Value</th>
<th>Share of total (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td>6,100</td>
<td>17.4</td>
<td>Italy</td>
<td>4,454</td>
<td>23.6</td>
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<tr>
<td>Switzerland</td>
<td>5,627</td>
<td>16.0</td>
<td>Belgium-Luxemb.</td>
<td>2,755</td>
<td>14.6</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>5,260</td>
<td>15.0</td>
<td>France</td>
<td>2,351</td>
<td>12.5</td>
</tr>
<tr>
<td>Belgium-Luxemb.</td>
<td>4,286</td>
<td>12.2</td>
<td>Austria</td>
<td>2,102</td>
<td>11.2</td>
</tr>
<tr>
<td>Italy</td>
<td>2,620</td>
<td>7.5</td>
<td>United States</td>
<td>1,710</td>
<td>9.1</td>
</tr>
<tr>
<td>France</td>
<td>2,546</td>
<td>7.3</td>
<td>Brazil</td>
<td>950</td>
<td>5.0</td>
</tr>
<tr>
<td>Germany</td>
<td>2,430</td>
<td>6.9</td>
<td>Spain</td>
<td>565</td>
<td>3.0</td>
</tr>
<tr>
<td>Austria</td>
<td>1,874</td>
<td>5.3</td>
<td>Germany</td>
<td>560</td>
<td>3.0</td>
</tr>
<tr>
<td>Brazil</td>
<td>827</td>
<td>2.4</td>
<td>Japan</td>
<td>460</td>
<td>2.4</td>
</tr>
<tr>
<td>Spain</td>
<td>609</td>
<td>1.7</td>
<td>Netherlands</td>
<td>421</td>
<td>2.2</td>
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<td>Netherlands</td>
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<tr>
<td>Japan</td>
<td>310</td>
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<td>Finland</td>
<td>303</td>
<td>1.6</td>
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<tr>
<td>Australia</td>
<td>298</td>
<td>0.8</td>
<td>Portugal</td>
<td>247</td>
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<tr>
<td>Finland</td>
<td>275</td>
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<td>228</td>
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<td>Romania</td>
<td>72</td>
<td>0.4</td>
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</table>

**Source:** International Monetary Fund, 1996. *Balance of Payments Statistics Yearbook*, Washington, DC.

Statistics on insurance services include both life and non-life insurance, as well as reinsurance and retrocession, insurance intermediation, and services auxiliary to insurance. Germany tops the list with exports of US$8,670 million in 1995, which were a quarter (25.5 per cent) of the total world exports (Table 2). France (US$7,507 million) and the United Kingdom (US$3,890 million) exported 22 per cent and 11 per cent of the total, respectively. On the imports side, Germany (US$8,830 million) was also the largest importer of insurance services, importing 19.6 per cent of the total imports. It was closely followed by France (US$7,021 million) and the United Kingdom (US$4,470 million), accounting for 15.6 per cent and 9.9 per cent of the total imports, respectively. The top ten exporters and importers of insurance services in 1995 accounted for approximately 84 per cent and 72 per cent of reported exports and imports of insurance services, respectively.
The GATS distinguishes four different modes of supply of services. The cross-border trade data discussed above was gleaned from balance of payments statistics. Therefore, it refers only to mode 1 and to elements of other modes where transactions take place between residents and non-residents. No reliable source of statistics exists on mode 3 and mode 4 trade in services. The statistics presented above are, therefore, far from complete and exhaustive. Different economies have different degrees of internationalisation in their financial services sector. For instance, Hong Kong and Singapore have the most internationalised banking sectors, with the share of foreign-owned assets in total banking assets close to 80 per cent in 1996 in these two economies. Ireland, Portugal, Greece and New Zealand have the most internationalised insurance sector, with foreign market share in life insurance services close to 25 per cent in these four economies. In non-life insurance services, Canada tops with more than 60 per cent market share going to foreign companies, followed by Austria and Australia, with close to 50 per cent of the market share for foreign firms (WTO 1997a).

Opening markets in financial services

Opening markets in financial services is not an easy, risk-free, task as the 1997–98 financial crisis proves. Market liberalisation requires careful planning and preparation. It raises a
number of issues related to both macroeconomic and microeconomic policies (Johnston 1994; McKinnon and Pill 1994; Goldstein and Turner 1996; BIS 1997b). Since it could be a little risky, the conventional view tends to place the opening of financial markets relatively late in the overall sequence of reform and to favour a gradualist approach. The conventional approach, posited by scholars like McKinnon (1991), requires that fiscal adjustment should occur before opening up of the financial sector and elimination of controls on transborder capital movements should occur after the domestic financial system is liberalised. Opening markets in financial services amounts to erasing the onshore-offshore distinction, which in turn has implications for prudential and regulatory controls. Should the post-market liberalisation system be based on the prudential system that existed for the offshore markets in the past or on one intended for the onshore market? Should it have characteristics of the two? It has been a difficult question to answer for the monetary authorities. The reason is that one of the differences between trade in financial services and trade in other services (and goods) is in the extent to which financial services raise issues of prudential regulations, macroeconomic policy and the stability of financial markets. The 1997–1998 financial crises in the emerging market economies is an excellent illustration of this point. Some economists have challenged the notion that financial services, particularly banking services, should be treated in an ad hoc manner. They question the special attention that financial services have received from national governments (Lewis 1996). Yet, the stark reality is that every country has a banking system, albeit every country does not have an electronics or auto industry. In most countries banks are run by nationals, sometimes by governments. In most banking systems public confidence is generated by collective support mechanisms, entailing deposit insurance, central banking authorities and prudential regulations.

It is essentially for this reason that many governments hesitate to be even-handed in their treatment of foreign-owned entities, arguing that the ‘commanding heights’ of the economy must be firmly in local hands. They believe that the right to deny foreign entities access to the national markets is an important expression of sovereignty. This authority of the government is displayed in regulations on local equity requirements, limitations upon the asset share of foreign banks, branching restrictions, portfolio restrictions, and limits upon funding from overseas. Therefore, the principal of equality of competitive opportunity in the national market underlies much of the negotiations about market entry in the area of financial services.

Several industrial and developing economies had problems during the 1980s and 1990s after opening their financial markets. These crises had high economic and financial costs. This led some to conclude that the opening up of financial markets was the main culprit. This is a classic case of the logical fallacy of ‘after it, therefore due to it’. If there is a link between financial market liberalisation and opening up of financial markets on the one hand and banking and financial crises on the other, it is the twin factors of unsound macroeconomic policies, and inadequate prudential regulations and supervision (BIS 1997b). It is widely believed that a major causal factor behind the 1997–98 financial crisis in the Asian economies was their weak banking and financial systems. These economies were driven to a crisis point by their highly inadequate prudential frameworks and regulatory systems. Opening up markets in financial services can ignite a crisis if monetary policies are lax because they can result in imprudent lending by banks and encourage excessive foreign exchange exposure of financial institutions and firms. If corporate governance problems exist with lax monetary policies, as they recently did in Asia and Latin America, financial institutions
will be undermined. Weakened financial institutions will not be able to survive in an environment which will be more competitive than in the past because of liberalisation. Thus, it is not the opening up of financial services markets that will cause a financial crisis but policy and management errors.

