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LIBERALIZATION OF TRADE IN FINANCIAL SERVICES: LESSONS FROM LATIN AMERICA AND THE CARIBBEAN

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LIBERALIZATION OF TRADE IN FINANCIAL SERVICES – LESSONS FROM LATIN AMERICA AND THE CARIBBEAN^{*}

1. INTRODUCTION

China's accession to the World Trade Organization (WTO) in 2001 marked a watershed with regards to its process of trade liberalization in financial services. As others have already pointed out, China's financial services commitments – which were phased in over a 5-year period following accession – were among the most radical ever negotiated in the context of the WTO. Although the structure of commitments was similar to that made by other countries (e.g. more liberalization in mode 3 and in banking services), the degree of liberalization – both in terms of market access and national treatment – went significantly beyond the regulatory *status quo* as of 2001¹. This reflected both China's relatively low starting point and the asymmetric nature of the accession's bargaining process (non-reciprocal concessions).

China is currently engaged in several free trade agreements (FTAs) and must carefully consider whether to include financial services commitments in them. China's Economic Partnership Agreements with Hong Kong and Macau in 2004 – which granted service providers from those territories preferential access to China's market ahead of the WTO liberalization schedule – can be considered as special cases, since they were intended to promote deeper integration with the mainland. However, China is currently negotiating several FTAs concurrently, both bilateral (Australia, New Zealand, Singapore, Brazil etc.) and plurilateral (ASEAN, GCC, SACU etc.) in nature. The main purpose of these initiatives is to secure market access for China's goods exports and raw materials imports, as well as to institutionalize economic and political partnerships². Even though the focus is not on financial services *per se*, China will need to decide whether to include a financial services chapter in these trade agreements. The following sections address this issue by discussing what can realistically be accomplished in terms of trade liberalization in financial services within the context of a trade agreement, and by reviewing the experience of such agreements in Latin America and the Caribbean (LCR).

Any trade commitments in financial services will need to be aligned with China's financial system condition and policy objectives. In particular, although China's financial system has been successful at mobilizing savings, it is not yet fully

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¹ Commitments were phased in following WTO entry, and culminated in the elimination by December 2006 of several mode 3 restrictions on form of establishment, geographical presence and business scope, particularly for banking services. As is common with the vast majority of trade agreements, China's mode 4 commitments in financial services are horizontal in nature and fairly restrictive.

² See Hufbauer and Wong (October 2005) for a discussion.

playing the role of allocating capital effectively to the economy. The system remains heavily bank-dominated and relatively unsophisticated in assessing credit risk, while firm financing via equity and corporate bond markets is limited³. Foreign entry has increased in recent years, but it has primarily taken the form of strategic non-controlling investments in Chinese banks; by contrast, foreign banks operating in China via branches or subsidiaries have a market share of only around 2 percent of system-wide assets⁴. Foreign penetration of capital markets is even lower, while cross-border trade in financial services is minimal⁵. This can be partly attributed to China's exchange rate regime and lack of capital account convertibility, which has resulted in a 'long debt, short equity' international financial position⁶. The slow pace of market opening suggests that Chinese policymakers want to liberalize financial services (as well as the capital account) in a gradual, controlled manner until domestic financial institutions build up their expertise and commercial orientation in order to avoid any crisis. As a result, even though domestic institutions benefit from access to foreign capital and technical expertise (e.g. risk management, product development etc.), relatively little has been achieved to-date in terms of increased competition or greater product variety outside a few major cities.

China's implementation record of its existing WTO financial services commitments will also affect FTA partners' negotiating stance. As part of its WTO accession protocol, a transitional review of China's implementation record is undertaken annually for the first few years following accession. During the latest review process, some countries have expressed doubts as to China's implementation of certain commitments in financial services – in particular, they perceive certain prudential norms as disguised entry restrictions. Examples include the inability of foreign banks to acquire existing domestic banks (differences in interpretation on the right of establishment), regulatory restrictions on the ability of foreign banks – particularly those operating via branches – to supply local-currency banking services (differences in interpretation on the prudential carve-out clause), and limitations on the ability of foreign financial institutions to supply credit card and electronic payment services via their own networks (differences in interpretation on the classification of financial services and related commitments)⁷.

