LIBERALIZATION OF TRADE IN FINANCIAL SERVICES

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Outline

- Trade in Services: Background
- Introduction to Trade in Financial Services
- Liberalization of Trade in Financial Services
- Financial Services vs. Capital Account Liberalization
- GATS and Trade in Financial Services
- Summary of GATS specific commitments
- Commitments vs. Actual Practice

Trade in Services...

- has become one of the driving forces of globalization;
- is the fastest growing sector of the global economy;
- world commercial services exports reached $2.8 trillion in 2006 or almost ¼ of total merchandise exports.

Services Trade Classification (WTO)

- Business
- Communication
- Construction and Engineering
- Distribution
- Education
- Environment
- ***Finance***
- Health and Social Services
- Tourism
- Recreation, Culture, Sports
- Transport

Liberalization in Services Trade (1)

- Decreux and Fontagne (2006): a 50 percent reduction in global barriers to services trade would generate as much welfare gain as a moderately ambitious merchandise trade liberalization.
- Arnold et al.(2006): greater access by foreign services providers enhances productivity of domestic manufacturers.

Liberalization in Services Trade (2)

- Matoo et al. (2006): countries with open financial and telecommunications sectors grew 1 percentage point faster.
- Eschenbach and Hoekman (2006): services policies (including liberalization) in banking, non-bank financial services, and infrastructure can explain some of the growth performance in transition economies.

Financial Services

- Primarily banking and insurance;
- The WTO classification:
  - 4 sub-sectors under the insurance services
  - 12 sub-sectors under the banking and other financial services;
- Excludes activities in the exercise of governmental authority (e.g. central banks, statutory social security and public pension plans, public entities using government financial services).

Largest Exporters of Financial Services in 2006

Exporter	In USD Billions	Share percent	Growth rate averages 1-year	5-year	10-year
United Kingdom	52.4	27.6	23	18	15
United States	37.1	19.6	20	19	16
Luxembourg	33.8	17.8	34	22	19
Switzerland	11.7	6.2	12	9	6
Germany	8.4	4.4	29	21	12
Ireland	7.8	4.1	29	33	-
Japan	6.2	3.2	22	18	8
Singapore	4.1	2.1	34	28	9
Spain	3.9	2.1	39	21	18
Belgium	3.6	1.9	6	-	-
Other	20.8	11.0	24	20	15
Total	189.8	100.0	18	15	13

Source: IFS and staff calculations

Largest Importers of Financial Services in 2006

Importer	In USD Billions	Share percent	Growth rate averages 1-year	5-year	10-year
Luxembourg	17.6	21.2	33	20	18
United Kingdom	10.8	13.0	16	18	15
United States	8.5	10.2	26	14	11
Germany	5.4	6.5	25	19	18
Ireland	4.7	5.7	43	30	-
Spain	4.2	5.0	52	28	23
France	3.7	4.5	57	21	8
Belgium	3.5	4.2	-2	-	-
Japan	3.0	3.6	11	13	0
Canada	2.9	3.5	22	12	9
Other	18.7	22.6	27	20	15
Total	82.9	100.0	19	12	11

Source: IFS and staff calculations

Other Notable Exporters and Importers of Financial Services in 2005

(in billions of US Dollar)

Exporters	Value	Importers	Value
Hong Kong, China	6.3	Hong Kong, China	1.4
Korea	1.7	Taiwan, Province of China	1.4
Taiwan, Province of China	1.5	Norway	1.2
India	1.5	India	1.2
Australia	0.8	Switzerland	1.0
Norway	0.7	Russia	0.9
South Africa	0.5	Singapore	0.8
Brazil	0.5	Brazil	0.7
Russia	0.4	Mexico	0.6

Source: WTO.

Multinational Corporations (MNCs) in Financial Services

- MNCs and their affiliates dominate financial services trade;
- Large share of financial services is supplied through local affiliates of foreign firms and is not recorded in the BOP statistics;
- The U.S. cross-border exports were $32.7 billion (of which $4.9 billion to affiliates) in 2004;
- In contrast, the sales of the U.S. owned affiliates abroad were $74.1 billion in the same year.

Liberalization in Financial Services Trade (1)

- impact similar to typical goods trade liberalization...
  - higher sector productivity due to competition;
  - spillovers from foreign banks in form of new and better skills, management techniques, training procedures, and technology;
- and additional benefits from...
  - enhanced long-term growth potential due to improved access to financial services/credit.