A natural consequence of opening up the markets in financial services is increased capital inflows. Market opening also renders reverse capital flows easier. If loss of market confidence leads to a reverse flow of capital, domestic financial institutions are weakened, which in turn magnifies the adverse effects of poor macroeconomic and regulatory policies. In developing economies where the depth of the financial markets is limited, such capital outflows can have a highly destabilising effect on the financial markets and subsequently over the economy in general. Foreign investors are known for ‘herding’ behaviour which can soon cause a crisis-like situation in the economy. Furthermore, speculative pressure aggravates the situation and can eventually precipitate crisis. However, it is apparent that outward capital movements are reactive rather than proactive, occurring in response to imbalances in economic and financial variables. This strengthens the case for (a) following sound macroeconomic policies and (b) having a strong prudential regulatory and monitoring systems in place.

In the context of opening up financial markets, liberalisation of capital accounts has generated a good deal of policy debate (Johnston 1994; Helleiner 1997). There are several reasons why it may be desirable to liberalise capital accounts rapidly. Some of the more important ones are

- to discourage or eliminate the ‘black’ market in foreign exchange
- to create an environment conducive to the establishment of a competitive and efficient domestic financial system
- to liberalise domestic interest rate policies and bring them in line with international rates
- to reduce capital flight effectively (in the context of appropriate macroeconomic policies).

Although these views stand to reason, a consensus is developing around the view that capital account liberalisation should not be introduced prematurely and that it must be carefully sequenced. Poorly timed liberalisation always runs the risk of reintroducing capital controls. However, capital account liberalisation and opening up the financial services sector are two distinct issues. The GATS focuses on the latter not the former. It seeks improvements in the terms and conditions of market access and non-discriminatory treatment or national treatment for foreign suppliers of financial services. The GATS not only allows members to maintain prudential regulations to ensure stability of their financial systems but also to maintain temporary restrictions on trade in financial services due to balance of payments reasons. Article XII of the GATS entitles members to adopt such restrictions, although these restrictions have to be non-discriminatory.

In some quarters it is believed that opening up financial services can potentially increase the volatility of capital flows, and thereby have a pernicious influence on the macroeconomic and financial system. However, there is little empirical evidence supporting this claim. Most indicators of financial volatility have decreased over the past decade in both industrial and developing countries. According to the World Bank (1997) long-term interest rates, stock prices and volatility of capital flows decreased during the 1980s and the 1990s—most notably in Asia and Africa—with the result that foreign currency reserves have become more stable on average.
Impact of opening up trade in financial services

Since the very activity of opening up trade in financial services is relatively new, a large number of impact studies are not available. Claessens and Glaessner (1998) provide a brief survey of the evidence of impact, and there are some country or country-group studies available (Bhattacharya 1993; Pigott 1986; McFadden 1994; White 1996). In Pakistan, the Republic of Korea and Turkey, foreign banks provided capital, including foreign exchange, for funding domestic projects. For the Pacific basin economies it was found that foreign banks bring in external capital, yet a great deal of their resources (as much as three-fourths) are domestically generated. The presence of foreign banks also brought about qualitative improvements in the domestic banking operations. Countries that opened their markets to foreign financial operators had lower gross interest margins, lower operating costs and lower pre-tax profits. Opening up also led to improvements in domestic institutional standards. These studies provide evidence that open financial systems are more efficient and provide better services. Foreign financial service providers generally introduced new financial products which led to improvement in the quality of services. The same observation applies to insurance services.

Most industrial and some developing countries allow for free entry of foreign financial services suppliers without adverse effects on the conduct of monetary policy or the soundness of the financial system. There are some countries (like New Zealand) where the financial system is entirely owned and run by foreign firms. This has not had an adverse effect on monetary policy. Also, little evidence exists proving that foreign financial firms do not have enough commitment to the local market or the local economy. Whenever there were lacuna in financial services and segments of the domestic economy were found to suffer, foreign firms, like domestic firms, could be encouraged to serve the less profitable market segments through explicit subsidies.

Experiences of the 1994–95 financial crises in Latin America and 1997–98 banking and financial crises in East Asia show that foreign banks played an important role in the recovery of many economies in the crisis-stricken economies during the post-crisis phase. Foreign banks are better capitalised and are subject to a more stringent supervisory system, therefore, they are better equipped to recapitalise the weaker financial institutions in crisis-stricken economies. In Mexico and Venezuela foreign banks emerged as key players in recapitalising and restructuring banks during the post-crisis period. They played a similar and significant role in the Republic of Korea and Thailand during the 1997–98 period, although they played a less prominent role in the recovery of Malaysia and the Philippines, where the financial crises were relatively less severe.

Strategies for opening the financial services sector

The foregoing exposition has clearly established the benefits of trade in financial services. However, there is neither a universally applicable sequence nor is there a rule of thumb regarding how market opening should be phased to maximise the benefits. Despite the absence of an optimal strategy, there are some principles that need to be followed for a risk-free—or rather minimal risk—opening of financial services markets. There is consensus regarding the timing of market opening. Periods of economic or political instability are the most inopportune for commencing market opening. For instance, if the domestic economy is suffering from high inflation, liberalisation of financial markets and opening trade in financial services will have a severe destabilising effect on the economy. Conditions for successful opening of trade in financial services include sound macroeconomic management, an adequate basic system for banking supervision and its effective implementation.
There are two rival strategies for opening financial services sector. The rapid-fire, so-called ‘big bang’, approach and the gradualist approach. The former strategy allows introduction of all the market opening measures simultaneously. It has several benefits. Since all the measures are adopted rapidly, the danger of leaving the process half-way through, common in developing economies, is reduced. An interesting example is that of India, where reforms and market opening were started slowly in 1991. With the passage of time, the pace became slower and by mid 1998 the whole exercise was still incomplete. Generally, vested interest groups are against opening financial services markets. The big bang strategy gives them little time to organise and obstruct the opening up process. The advantage associated with the gradualist approach is that it provides time to adjust to new conditions. The gradualist approach also provides time for raising the level of credibility of the opening-up process and the government’s commitment to it. The EU economies took several years to open up their financial services sector. They paid a good deal of attention to public persuasion regarding its benefits (WTO 1997a).

It is the circumstances of individual economies that determine how much macroeconomic stability and prudential regulations are needed for launching into market opening. Economies having inadequate prudential standards, weak institutional structures and a history of economic crises will do better if they defer opening up their financial services. In such cases priority should be given to getting all the ducks in a row before launching into trade in financial services. Economies that do not suffer seriously from such systemic weaknesses, can go ahead and launch into a big bang style market opening process. Along with that, they would do well to start domestic financial reform programs, which are consistent with the framework of the GATS.