³ While the domestic banking system's credit portfolio exceeds 100 percent of GDP, the corporate bond market represents less than one percent of GDP. Equity market capitalization has accelerated substantially since 2004 and has recently reached 100 percent of GDP, but a large part of the increase is due to the revaluation of existing assets, while free float is small and most publicly-listed firms are state-owned. See Allen et al (March 2007), and McKinsey Global Institute (May 2006) for details.

⁴ According to Fitch Ratings (May 2007), 29 Chinese banks, accounting for around 53 percent of system-wide assets, have been invested in by foreign banks over the past few years. Low penetration can also be attributed to the fact that foreign banks were only allowed to offer local-currency services to domestic customers across all regions in December 2006, while there remain several regulatory requirements that increase the cost and slow down the pace of their expansion.

⁵ In spite of significant *de novo* liberalization as part of the WTO accession, China's financial services trade commitments in mode 1, as well as its commitments on securities and insurance services in mode 3, remain significantly lower than those made by the majority of developed countries in the GATS.

⁶ See Lane and Schmukler (February 2007) for details and for a description of China's financial liberalization process to-date.

⁷ See USTR (2006) and related correspondence of the WTO Committee on Trade in Financial Services (www.wto.org) for more details.

Such differences of opinion will inevitably be internalized by China's FTA partners and will affect their stance in future financial services trade negotiations.

2. OVERVIEW OF TRADE IN FINANCIAL SERVICES

Liberalization of trade in financial services versus financial liberalization

An important conceptual distinction needs to be drawn between the liberalization of trade in financial services and financial liberalization. The purpose of the former is to increase financial market access and remove discriminatory and other access-impeding barriers to foreign competition. By contrast, the chief purpose of financial liberalization is to remove distortions in domestic financial systems – for example, interest rate and capital account controls, directed lending policies, restrictions on intra-sectoral activities, preferential treatment of publicly-owned banks, entry barriers for new operators – that impede competition and the allocation of capital to its most productive and profitable uses. Financial liberalization can be conceptually divided into domestic financial reform and capital account opening, and there is a broad literature on its appropriate speed and sequencing. In that context, the liberalization of trade in financial services is merely a subset of the broader financial liberalization agenda. A country may thus not directly discriminate against foreign financial service providers while still operating a repressed financial system. Conversely, a country may decide to engage in partial, pro-competitive regulatory reform in its domestic financial market, but keep it closed to foreign competition. Table 1 provides a simple example that distinguishes between different types of financial service provision and identifies those that would constitute trade in financial services as well as those that generate a capital flow or foreign direct investment.

Table 1: Comparison of Different Types of Financial Service (Loan) Provision

	Loan provided by domestic supplier	Loan provided by foreign supplier abroad	Loan provided by foreign supplier established in the country
Loan involves only domestic capital	Neither financial services trade, nor international capital flow	Only financial services trade	Financial services trade plus inward direct investment
Loan involves only international capital	Only international capital flow	Financial services trade and international capital flow	Financial services trade plus inward direct investment and international capital flow related to the supply of the loan

In practice, of course, there are typically strong overlaps between the two types of policy reforms described above. Trade in financial services is often linked to capital movements, notably in the context of the establishment of a commercial presence which requires inward direct investment. Certain types of cross-border financial transactions may also involve capital movements and hence require some measure of

capital account opening as an inherent part of the service provision⁸. In addition, countries often seek to promote greater policy coherence by opening up domestic financial markets to foreign competition in the context of broader financial reform efforts. Finally, it bears noting that neither the liberalization of trade in financial services nor financial liberalization imply the complete deregulation of the domestic financial system *per se*. Quite the contrary, experience shows that stronger regulatory and supervisory frameworks are key complements to market opening measures so as to ensure that consumers and depositors are properly protected and that the integrity of the financial system and its ability to discharge its critical economy-wide functions are properly preserved.