Liberalization in Financial Services Trade (2)

- Some have suggested a potential trade-off between competition and financial stability...
  - stiffer competition from foreign banks may lower profit margins;
  - profit erosion may induce risk taking, making the financial system more vulnerable to shocks;
  - foreign banks may spur excessive borrowing and facilitate volatile capital flows.

Liberalization in Financial Services Trade (3)

- But, little evidence from empirical studies;
- Schaeck et al. (IMF, 2006):
  - more competitive banks are less prone to experience a systemic crisis;
- Demirguc-Kunt et al. (1998) show that foreign bank participation:
  - lowers probability of a banking crisis;
  - accelerates overall growth by boosting domestic banking efficiency.

Liberalization in Financial Services Trade (4)

- If stability is a concern, it should be addressed through stronger supervision and regulation.
- Kireyev (IMF, 2002) concludes that financial liberalization:
  - is broadly conducive to the banking stability;
  - but needs to be complemented by macroeconomic and regulatory measures.

Financial Services vs. Capital Account Liberalization (1)

- Financial services trade liberalization is related, but not the same as the capital account liberalization.
- The latter reduces barriers to capital flows between countries, while the former reduces barriers to foreign suppliers of financial services.

Financial Services vs. Capital Account Liberalization (2)

- The capital account can be liberalized without allowing foreign financial institutions to compete against domestic ones.
- Financial services liberalization may have implications for capital mobility:
  - e.g., members cannot impose any controls on the movement of capital if the capital is an essential part of the service itself in mode 1 (GATS).

General Agreement on Trade in Services (1)

- The first and only set of multilateral rules on trade in services;
- the product of the Uruguay Round; in force since 1995;
- ensures increased transparency and predictability in rules and regulations;
- promotes progressive liberalization through successive rounds of negotiations.

General Agreement on Trade in Services (2)

- Key sections:
  - main text on general rules and disciplines;
  - annexes on specific sector (including trade in financial services);
  - schedules (lists) of members' commitments and exemptions from MFN treatment.
- the 5th protocol (1997 Financial Services Agreement) in force since 1999 provides for improved schedules for 70 members.

Modes of Supply (1)

- Cross-border supply (mode 1):

  foreign bank grants a loan to the country's resident;

- Consumption abroad (mode 2):

  a resident opens an account in a foreign bank while being abroad.

Modes of Supply (2)

- Commercial presence (mode 3):

  foreign bank supplies financial services through its local agency, branch, or subsidiary;

- Presence of natural persons (mode 4):

  professionals of foreign bank sent to its subsidiary to provide financial services.

Cornerstones of GATS (1)
General Commitments

- Transparency;
- Most-favored nation (MFN) treatment.
  - exemptions (regional agreements or member-listed).

Cornerstones of GATS (2)
Specific Commitments

- Market Access
  - commitments appear in country’s schedule (positive-list approach);
  - subject to limitations.
- National Treatment
  - non-discrimination against foreign suppliers;
  - subject to limitations.

Market Access Limitations

- The market access schedule must list the following limitations if they are to be used:
  - the number of service suppliers;
  - the total value of transactions or assets;
  - the number of operations or output quantity;
  - the number of persons that may be employed;
  - measures restricting supply of services through specific types of legal entity or joint venture;
  - the value or share of foreign investment.

National Treatment

- Independent from market access commitments.
- Members may impose limitations.
- Examples of limitations:
  - more stringent capitalization requirement;
  - higher tax rates;
  - a physical presence (subsidiary) as a condition for accessing country’s payment system or selling financial products to domestic consumers.

Prudential Carve-Out (1)

- Members have full autonomy over their prudential regulation.
- Under prudential carve-out provisions members can take prudential measures that may contravene their GATS commitments:
  - to protect investors, depositors, and policy holders;
  - to ensure the integrity and stability of the financial system.

Prudential Carve-Out (2)

- However, the scope of the carve-out is ambiguous;
- No guidance on the types of regulatory standards and rules that would be necessary to accomplish prudential objectives.

The Balance-of-Payments Safeguards

- Members can impose restrictions on trade in services, including on payments or transfers for service transactions.
- Such restrictions...
  - cannot discriminate among members;
  - should be consistent with the IMF's articles of agreement (the IMF's assessment of the BOP);
  - should be temporary and avoid unnecessary damage to other members.