The GATS framework and its role

The framework

Like any international agreement, the GATS essentially comprises a framework of rules and schedules of commitment from the member countries regarding market opening or market access. These rules are based on the concepts developed and honed in the context of the GATT and the WTO. Therefore, the MFN principle and transparency form the foundation of the GATS. Not all governments were willing to apply the MFN principle across the board, therefore Article II, paragraph 2, permits members exemptions which could be expressed at the time of initial GATS commitments. These exemptions are subject to review. The first such review shall take place no more than five years after the entry into force of the agreement. The Council for Trade in Services (CTS) shall determine the date of any such review and examine whether the conditions which created the need for the exemptions still prevail. Thus, in principle, the exemptions can not be of a permanent nature but are to be of limited duration. In part, the MFN exemptions reflected the desire of members to preserve existing preferential arrangements that were not broad-based enough to be covered by the GATS Article V, which deals with the provision permitting departures from the MFN principle in the name of economic integration.

The second reason for countries, particularly the larger ones, asking for exemptions was the concern regarding ‘free riders’. Larger exporters of financial services felt that by granting MFN access to their markets, they would be losing the opportunity to exchange their relatively open access for further liberalisation in the markets of their trade partners. In other words, the larger exporters thought that by granting MFN access they would lose opportunities for asking for reciprocity from their trading partners. Therefore, as many as 60 countries asked for MFN exemptions at the time of entry to the GATS in 1997.
Another noteworthy feature of the GATS is that it accommodates gradualism. It is wedded to progressive liberalisation, which implies a gradual market opening approach. The GATS recognises that liberalisation in the services sector, particularly in the financial services sector, cannot be brought about suddenly. The GATS also provides for an appropriate judicial, arbitral and administrative complaint procedure (Article VI, paragraph 2), which is of a general nature. The other general rules relate to economic integration (Article V), provisions dealing with recognition of qualifications (Article VII), monopolies and exclusive suppliers (Article VIII) and business practices restricting competition (Article IX).

During the negotiations, members were required to specify the sectors and activities in which they intended to undertake specific commitments. They are listed in country schedules appended to the agreement. Part III of the agreement comprises Articles XVI (market access), XVII (national treatment), and XVIII (additional commitments). These three Articles of Agreement are the core of the agreement as far as specific sectoral commitments are concerned. Article XVI defines market access in specific terms. Having established that signatories will accord services and service suppliers treatment at least as favourable as that provided for in the schedules, the article goes on to define six types of market access restrictions that will not be adopted in respect of sectors where market access commitments are undertaken ‘unless specified in its schedule’. That is, market access discipline will apply to scheduled commitments unless a reservation is registered to the contrary. Limitations on market access should be scheduled in terms of one or more of the six measures specified in Article XVI, paragraph 2. Article XVI can be treated as exhaustive, in the sense that the six types of market access restrictions defined in it are the only limitations on market access that members are permitted to include in their schedules.

Article XVII contains the national treatment provision of the agreement. The approach adopted here is similar to that of market access, that is, national treatment is applicable only to scheduled commitments, and only if reservations are not made to the contrary. The definition of national treatment is the same as that in the GATT. It is defined as treatment no less favourable than that accorded to domestic homologues, in this case services and services suppliers. However, there is a significant difference between national treatment in the GATT and the GATS. While in the former case national treatment applies across the board, in the latter case it has been given negotiating currency. It is something to be ‘granted, denied or qualified, depending on the sector and signatory concerned’ (Kono and Low 1998).

Article XVIII offers further possibilities to expand commitments not dealt with under the market access (Article XVI) and national treatment (Article XVII). These additional commitments could apply to such matters as qualifications, standards and licensing, and need to be inscribed in members’ schedules of commitments. This option was not used much in the Uruguay Round. The most significant aspect of Article XVIII measures is that they invite and facilitate commitments favouring more open access, not additional barriers, thus making it an instrument of greater opening of trade.

In addition to the provisions of Part III, the Annex on financial services provides for specific commitments as opposed to general obligations. The Annex deals with the ‘specificities’ of the financial services and takes into account the sector-specific characteristics of financial services. The most significant sector-specific provision relates to prudential measures in domestic regulation [paragraph 2(a) of the Annex], which states that ‘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’. Since the start of the negotiations on financial services during the Uruguay Round, negotiators recognised the need for maintaining measures protecting domestic prudential
regulations as well as investors and depositors. Therefore, paragraph 2(a) had to be added to the Annex. These measures need not be inscribed in the schedules of members’ specific commitments regardless of whether they are in conformity with Article XVI (market access) and XVII (national treatment), so long as they constitute prudential measures as defined in the same Annex.

Except under Article XII (restrictions to safeguard the balance of payments), the GATS does not allow members to apply restrictions on international transfers and payments for current transactions relating to its specific commitments (Article XI, paragraph 1). If a member is committed to the cross-border supply of a service, the associated movement of capital is to be accepted as its natural counterpart. Although such provisions apply to trade in all services, they are particularly relevant in the context of financial services. A commitment to liberalise market access in financial services would be virtually worthless without a concomitant obligation to liberalise associated capital flows. When external financial difficulties cause serious balance of payments pressures, a member is permitted to introduce restrictions of a temporary nature on trade in services. This implies restrictions on international payments or transfers as well. Article XII stipulates conditions so that these measures are not recklessly applied.

Clairvoyantly, Article XI, paragraph 2, provides that nothing in the GATS affects the rights and obligations of the members of the International Monetary Fund (IMF) under the Articles of Agreement of the IMF. This includes the use of exchange actions which are in conformity with the Articles of Agreement of the IMF. Member of the GATS are not to impose restrictions on any transactions inconsistently with their specific commitments, except under Article XII, or at the request of the IMF. Before invoking these measures a member is obliged to consult other members and the IMF. The latter plays a crucial role in determining whether these measures are legal or extra-legal. Also, for consultations with the GATS members, the statistical data and other facts prepared by the IMF relating to the balance of payments and foreign exchange reserves situations, will be accepted as the basis of discussion.

Current level of commitments

As specified in Article XX, members are expected to put out their Schedules of Specific Commitments (SSC), which have been annexed to the Fifth Protocol of the GATS agreement. This document contains each member’s market access (under Article XVI), national treatment (under Article XVII) and additional commitment (under Article XVIII) made for different sectors and subsectors of financial services, with respect to each of the four modes of supply. The document containing SSCs, as may be imagined, is voluminous (790 pages) and complex. 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 accordance with Article XX. As a result of this method of scheduling, the entries in the national treatment column only cover a residual class of measures. Besides, most of the entries in the national treatment column are highly correlated with those in the market access column. According to this procedure, liberal market access can be equated with full national treatment, and vice versa.

As regards the question of which services and modes are the most important and attract the largest number of commitments, the answer is that in insurance sector, direct insurance (both life and non-life) and in banking and other financial services sector acceptance of deposits and lending of all types are the most important activities. These services constitute the core of the financial services sector. Securities-related services are of considerable importance in the industrial and emerging market economies. As for the modes, the first three modes, namely cross-border trade, consumption abroad, and commercial presence, are relatively more important. The fourth mode, the presence of natural persons, is
less important than the other three. The commitments of countries in the fourth mode are, in any case, almost uniformly limited to the intra-corporate transfer of managers, executives and specialists.