Barriers to liberalizing trade in financial services

In contrast to trade in goods, the main barriers to trade in financial services are “behind-the-border” domestic non-tariff measures. These include laws, regulations and administrative procedures that impede access to markets by, or take the form of discriminatory treatment of, foreign financial service providers. As regards the domestic presence of foreign service providers, examples of potential impediments include differential taxation rates and unduly onerous prudential regulations (e.g. licensing requirements), as well as restrictions on their entry and on foreign equity participation in existing domestic financial institutions, restrictions on the location of branches and the scope of operations, or on the value of transactions or assets. Barriers to cross-border trade in financial services include the prohibition for consumers to purchase financial services abroad and on services being supplied remotely by non-established foreign providers. The lifting of barriers that impede the ability of foreign financial services providers to be placed on an equal competitive footing with domestic suppliers is what is typically understood by the liberalization of trade in financial services.

In addition to direct barriers to trade in financial services that are usually explicitly discriminatory, there also exists a continuum of non-discriminatory barriers whose adverse effects can be implicit and unintentional. Such indirect barriers include those related to the co-existence of diverse national laws and regulatory standards and practices which – in the absence of regulatory harmonization or mutual recognition – may raise the cost of regulatory compliance and of doing business for foreign providers (home and host country regulatory burden). The latter measures are often justified on the basis of the overarching objective of protecting the stability and integrity of domestic financial systems, even though the development and adoption of international standards and codes ('soft laws') by multilateral organizations have facilitated the process of regulatory convergence with respect to the prudential oversight of financial markets. Indeed, there is some uncertainty as to where discrimination 'stops', i.e. where the line is (or should be) drawn between trade-distorting measures and domestic regulation. It should be noted that international trade agreements ('hard law')

⁸ GATS commitments do not directly oblige WTO Members to open up their capital accounts. However, if a Member undertakes a market access commitment for mode 1 and if the cross-border movement of capital is an essential part of the service itself, then that Member is thereby committed to allow the relevant capital flow; the same applies for mode 3 commitments, but only for related capital inflows. Members do not have any obligations with respect to capital flows related to consumption abroad (mode 2).

have primarily focused to-date on market access-impeding and discriminatory barriers to trade in financial services, although they have also contributed to the reduction of non-discriminatory barriers via, for example, greater regulatory transparency and commonly accepted dispute settlement mechanisms.

Complementing trade liberalization with regulatory reform is particularly pertinent for China, given its long-term financial system reform agenda. Freeing trade in financial services is not an end in itself – it is desirable in order to serve the development needs of the domestic financial system by improving efficiency and the allocation of resources via healthy competition with foreign providers. There already exists a substantial body of literature on the positive relationship between finance and growth⁹, although there also important sequencing/speed considerations and other preconditions to the process of financial liberalization¹⁰. More specifically, the size of benefits from trade liberalization in financial services depends critically on the market's attractiveness that will determine the extent to which foreign providers will take advantage of the opportunity (the so-called ‘if you build it, will they come?’ argument), as well as on complementary regulatory reforms. The latter include the adoption of international prudential standards, the elimination of financial repression measures (e.g. interest rate ceilings, directed lending etc.), and the strengthening of the enabling ‘financial infrastructure’ environment (i.e. rule of law, credit bureaus and rating agencies, collateral registries, accounting and auditing standards, payment systems etc.). It is important to note that such reforms go well beyond trade policy and cannot therefore be tackled in the context of a trade agreement *per se*.

Approaches to Liberalizing Trade in Financial Services

Countries have achieved the liberalization of trade in financial services in three main ways: (i) unilaterally, by opening their financial systems to international competition in the context of domestic reform efforts; (ii) at the multilateral level under the auspices of the WTO’s *General Agreement on Trade in Services* (GATS); and (iii) on a reciprocal or preferential basis by concluding bilateral or plurilateral preferential trade agreements (PTAs), of which the FTA is the most common type. Depending on the country context and circumstances, one or more of these approaches has been used to liberalize specific sub-sectors and/or modes of financial services provision¹¹.