GATS Sectoral Commitments (1)

- All WTO members assumed some commitments in individual sectors (155 sub-sectors within 12 core services sectors).
- Average number of odd-service sectors:
  - developed countries – 105;
  - least-developed countries – 25;
  - but acceding developing countries at par with developed countries.
- Substantial variation within groups.

Snapshot of GATS Commitments

(in percent of full liberalization)

	Total	Market Access	National Treatment
World	26.5	25.3	27.7
OECD	55.2	55.7	58.3
Europe and Central Asia	54.6	51.5	57.6
Middle East and North Africa	25.1	23.1	27.1
High-income non-OECD	23.5	21.5	23.2
East Asia-Pacific	19.5	17.7	21.2
Latin America and Caribbean	13.9	13.0	14.3
Sub-Saharan Africa	11.3	10.7	12.0
South Africa	10.1	8.8	11.3

Source: World Trade Indicators, World Bank Institute.

GATS Sectoral Commitments (2)

- Four sectors are the most widely liberalized across the membership (percent of members with at least one commitment in the sector):
  - **financial services – 81 percent;**
  - tourism services – 95 percent;
  - business services – 78 percent;
  - telecommunications – 71 percent.

Example: Schedule of Specific Commitments (Kyrgyz Republic)

Sectors	Limitations on Market Access	Limitations on National Treatment
Horizontal Commitments (apply to all services)		
Mode 4	Unbound except for measures concerning entry and stay of services salespersons and intra-corporate transferees-nationals of another member. Entry is limited to 3 year period that may be extended for up to 2 years for a total term not to exceed 5 years.	Citizens from other countries are required to obtain entry visas. CIS citizens are exempted from the visa requirement.

Source: WTO.

Example: Schedule of Specific Commitments (Kyrgyz Republic)

Sectors	Limitations on Market Access	Limitations on National Treatment
Financial Services		
All insurance and insurance-related services (all 4 sub-sectors)		
Mode 1	Unbound, except for insurance of cargo, transportation, brokerage and reinsurance	None
Mode 2	None	None
Mode 3	None, except for foreign ownership in Kyrgyz legal entities providing insurance must not exceed 49%. To be eliminated by Jan, 2002.	None
Mode 4	Unbound, except as indicated under horizontal commitments	Unbound except as indicated under horizontal commitments

Source: WTO.

Example: Schedule of Specific Commitments (Kyrgyz Republic)

Sectors	Limitations on Market Access	Limitations on National Treatment
Banking and other financial services (all 12 sub-sectors)		
Mode 1	None	None
Mode 2	None	None
Mode 3	None	None, except for: The minimum capital requirement for banks with less than 20% foreign participation is half that required for banks with more than 20% foreign participation. To be eliminated by Jan, 2003.
Mode 4	Unbound except as indicated under horizontal commitments	Unbound except as indicated under horizontal commitments

Source: WTO.

Banking: Actual Policy vs. Commitments (1)

- Recent research (Barth et al.) compares country's GATS commitments with actual practice in banking:
  - there is a weak link (correlation) between actual practice and GATS commitments;
  - same is true regarding national treatment.

Banking: Actual Policy vs. Commitments(2)

- developed countries take more open stance than developing countries both under the WTO and in actual practice;
- however, developed countries are more restrictive in practice than what is committed under the WTO; opposite is true for developing countries.
- in terms of commitments, developed countries discriminate less against foreign banks;
- but both groups favor local banks to a comparable extent in practice;

Banking: Actual Policy vs. Commitments (3)

- countries are less restrictive in practice on whether a foreign bank can enter via acquisition or subsidiary;
- countries have allowed foreign competition in a wider range of banking activities (underwriting, dealing and brokering, and mutual fund activities) than their GATS commitments suggest;
- more countries seem to restrict bank branching;

Banking: Actual Policy vs. Commitments (4)

- some countries allow cross-border provision of banking services (w/o physical presence);
- only a few of them are developed countries;
- but most are either low-income or CIS countries.