In the schedules of commitment, there are three levels of commitments. First, ‘full bindings’ that is absence of any limitations, second, ‘no bindings’ that is a commitment can be revoked, and, third, the intermediate case of ‘limited’ bindings which refer to those commitments which are conditioned in some way by a limitation. Some members also inscribed prudential measures and other regulatory interventions in their SSCs. This is manifested by the frequent appearance of approval or authorisation requirements in their SSCs.

During the Uruguay Round, many governments undertook commitments in financial services, however, some important trading countries like the United States judged them inadequate and the negotiations had to be extended after the Uruguay Round was completed. Subsequently many members improved their commitments, some substantially. The WTO (1997a) analytical database permits an examination, albeit not detailed, of scheduled commitments. This database is able to generate analytical information on the market access and national treatment commitments undertaken by members in their schedules. The schedules of members have not been constructed in a uniform manner. Some members have used different classifications of financial services while others have scheduled their commitments in accordance with the Understanding of Commitments in Financial Services. This has made cross-country and cross-sectoral comparisons difficult. Therefore, for comparison, interpretations based on judgement becomes mandatory. In addition, in taking account of horizontal measures in the schedules, it was observed that the relationship between these measures and sector-specific entries was not always clear.

Limitations on market access should be scheduled in terms of one or more of the six measures specified in Article XVI. The limitation statements of many members were neither clear nor explicit enough, therefore, they could not be readily classified along the lines indicated by Article XVI and classification had to be judgement-based. In fact, some entries did not fit any of the Article XVI limitations and therefore a new category of ‘residuals’ had to be created. Many of the limitations were clearly of a prudential nature and should not, therefore, have appeared in Article XVI limitations at all. That being said, a consensus on what can be classified as a prudential measure has not emerged as yet.

Since Article XVII does not contain a statutory list of national treatment departures, a categorisation of typical measures was developed. A residual category was also established for other national treatment measures. Due to ambiguities in national commitment statements the residual category contains a large number of measures. A caveat is in order here. Since the WTO analytical database is in an early stage of development, and closer examination may lead to revision, the analysis of results may have to be revised in the future.

During and after the negotiations for the interim agreement in mid 1995, 29 WTO members (counting the EU as one) improved and modified their SSCs. In the final GATS agreement, which was a significant improvement over previous agreements, 25 members (counting the EU as one) continued to utilise their MFN exemptions under Article II of the GATS. These exemptions, apparently, allowed members to discriminate among their trading partners. Where such exemptions have been noted in the schedules, the policy treatment need (can) not be mentioned in the commitments of market access and national treatment. This is because the commitments or exemptions under market access and national treatment are provided only on an MFN basis. In some cases, exemptions cover preferential treatment in regional agreements. In many cases, however, they are intended to secure bilateral reciprocity with respect to market access. The WTO (1997a) prepared several large summary
tables to infer that governments have made more commitments in financial services than in any other services sector. By mid 1997, 84 WTO members made commitments in financial services. The number of members making commitments in this sector was second only to tourism. However, the number of limitations maintained, on market access or on national treatment, were also higher in the financial services sector than in other sectors. Of the 84 members, 71 made commitments in insurance services and the same number in banking and other financial services, with some countries making commitments in only one of the two major sub-sectors.

Several developing countries and least developed countries have been more willing to make commitments in banking and other financial sectors. This is essentially due to the higher priority placed on opening the banking sector for foreign investors. Some island economies and those with off-shore financial businesses (like those in the Caribbean, Bahrain and Malta), readily made substantial commitments in insurance services. Of these, the largest commitments were in reinsurance, which is a highly internationalised activity. The coverage of sub-sectors varies. For instance, life insurance was covered by 59 members while non-life insurance by 61 members.

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. As opposed to this, only 37 countries made commitments in settlement and clearing services and 38 in trading in derivatives. The Annex on financial services has listed 16 sub-sectors. On average, members made commitments in 10 sub-sectors each. Coverage was more comprehensive for industrial countries than the other country groups. A noteworthy development was that some least developed countries (Gambia, Malawi and Mozambique) covered all banking and financial services excluding insurance. An easy generalisation that can be made is that higher levels of commitments were made in more internationalised financial services (like reinsurance or services to the corporate sector) or the so-called ‘core’ services of banks and other financial institutions, compared to domestically oriented financial services.

As regards the level of commitments, sectoral comparison reveals a relatively lower share of ‘full commitments’ in the financial services sector compared to other sectors like tourism. Schedules contain a large number of limitations or guidelines on the types of legal entity financial services providers may establish. The reason is that this sector is politically sensitive. 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. Mode 3 had the highest combined share of full and partial commitments. It should, however, be pointed out that the differences were minor. Stronger commitments in financial services in mode 3 compared to mode 1 and mode 2 are natural because of relatively strong supervisory concerns on the part of financial regulators and the knowledge and technology transfers expected from such trade. The observed distribution of commitments confirms that governments prefer commercial presence to cross-border supply, but the differences are not great.

**Some systemic limitations of the GATS**

The agreement on financial services, for that matter the GATS, has several weaknesses. There is total absence of generic rules. Since the schedules of commitments are sector-specific, the agreement lacks transparency. This is notwithstanding Article III which demands transparency. No information is generated on sectors and activities in which no commitments are scheduled. More often than not, these are the sensitive areas in which restrictions and discriminatory practices abound. This shortcoming of the agreement is a serious one, given the nature of impediments to trade in financial services. At the time of the Uruguay Round negotiations it was felt that negotiations in services were sectoral, driven by and large by the
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The concerns and interests of the major players in each sector and each industry. This led to an emphasis on achieving sectoral reciprocity in absolute terms, which in turn limited the scope for incremental liberalisation and for cross-issue trade-offs. These are commonly used instruments in trade negotiations. What was worse was that this led to a loss of an economy-wide perspective.

Since the GATS imposes no limitations on national policy (Article VI), many developing countries have been able to accede to the GATS, as well as to the agreement on financial services, with only minimal commitments. Therefore implications for these countries are limited. The non-generality of national treatment, and the sector-specificity of market access commitments reduces the value of the agreement to those governments that are seeking significant liberalisation of trade in services. Because of strong domestic lobbying pressure, some governments need an external justification for liberalising. The GATS does not provide this justification.

Because market access and national treatment are ‘specific commitments’ in the GATS, as opposed to general obligations, national treatment and market access do not apply across-the-board to all the financial services sectors and sub-sectors. Instead, they apply only to sectors, sub-sectors and activities that are listed in a country’s schedule of commitments. The use of specific commitments for market access and national treatment, instead of general obligations applicable to all services sectors, is widely regarded as a structural weakness of the GATS. This weakness is usually discussed in terms of the associated scheduling techniques, the so-called hybrid list approach.