Autonomous market opening has been the most common form of liberalizing trade in financial services. Most developed countries have adopted such a strategy, progressively liberalizing their financial markets over a relatively long period of time. Many developing countries followed (or are following) the same path, although in some cases – such as Mexico – the advent of a crisis led to or even accelerated the market opening process. When the time came to negotiate the GATS, these countries merely bound at (or below) the regulatory *status quo* in their schedules, consolidating the actual

⁹ See, for example, Levine (July/August 2003) for an overview.

¹⁰ See, for example, Johnston, Darbar and Echeverria (November 1997), Demirguc-Kunt and Detragiache (May 1998), Johnston (July 1998), and Kose, Prasad, Rogoff and Wei (August 2006).

¹¹ See Saez (December 2006), Arbeláez., Flórez and Salazar (August 2006), and Echandi (September 2006) for the cases of Chile, Colombia and Costa Rica respectively.

degree of openness prevailing at the time of the agreement's entry into force. China and some recent WTO accession countries (e.g. Vietnam), are the clearest examples of liberalization of trade in financial services in a multilateral context, while there are very few examples of *de novo* liberalization stemming from PTAs (see section 3 below).

GATS versus NAFTA templates

PTAs that have developed disciplines on services in general (including financial services) have traditionally followed two ‘architectural’ models: one based on the GATS and the other on the *North American Free Trade Agreement* (NAFTA). The liberalization of financial services under the GATS is based on a hybrid list approach, which combines elements of ‘positive’ or ‘bottom up’ listing (i.e. identifying the sectors and/or modes of supply concerned) and ‘negative’ or ‘top down’ listing (i.e. identifying the limitations and restrictions attached to specific commitments). By contrast, NAFTA-type PTAs use a negative-list or top-down approach in which trade (cross-border and investment) in financial services is assumed to be free from discriminatory treatment except for those non-conforming measures that are explicitly included in annexes containing reservations. This approach obliges countries to list all non-conforming measures prior to an agreement's entry into force (or subject to mutually agreed longer timeframes in some instances), otherwise they are deemed to be fully and automatically liberalized (a so-called “list it or lose it” approach).

In terms of scope and coverage, the approaches used under NAFTA- and GATS-type PTAs differ. GATS-type agreements cover the supply of financial services through four modes of supply, whereas NAFTA-type agreements feature separate chapters dealing with cross-border trade in services (modes 1 and 2 of GATS), investment (mode 3) and the temporary entry of business people (mode 4), the latter two being horizontal in character and applying to all subject areas covered by the PTA. In addition, an important distinction in NAFTA-type agreements is that between regulated financial institutions that are covered by the financial services chapter, and financial services providers (which might include non-regulated financial institutions) that are subject to the investment chapter of such agreements. This implies different standards of treatment and protection for financial services providers in different countries depending on whether the country regulates their activities or not, a potentially important consideration for certain lending activities that can take place outside a bank (e.g. factoring, leasing, consumer financing). Such a distinction, and the risk of differentiated rule-making, does not arise under GATS-type agreements. Finally, NAFTA-type agreements include many of the same obligations found in the GATS for financial services (e.g. *market access, non-discrimination, prudential safeguards* etc.), but often go beyond them by providing different (e.g. *dispute settlement*), stronger (e.g. *transparency*) or new (e.g. *new financial services, Senior Management and Board of Directors and ratcheting*) provisions; it is worth noting that PTAs using the GATS template have adopted some of these provisions as well.

3. LESSONS FROM LCR

PTA developments in LCR

Since the 1990s, the world economy in general – and LCR in particular – has witnessed an unprecedented proliferation of PTAs. Almost every WTO Member is party to at least one PTA, and LCR has been particularly active in this regard with trade agreements ranging from FTAs to custom unions and common markets.

Two LCR countries in particular – Mexico and Chile – have been the initial driving forces behind the proliferation of PTAs in the region over the last decade, although other countries have also recently joined the fray. The entry into force of the NAFTA between Mexico, the US and Canada in 1994 is widely considered as a defining event in developing countries' attempts to engage in PTAs with a view to securing greater access to key markets and consolidating recent domestic reforms. The proliferation of PTAs in recent years can be explained by political, strategic and economic reasons that may differ depending on the level of development of participating countries. In general, these agreements are considered relatively easier and faster to negotiate, particularly in markets where geographic or cultural proximity matters, and they may allow for progress in areas where multilateral reforms are less advanced.