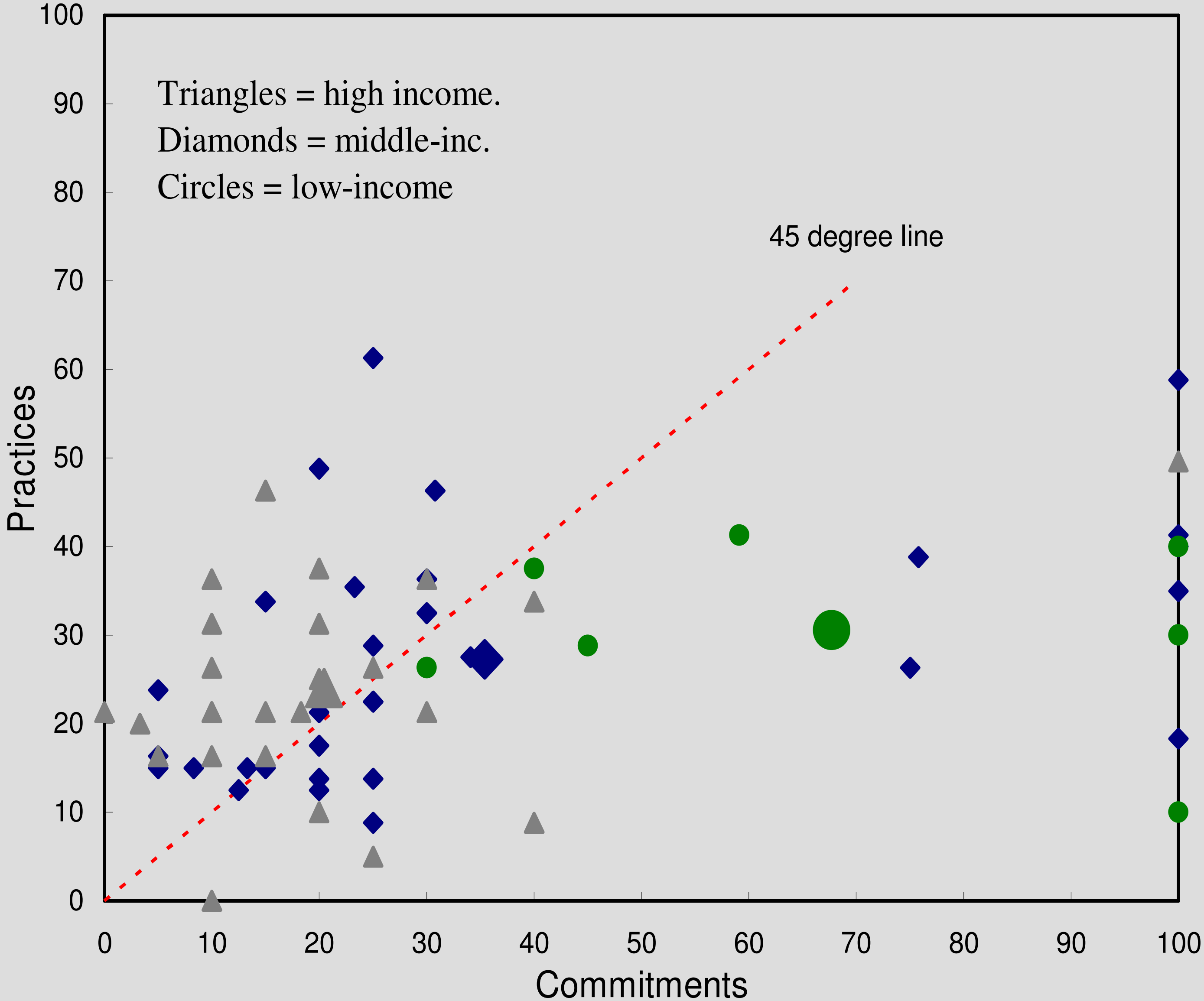
Entry requirements and permissible banking activities

WTO Commitments vs. Reported Practices
(number of countries in sample)

	Commitments		Practices	
	Yes	No	Yes	No
Entry Requirements:				
Foreign banks can enter via acquisition	90	33	123	0
Foreign banks can enter via establishment of subsidiary	79	44	122	1
Foreign banks can enter via branching	81	42	112	11
Minimum capital entry requirement similar for domestic and foreign banks	86	37	87	36
Permissible Banking Activities:				
Securities Activities: Underwriting	50	73	111	12
Securities Activities: Dealing and Brokering	53	70	99	24
Securities Activities: Mutual Funds Activities	42	81	89	34
Insurance: Underwriting and/or Selling	13	110	37	86

Source: Barth et. al., 2006

Entry requirements for foreign banks: WTO commitments vs. practices
Income group averages and individual country points
(indices: Fully restrictive = 100; No restrictions = 0). Barth et al. (2007).



Equality of treatment of foreign vs. domestic banks: WTO commitments vs. practices; Income group averages and individual country points (Indices: Fully restrictive = 60; No restrictions = 0). Barth et al. (2007).