If market access and national treatment were general obligations, a negative list of exceptions or a ‘top-down’ approach could be used for scheduling. Under this approach all non-conforming measures (measures that do not conform to the principles of market access and national treatment) could be listed as limitations in a country’s schedule of commitments. Consequently, market access and national treatment would apply to all sectors not listed in a country’s schedule of commitment. For instance, in the banking sector if a member wishes to prohibit further expansion of foreign branches or deposit accumulation by foreign banks in the domestic market, and wishes to do so without violating its GATS obligations, all it needs to do is inscribe these limitations in its schedule. However, this strategy was resented and resisted by the developing and emerging market economies. Their interpretation of this strategy was that the general obligation would be binding across all services sectors, with some specific exceptions. Since during the Uruguay Round negotiations, these countries remained adamantly opposed general obligations and negative lists, a hybrid approach was adopted as a compromise. This approach entails both a positive and a negative list of sectors and subsectors. In case of financial services, some countries mentioned such narrow subsectors that their schedules of commitments appear detailed lists of activities (Key 1997).

One of the weaknesses of the hybrid list is that it provides no accounting of barriers for unlisted sectors and for ‘unbound’ modes of supply. This affects the dynamics of negotiations in a negative manner, that is, how does one negotiate further liberalisation of trade in financial services with a hybrid list? The absence of a standstill is another major limitation of the GATS. In the absence of a standstill, some countries scheduled commitments in financial services that were more restrictive than measures currently in force. Let me illustrate this with the help of an example. If country A allows foreign banks to have 60 per cent ownership in its banks or financial firms, by making a binding commitment for a 40 per cent foreign ownership, the country A retains the option of restricting foreign ownership positions to the previous level.

A large number of member countries asked for and subsequently maintained MFN exemptions. This vitiates the agreement. To some analysts (Sorsa 1997), the GATS
agreement has failed as a multilateral agreement because it has allowed too many MFN exemptions. The largest majority of commitments are in commercial presence and subject to many conditions. Therefore, the immediate importance of the agreement is systemic and political. It reinforces the multilateral system and will form a basis for continued multilateral liberalisation in the financial service sector. Multilateral binding of financial sector liberalisation should ensure that countries will not backtrack on commitments without due consultations with their trading partners.

Schedules of commitment have not been made in a uniform manner, therefore, comparisons between two schedules becomes difficult. Also, limitations on market access should have been expressed in terms of one or more of the six measures specified in Article XVI. However, the limitation statements were neither clear nor explicit. Therefore, they could not be classified along the lines indicated in Article XVI. Such a variety, or incompatibility, in the schedules makes comparisons and analysis extremely difficult. If the agreement on financial services, and the GATS in general, is to become an effective and credible instrument of multilateral trade liberalisation, it needs to address many challenges. The most important one is that the sector coverage must be greatly expended through binding of all measures violating national treatment and market access. In addition, a set of generally applicable rules and disciplines must grow significantly, pari passu the weight of specific commitments should decline (Hoekman 1995).

If past experiences are any guide to the future, future schedules for improving the agreement on financial services as well as the GATS, would build upon the existing schedules as much as possible. A comprehensive and feasible future strategy would include the following measures

- give members time—a transition period—to adopt a negative list approach
- eliminate all overlaps between national treatment and market access, ensuring that the latter applies only to non-discriminatory measures
- eliminate mode-of-supply specific limitations in the schedules
- expand the reach of the market access article, which could be done by adding the term ‘or measures with equivalent effect’
- agree to a formula-based approach for future liberalisation.

Experience of the various rounds of GATT negotiations suggests that progress in trade liberalisation improves if negotiators use a quantifiable focal point. A ‘formula’ approach can be adopted that could establish a target share of liberalisation for each member’s financial services sector that should be scheduled without restrictions. It should then be bound. More generally, the new approach to liberalisation should include generic disciplines in trade in services and in the general framework of the GATS.

Concern regarding free riders

Free riders were the bête noire of the GATT, the WTO and now the GATS. From the perspective of trade theory, free riders should not be a major issue because a country can maximise its own welfare by opening its markets, it matters little if some of its trading partners do not provide reciprocal access. To be sure, if some markets remain restricted, the welfare of the world economy will not be maximised. However, what is established by trade theory is consistently and persistently ignored in trade negotiations. The GATS framework is such that countries can develop into free riders relatively easily. Since Article XIX states that the process of liberalisation shall take place ‘with due respect for national policy objectives and the level of development of individual members’ and calls for ‘appropriate flexibility’ for individual developing countries to open fewer sectors. Thus, Article XIX, provides ‘special and differential treatment’ to developing economies in the GATS framework. A GATS signatory
is not obliged to cover every sector in its schedule of commitments. Some developing-country signatories of the GATS have only submitted schedule of commitments covering tourism. In addition, countries can submit schedules with a few commitments covering a small number of narrowly defined subsectors, with commitments for only one mode of supply.

When an emerging market economy tries to be a free rider, it is resented by large traders. Although about 80 countries made commitments in the financial services sector during the Uruguay Round, the United States conducted extensive negotiation with only half of them, which included 30 emerging market economies. The United States made its disapproval known when some of these emerging market economies attempted to take the status of a free rider. If having countries as free riders in an international agreement is unacceptable, there are three alternatives.

First, departures from the MFN principle, second, phased commitments, and third, fixed-term agreements. Taking the first alternative first, if the free rider status is unacceptable to a member, the GATS allows it to take an exemption from the MFN obligation at the time of entry into force of the agreement. Second, phased commitments could be used to help obtain strong underlying commitments to market access and national treatment from emerging market economies with concomitant MFN-based commitments by all parties. Phased commitment implies commitments that are guaranteed to be implemented during a predetermined period. These commitments may also specify a series of benchmarks for eliminating current restrictive measures. Third, another approach to dealing with the free rider problem is to negotiate a fixed-term MFN-based agreement. The benefit of this approach is that it recognises that some emerging market economies are not ready to make strong commitments to market access and national treatment but can do so in future. Another benefit is that a fixed-term approach can lock in commitments that represent the maximum progress achievable at a particular point in time (Key 1997).

Trade in financial services in Asia

Asia’s strengths and weaknesses

Most Asian economies are in a good position to make market access and national treatment commitments in trade in financial services because they have strong fundamentals, that is if we ignore the financial turbulent period of 1997–98. High GDP growth rates of the last three decades, and establishment of many new business enterprises, can cushion any negative impact of opening up on the financial institutions. The financial services sector is expected to grow at rates far exceeding overall economic growth, with consumer financial services projected to expand at growth rates two to three times GDP growth rates. In many Asian economies, with the exception of the transitional economies, supervision and prudential standards are better than other developing countries, although they need further improvement.