North-South agreements take the form of FTAs, while some South-South agreements aim for a higher level of economic/political integration at a sub-regional level via customs unions and common markets. The four main South-South PTAs in LCR are the *Southern Cone Common Market* (MERCOSUR, established in 1991), the *Andean Community* (CAN, established in 1969), the *Caribbean Community and Common Market* (CARICOM, established in 1973) and the *Central America Common Market* (CACM, originally established in 1960 and reinstated in 1991).

Coverage of financial services in LCR PTAs

Financial services are typically covered via provisions included in a separate, self-contained chapter. This chapter is, for analytical purposes, the principal vehicle for influencing the operations of the domestic financial system although, strictly speaking, it does not fully capture all such activities¹². The coverage of financial services by PTAs in LCR follows 3 main approaches:

- *no coverage* because of the exclusion of services in general, or of financial services in particular, from the scope of a particular trade agreement¹³

¹² Areas relevant to the domestic financial system that are not captured by the financial services chapter include foreign investments in domestic non-financial securities, activities of non-regulated financial institutions (only in NAFTA-type agreements), provisions on payments and capital movements, as well as accounting, data processing, telecoms, legal and taxation services.

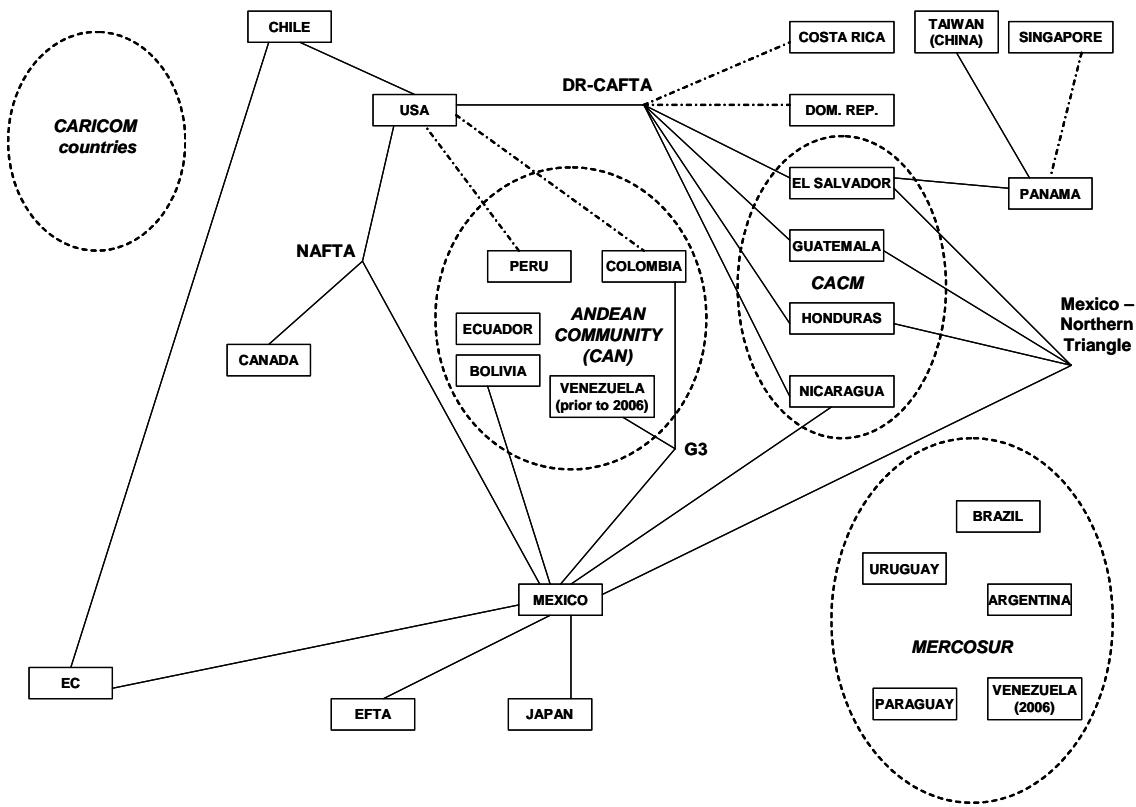
¹³ Some of these FTAs include an obligation to negotiate a financial services chapter some time after the entry into force of the agreement.