In many Asian economies, the financial services sector is not weak. These countries have managed to keep their interest rates positive. In several East Asian economies the financial systems are deep, with the ratio of credit to GDP above 50 per cent. For Hong Kong and Singapore, this ratio is above 250 per cent. Many have gradually liberalised their capital accounts and have enjoyed access to international capital markets, and many have announced plans to further deregulate their financial systems. Several off-shore financial centres exist in the region. Countries having financial centres indicate their desire to internationalise as well as deregulate their financial services sectors. Some Asian economies also have ambitions to make their country a regional financial centre, which must be based on a belief that their financial institutions can compete on a regional and global basis.
Although financial systems in East Asian economies are better developed than in some other developing economies, relative to income level, institutional development is inadequate. Improvements in payments systems, developments of money markets and central bank open market operations are some of the areas badly needing development in many Asian economies. Credit analysis techniques and risk management are poor in most East Asian economies. In addition, many banks do not appear to measure and manage their currency and interest rate risks carefully. It is little wonder that the financial systems in the region are burdened with relatively large amounts of non-performing assets. The principal reason is that institutional development generally lags behind real sector development. Additionally, significant state ownership of the financial services sector has also retarded institutional development. These infirmities, however, need not retard opening up of the financial services sector in Asia. If anything, by internationalising the financial services sector these countries will be able to quicken the pace of financial sector development.

To determine the effect of opening-up on the financial services sector and on the economy, it is necessary to know the costs and efficiency levels in different Asian economies. If we can find those with a reasonable degree of accuracy, they can be correlated to the degree of openness of a particular economy. But the cost of financial services is affected by, or distorted by, the regulatory measures, tax and macro and microeconomic factors. Therefore, such a comparison runs the risk of being ‘dirty’. For instance, direct comparisons between nominal and real interest rates may not reveal anything regarding the competitiveness of two banking systems. Decomposition of interest rates shows that a good part of the level of nominal interest rate can be explained by factors other than the efficiency of financial intermediation. Another example is banking margins which are affected by reserve requirements of each economy, inflation, tax on financial services, and credit differentials between firms. Margins are also affected by the stage of the business-cycle in an economy. Thus, direct comparisons between variables can be misleading. As the financial services sector develops and matures, the cost of financial intermediation also changes. For instance, over the last ten years many Asian countries have made significant improvements in the institutional infrastructure for equity markets. Trading and settlement systems are now properly established, and regulatory frameworks have improved. These developments have led to reduction in the cost of financial intermediation through equity markets. Several, albeit not all, of these improvements have been driven by foreign pressures or by the degree of openness of the financial services sector (World Bank 1997).

Given the above caveat, Claessens, Demirguc-Kunt and Huizinga (1997) took several measures of costs of financial services in Asia and related them to measures of openness. Cross-country empirical evidence for Asia specifically suggests that the limited openness to date has been costly in terms of slower institutional development, greater fragility and higher costs of financial service. For banking services in eight East Asian countries (Hong Kong, India, Indonesia, Malaysia, Philippines, Singapore, South Korea and Thailand), a clear negative relationship was found between net margins and de facto and de jure openness of financial institutions. At the same time, a positive correlation was found between profitability and openness. It suggests that opening trade in financial services encourages banks to reduce costs and diversify their income. Less open East Asian banking systems (such as the Indian system) appeared less institutionally developed and more fragile. For securities markets in Asia, a positive correlation was found between the degree of openness and measures of functional efficiency. For life insurance markets, a negative correlation was found between operating costs and openness on the one hand and pay-back and openness on the other. Hong Kong is a conspicuous exception in having both open as well as efficient and robust financial markets for all three types of financial services.
The degree of openness

If the schedules of commitment are compared, the East European and African economies are ahead of Asian and Latin American economies. For the latter two regions, evidence suggests that Asia has on the whole made more liberal commitments on insurance, whereas Latin America is ahead in banking (Mattoo 1998). Despite the recent trend towards greater market openness in Asian financial markets, the outcome of the GATS negotiations suggests that there is still considerable caution concerning a rapid opening of the financial services to outside competition. Worries linger over the ability of local financial institutions to survive the advent of increased foreign competition.

If both principal openness measures, namely, market access and lack of national treatment measures are taken into account, we find that the degree of openness varies among Asian economies from very open to highly restricted. As of the end of 1996, entry barriers have been ranked on a 1 to 5 scale, with 1 being the least open or closed and 5 the most open (Table 3). According to the rankings, the financial services sector in Hong Kong is almost completely open, while at the other end of the spectrum are countries like South Korea, Malaysia and India, where this sector is almost completely closed.

Some Asian economies apply restrictions to domestic as well as foreign suppliers of financial services. For instance, Malaysia has a restrictive regime both for domestic firms as well as those from abroad, the only difference it makes is that foreign firms face more barriers than the domestic ones. South Korea imposes very high capital requirements on all investment management firms, with extra restrictions on the foreign firms. Most Asian economies stringently restrict branch expansion by foreign banks. Restrictions on expansion of ATMs (automatic teller machines) are even higher. Relatively speaking, entry into banking services in Asia is easier than that in insurance and securities businesses. To be sure, there are large differences across countries in the treatment of the three types of financial services. For entry into securities markets, Hong Kong is the most open economy while Thailand the least open, with South Korea and India close on the heels of Thailand (Table 3). In case of insurance, again Hong Kong and Singapore are the least restrictive to foreign firms while Malaysia and India are almost closed. The majority of Asian countries do not allow cross-border trade in insurance services.
In Table 3, commitments, like practices, are ranked on a 1 to 5 scale. Based on the commitments made during the interim accord of June 1995, the most open banking market would be Hong Kong, followed by Indonesia, and Thailand. South Korea is at the opposite extreme. There were few commitments in its 1995 schedule. For the securities markets, again Hong Kong made the largest number of market commitments, followed by Indonesia and Singapore. At the opposite extreme was South Korea. In the insurance sector, the same story was repeated. Hong Kong topped the list while South Korea and India were at the other extreme. Comparing commitment and practice indicators, one can see that commitment index falls short of the current practice index in many Asian economies (Table 3). This is most frequent in banking services. The Philippines has committed to allowing 49 per cent foreign ownership in banking, while current practice limits it to 60 per cent. Indonesia did not bind its current practice of allowing up to 80 per cent ownership in joint ventures in brokerage services, but tried to emulate the other Asian economies in allowing 49 per cent ownership in financial services.

An indicators of capital controls and exchange rate restrictions is also provided in Table 3. This indicator has as much inter-country variance as the others. Hong Kong is almost completely open, while Indonesia has opened considerably in recent years. South Korea has significant restrictions, while India is almost totally closed. After the commitment made in the interim accord in mid 1995, there has been some progress in unilateral liberalisation. For instance, Singapore, in an attempt to reinforce its status as a regional financial centre, announced several unilateral liberalisation measures. Similarly, in the context of its accession to the OECD, South Korea announced many liberalisation measures, which includes greater access by foreign financial services firms.