- *direct coverage* via the introduction of dedicated provisions in a separate chapter or annex dealing exclusively with financial services
- *indirect coverage* via ‘horizontal’ provisions of a more generic character covering services and/or investment that partly apply to financial services.

The vast majority of PTAs with financial services chapters that were negotiated by LCR countries have followed the NAFTA model. This is partly explained by the role played by Mexico in using the NAFTA template in its own subsequent PTAs. Because of the experience acquired in negotiating this type of FTA and the influence of the US, other LCR countries have developed templates similar to NAFTA in their own FTAs. Recent agreements (e.g. EU-Mexico and EU-Chile FTAs) have introduced some innovations to the traditional template, by mixing in elements of the GATS, NAFTA, and of the GATS’s *Understanding on Commitments in Financial Services*. In the case of FTAs negotiated with the US, the NAFTA template still serves as the basis for the treatment of financial services, but provisions from the GATS were also incorporated¹⁴.

¹⁴ Examples include the adoption of a positive-list approach for the cross-border supply of financial services, the treatment of potentially sensitive information, as well as the introduction of a binding – as opposed to “best endeavors” as in NAFTA – market access provision listing the types of restrictive measures that Parties cannot adopt or maintain with regard to investors or providers of another Party.

Figure 1: ‘Map’ of Financial Services-Related Trade Commitments in LCR (mid-2006)

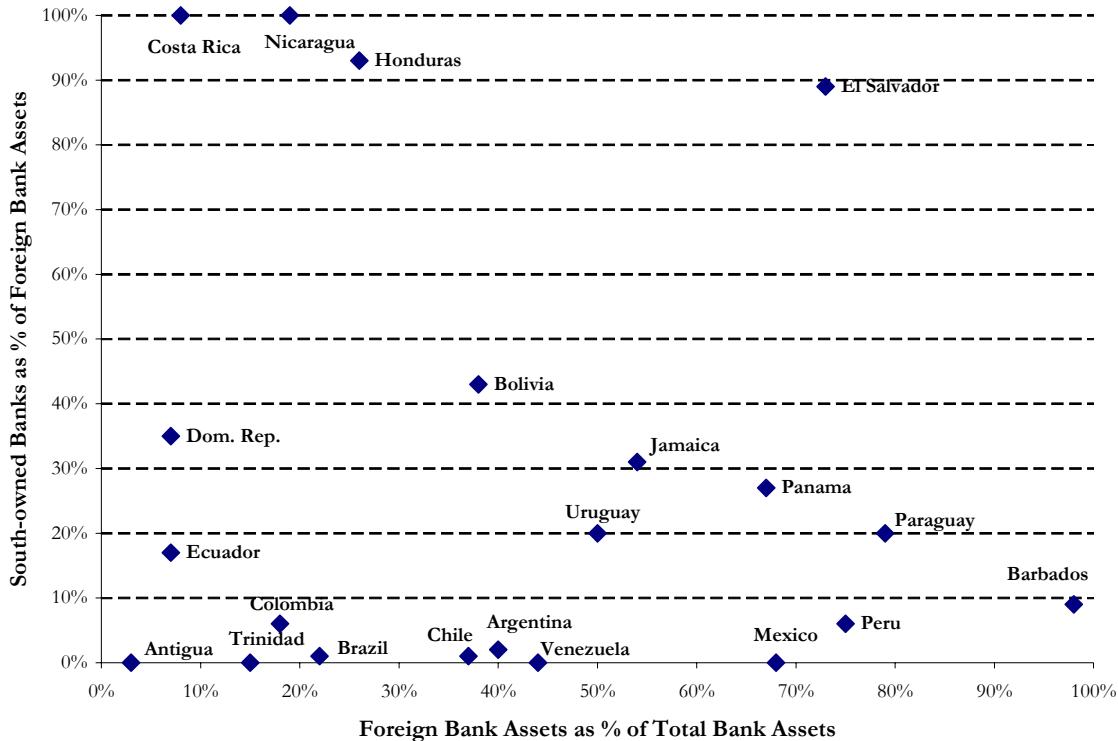


Source: Goncalves and Stephanou (April 2007).