The exports and imports statistics of some selected Asian economies are reported in Tables 4 and 5. Since their source is the IMF Balance of Payments Statistical Yearbook, we shall have to repeat the caveat given earlier with respect to these data. As may be expected, Hong Kong is the largest exporter of financial services in Asia. Between 1985 and 1996, its exports increased more than sixfold. South Korea and the Peoples Republic of China are the other major exporters of financial services in Asia, while India is also managed to remain a small but consistent exporter. If import positions of these economies are taken into account,
Hong Kong and China have managed to remain substantial exporters while India and Singapore were substantial importers. South Korea more or less broke even.

Table 4  Exports of financial services for selected Asian economies, 1985–96

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**Sources:** International Monetary Fund, various issues. *Balance of Payments Statistics Yearbook*; The Hong Kong Monetary Authority.

Table 5  Imports of financial services for selected Asian economies, 1985–96

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**Sources:** International Monetary Fund, various issues. *Balance of Payments Statistics Yearbook*; The Hong Kong Monetary Authority.
Some policy implications

Both classical and neoclassical trade theories as well as past experience suggest that irrespective of the stage of development of an economy and independent of the state of development of domestic financial market, opening trade in financial services can have favourable welfare implications. Although the GATS framework has limitations and it is still evolving, a well-conceived adherence to the GATS can help a developing economy build a more efficient, if not robust, financial system. By improving the quality and spread of financial services and by allowing a more stable spread of funds, opening trade in financial services can underpin growth endeavours. Since development of financial services sectors in Asia still has a long way to go, these benefits could mean substantial gains in terms of economic growth.

As noted earlier, East Asia has the benefit of having an efficient and robust financial system, namely, Hong Kong. As opposed to Hong Kong, many economies have not opened their financial services sectors, or are open only to a limited degree, which has a high cost in terms of slower institutional development, greater fragility, and higher cost of financial services. Limited openness in Asian economies has high costs in terms of slower institutional development, higher costs in the financial sector and greater fragility. There was a negative relationship between net margins and openness of the financial services sector and a positive relationship between profitability and openness. Thus, we can infer that opening trade in financial services encourages the banking sector to reduce costs and diversify income, beginning to rely more on fee income. Security markets also are functionally more efficient when they are open than when they are sheltered from foreign competition. Similarly, in life-insurance markets operating costs plummet with openness.

These conclusions have meaningful policy implications for the developing countries. If the domestic economies are kept heavily restricted by regulations and if foreign entry in different financial services sectors are limited, domestic competition is reduced. Consequently, the financial sector develops without competition or with only scanty competition. If this continues, financial sectors become high-cost and inefficient. Perhaps the most outstanding example of this is the Indian financial sector. Lack of competition has allowed it to become high-cost and extremely inefficient. A protected financial sector also creates distortions in an economy. A closed or restrictive environment prohibits financial institutions from exploring their comparative advantage. If controls are needed for prudential purposes, the GATS framework allows them, if they are imposed even-handedly on domestic and foreign firms. However, policymakers need to be cautious about opening trade in financial services without having a sufficiently developed supervision framework and prudential norms—such a move may have a great deal of downside risk. The recent (1997–98) financial crises in East Asia prove this convincingly. Balancing this risk is the fact that when the financial services sector is opened, it lets in foreign financial institutions which are generally far better capitalised than the domestic ones and are, therefore, beneficial to the host economy. Therefore, quality of domestic regulatory and supervisory framework need not become an absolute limitation for opening the financial services markets.

To be sure, opening markets will have short-term adjustment costs. There may be some displacement of labour as well. If policymakers think that these costs are inordinately high, they can commit to phased opening of their financial markets over an agreed time frame. They could emulate Mexico, which committed in the context of North American Free Trade Area (NAFTA) to a phased program of opening up, with a negotiated time table. In addition to lending credibility to a country’s market opening endeavours, a schedule of commitment, no matter how it is phased, provides security to foreign financial firms. It enables them to have a clear idea of the environment they will have to operate in. In case
they judge this environment as conducive to good business, they will price their services better, which in turn will benefit the host developing economy.

If policymakers in the Asian economies wish to be extra cautious, the GATS system allows them temporary suspension of commitments in the event of pronounced economic imbalances. Article X, paragraph 2, allows for withdrawal of ‘a specific commitment after a period of one year from the date on which the commitment enters into force’. In addition, Article XII allows temporary suspension of commitments for balance of payments reasons. Thus viewed, the GATS framework provides policymakers with a great deal of flexibility for dealing with the unexpected.

One principle common to trade in goods and trade in services is that quantitative restrictions should be avoided by policymakers because they lead to a higher level of systemic inefficiency. Quantitative restrictions can be converted into price-based measures. Wherever possible, host developing countries should harness the interests and special skills of foreign financial services firms and make them work to their own advantage. This can be done by making them a part of the domestic financial sector restructuring or market opening endeavours. In many developing economies foreign banks have helped in the restructuring and recapitalisation of existing financial institutions. They did so during the 1994–94 crises in Latin America and the 1997–98 crises in Asia.

**Liberalising financial services in the backdrop of Asian financial crises**

The preceding section provides some general policy prescriptions for developing economies, including those in Asia. However 1997 and 1998 have not been normal years for Asia. Therefore, some anxieties regarding opening up of financial services markets have gained currency. After the Asian crises, potential pitfalls of globalisation and the downside of deepening financial and economic integration are being questioned in some quarters. Since this is a period of financial and macroeconomic instability in Asia, some analysts have called for adopting no further market opening measures until the required adjustment of domestic economic and regulatory policies has taken place. Some have gone so far as advocating reining back market opening, particularly in the areas of financial services and capital movements. However, Asian governments have so far resisted calls for a protectionist response to the crises. The policy advice that the Asian governments have received is logical and sensible, and they are accelerating the pace of structural and regulatory reforms as well as pressing on with commitments to further trade and investment liberalisation. Asian governments seem to be acting on a perception that greater openness to trade, particularly trade in financial services, is more likely to be part of the solution to current problems than to aggravate them.

Hindsight reveals that the Asian financial and macroeconomic crises were ignited by the interaction of a number of financial and structural weaknesses. The principal ones were

- large capital inflows in an ambiance of inadequate regulatory frameworks and poor prudential norms
- misallocation of capital and large non-performing assets
- poor corporate governance
- over-leveraged corporate balance sheets
- rising current account deficits along with non-productive domestic investments
- herd behaviour by foreign portfolio investors.

There is consensus on the view that the crises have not been caused by mere liberalisation of the financial services sectors (Sauve 1998). If liberalisation measures had kept pace with growth of transparency, improvement in prudential norms and supervisory
standards, the likelihood of the precipitation of crises might have been lessened and their effects mitigated.

Despite occasional protectionist calls, the official policy responses to the crises have been to keep the markets open, particularly in the financial sector. During the Asia–Europe summit meeting in London and the WTO’s fiftieth anniversary, both of which took place in the first half of 1998, maintenance of open markets formed an essential ingredient of any recipe for the recovery for the affected Asian economies. Furthermore, under the sponsorship of the Asia-Pacific Economic Cooperation (APEC) Forum, 18 APEC countries at their annual summit in Vancouver in November 1997 designated 15 major sectors for early trade liberalisation. These countries also agreed on detailed plans for eliminating barriers in nine trade sectors, totaling over US$1.5 trillion in global trade by early 1999.