Note: Lines indicate the existence of a financial services chapter/Annex in a PTA between the relevant countries (dashed lines indicate that the agreement has not yet been ratified or implemented), while the ovals indicate the presence of a trade agreement for the creation of a common market or customs union.

The proliferation of PTAs in recent years has contributed to greater financial services liberalization commitments for many LCR countries and led to an increasingly complex regional ‘commitments map’ (or financial services ‘spaghetti bowl’). Most progress in financial services rule-making and market opening has been achieved via FTAs; by contrast, LCR countries that have relied on the multilateral framework and on sub-regional customs unions have not made much progress to-date (see Figure 1).

Figure 2: Foreign Bank Penetration in Selected LCR Countries



Source: Goncalves and Stephanou (April 2007), based on data in Van Horen (May 2006).

Note: A foreign bank is defined to have at least 50 percent foreign ownership. Figures reported represent averages over 2000-2004 in each country. South-owned banks are foreign banks headquartered in a developing country.

The inclusion of financial services in LCR PTAs depends greatly on whether it is a North-South or South-South agreement. Unsurprisingly, developed countries in North-South agreements have been the main proponents of including financial services. Most LCR countries are net importers of financial services and have few – if any – perceived ‘offensive’ interests linked to a “*demandeur*” or domestic constituency, both of which lessen the scope for striking reciprocal bargains within the sector. Conversely, the inclusion of financial services in most North-South agreements likely reflects the fact that the majority of foreign financial institutions in LCR countries are headquartered in developed countries (see Figure 2), as well as the relative (and asymmetric) bargaining powers between the negotiating counterparts. In fact, only two LCR countries have tended to include financial services chapters in South-South agreements – Mexico (primarily in the immediate post-NAFTA period¹⁵) and Panama (which is an offshore financial center and a net exporter of financial services).

¹⁵ The NAFTA was the first FTA by a LCR country that included trade in financial services within its scope and devoted a specific self-contained chapter to such trade. Subsequently, Mexico has been a key player in incorporating financial services in its preferential trade agreements; of the twelve PTAs (all are FTAs) entered into by Mexico, seven contain a financial services chapter.

Country case studies: negotiating team, strategy and consultation process

An analysis of financial services chapters has been undertaken for a sample of LCR countries that have recently participated in FTAs (Chile, Colombia and Costa Rica)¹⁶. These comprise the Chile-US and Chile-EU FTAs, the (yet to be ratified) Colombia-US FTA and the DR-CAFTA as it applies to Costa Rica. The results strongly indicate that each country's financial services-related strategy and negotiating structure/process were shaped by initial conditions and historical experience.

Chile: Chile had unilaterally liberalized its domestic financial system following the 1982 crisis, and enjoyed strong macroeconomic and financial stability at the time of FTA negotiations. Its only previous financial services commitments were made in the GATS, and the FTA with the US was seen as an opportunity to set a precedent with other countries. It was decided to negotiate a separate, self-contained financial services chapter independently of other areas (whenever possible) to comfort financial supervisors and market players, with the Ministry of Finance undertaking full responsibility for it. The negotiating stance was aimed at locking-in the status quo, both because the authorities were comfortable with the existing (very high) level of market openness, and because they perceived FTAs as a “third-best alternative” for trade liberalization, behind unilateral and multilateral trade negotiations. The right to introduce capital controls and limitations on Balance of Payments transfers was the most politically sensitive issue, and was negotiated separately by a small team of specialists from the Ministry and the Central Bank. While the private sector was involved via meetings with financial industry associations and the commissioning of a study on the FTA effects, there were no broad consultations with civil society or other stakeholders in the area of financial services.