The Asian crises are promoting liberalisation of financial markets in two direct ways. First, the heightened need for foreign investment to finance continuing current account deficit in a sustained manner is working in this direction. Second, the need to recapitalise weak banking and financial systems is making it necessary to liberalise the financial services sector. Thus, the current wave of crises is leading Asian policymakers to open their markets further and remove distortions which have inhibited the growth of trade in general and trade in financial services in particular. Insofar as the crises are leading to a more open environment in the medium to longer-term, it may even come to be regarded as beneficial from an economy-wide perspective. If this sounds a little too optimistic, it should be noted that liberalisation is not a painless process. There can be little lasting structural change without adjustment costs. These can be high in terms of economic retrenchment, social sacrifices and political upheavals. The current experiences of Asian economies, particularly, Indonesia, Korea, Malaysia and Thailand bear witness these costs. Experience shows that the costs must be borne before benefits can be reaped. The challenge for policymakers is to take a realistic account of the transitional costs, and minimise them by choosing the most appropriate policy measures. Alternatively, if policymakers vote on the side of ‘playing safe’ and if the policy measures chosen are such that they stop liberalisation and transition in the affected Asian economies, it will mean a high cost to them in terms of reduced overall economic growth, and the overall effect would be socially regressive (OECD 1998).

Conversely, if financial markets are liberalised and other precautionary measures are taken, there is a possibility of this crisis turning into a blessing in disguise for the crisis-stricken Asian economies. The GATS can provide a tailor-made opportunity to the crisis-stricken economies. Making binding commitments for market access and national treatment, would not only contribute to stability and growth but also reaffirm and deepen their systemic commitment to the global economy, and restore investor confidence, all of which is critically needed at this juncture.

**Summing up**

After prolonged negotiations and delays, the GATS agreement was signed in December 1997. Like the GATT and the WTO, the foundation of the GATS rests squarely on the twin principles of non-discrimination and transparency. The GATS accord covers more than 95 per cent of the world’s multi-trillion dollar financial services market. There are widely differing views regarding the significance of financial services in an economy. Astonishingly, Adam Smith viewed all services as being unproductive. Contemporary researchers have attempted to come to a categorical conclusion in this regard through various rigorous theoretical and empirical methods. They have found a strong positive link between the expansion of financial services and economic growth.
Trade in financial services: an Asian perspective

Trade in financial services, in many respects, is similar to trade in goods and the classical and neoclassical theories of international trade apply to it. As opening trade in goods promotes production on the lines of comparative advantage and improves economic efficiency in the system, so does trade in financial services. Opening trade in financial services leads to both static and dynamic gains. In particular, competition with foreign financial institutions and more liberal conditions governing foreign entry can produce efficiency gains and promote technology transfer, thus leading to modernisation of domestic financial systems. It can also improve liquidity in stock markets.

Over the last ten years, growth of international financial activities has been more rapid than the growth of domestic financial markets. International securities and derivative transactions recorded a particularly brisk growth. To be sure, industrial economies dominate activities in the international financial market. However, developing economies are increasingly integrating themselves into it and are slowly becoming important players. Opening markets in financial services is not an easy, risk-free task and requires careful planning and preparation. It raises a number of issues for both macroeconomic and microeconomic policies. Before opening financial services markets, macroeconomic policies should be sound and strong prudential norms and regulatory frameworks should be in place.

The framework of rules on which the GATS is based was honed in the context of the GATT and the WTO. Many countries did not apply the MFN principle across the board and sought exemption from it. Article II, paragraph 2, of the GATS permits members such exemptions. Like the GATT and the WTO, the ‘free rider’ issue also plagues the GATS. In a pragmatic manner, the GATS accommodates gradualism. It is wedded to the idea of progressive liberalisation of markets. The GATS also provides for an appropriate judicial, arbitral and administrative complaint procedure. Part III of the agreement comprises Articles related to market access, national treatment and additional commitments. These three Articles of Agreement are the core of the agreement, as far as specific sectoral commitments are concerned. In addition to the provisions of Part III, the Annex on financial services provides for specific commitments as opposed to general obligations.

In the insurance sector, direct insurance (both life and non-life), and in banking and other financial services sector, acceptance of deposits and lending of all types, are the most important activities. They attracted the largest number of commitments. These commitments constitute the core of the financial services commitments. Securities related services are also of considerable importance in the industrial and emerging market economies.

The GATS as an institution is still evolving. Presently, it suffers from serious limitations. There is a total absence of generic rules. Since the schedules of commitments are sector-specific, the agreement lacks transparency. Since the GATS imposes no limitations on national policy, many developing economies have been able to accede to it, as well as to the agreement on financial services, with only minimal commitments. Another major weakness of the agreement is the hybrid list, which provides no accounting of barriers in the unlisted sectors. This affects future liberalisation negotiations. Besides, a large number of member countries have asked for and subsequently maintained MFN exemptions. This vitiates the institutional framework.

Most Asian economies are in a good position to make market access and national treatment commitments. In many Asian economies the financial services sector is not weak. Despite the recent trend towards greater market openness in Asian financial markets, the outcome of the GATS negotiations suggests that there is still considerable caution concerning a rapid opening of the financial services to outside competition. If both the principal kinds of

services and long-term economic growth. A fundamental fact that is worth emphasising in this regard is that financial services have economy-wide externalities.
openness measures, namely, market access and lack of national treatment, measures are taken into account, we find that the degree of openness varies among Asian countries from very open to highly restricted. It is in the interest of the Asian economies to make larger commitments to the GATS and open their financial markets rapidly. The financial and currency crises of 1997–98 have not pushed Asian economies towards protectionist policies. If anything, they seem to be more convinced of the benefits of opening their markets further and removing growth inhibiting distortions.

Endnotes

1 This is the fourth annex in the Articles of Agreement of the GATS.
2 The term ‘market opening’ is used here to cover commitments technically described as ‘market access’ or ‘national treatment’.
3 For an exhaustive survey of this literature, see Levine (1997).
4 It should be noted that the International Monetary Fund no longer classifies Hong Kong and Singapore as developing economies. According to its new classification they are called ‘advanced economies’.
5 The abbreviation GNS stands for group for negotiations on services. This group was formed during the Uruguay Round.
6 It needs to be clarified here that financial sector liberalisation is not the same as liberalisation of trade in financial services. Although related, they are two very different activities.
7 Indeed, we are counting the two crisis periods for Latin America and Asia out.
8 The General Agreement on Trade in Services, Results of the Negotiations on Financial Services, Geneva, 4 March 1998.
9 The term horizontal measure stands for measures applying to all the sectors.
10 This expression has been borrowed from the Articles of Agreement of the GATT, it does not exist in the Articles of Agreement of the GATS.

References


Lewis, M., 1996. ‘Financial services’ in B. Bora and C. Findlay (eds), Regional Integration and the Asia Pacific, Oxford University Press, Melbourne.