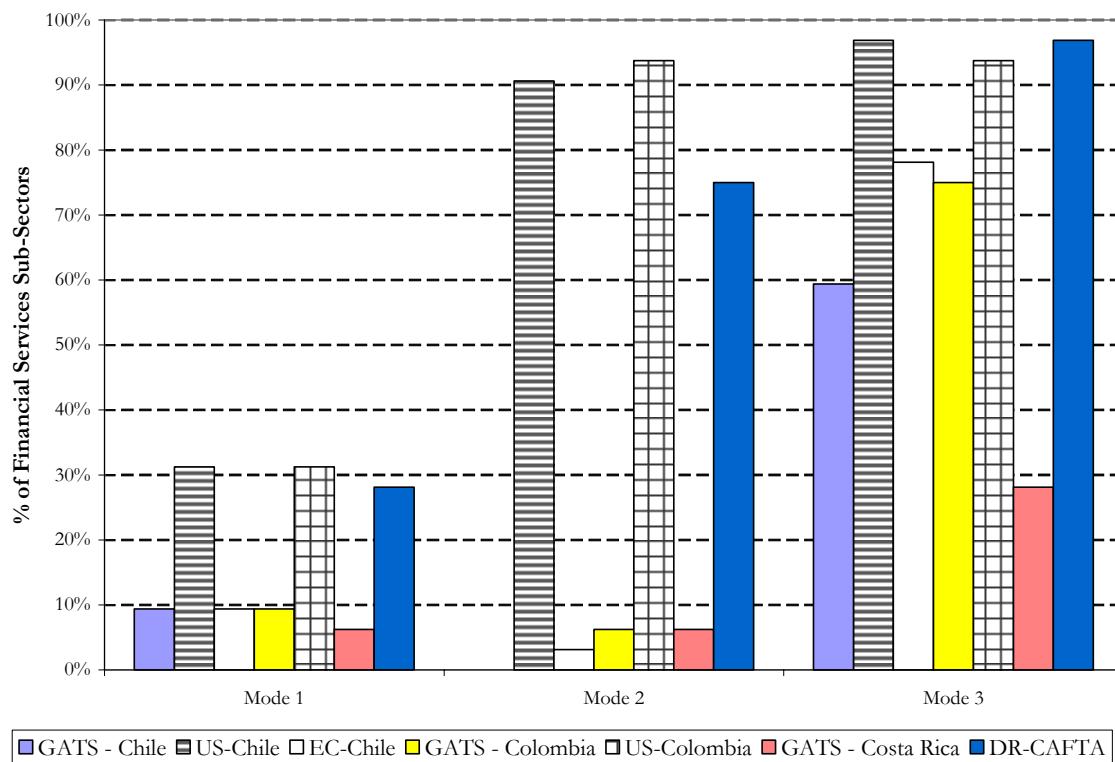
Colombia: At the time of FTA negotiations with the US, the Colombian financial system was still recovering from the effects of the 1998 crisis, which had also disrupted the progressive market opening process of the 1990s. Prior to the FTA, Colombia had made (limited) financial services commitments in the GATS and the G3 (with Mexico and Venezuela). The negotiating process for the financial services chapter was led by the Ministry of Finance, with the collaboration of the financial supervisors. Since the negotiations with the US were initially scheduled to take place at the same time for several Andean countries, Colombia coordinated with its peers to reach common negotiating positions whenever possible (e.g. on social security and collective investments). In particular, there was an exclusive emphasis on defensive interests and an attempt to prevent a non-level playing field that was perceived to arise from various US demands (e.g. insurance/bank branching and certain cross-border trade activities). The private sector was actively involved via ‘side room’ participation and preparation of relevant studies by financial industry associations; public presentations also followed each negotiating round.

Costa Rica: Costa Rica enjoyed a high degree of market openness but significant state ownership (particularly in the insurance sector) at the time of DR-CAFTA

¹⁶ See Saez (December 2006), Arbeláez., Flórez and Salazar (August 2006), and Echandi (September 2006) for the cases of Chile, Colombia and Costa Rica respectively.

negotiations. The only previous financial services commitments that it had made were in the GATS. Unlike the other two countries, it was the Ministry of Commerce – with support from financial supervisors – that took responsibility for preparing the negotiations ‘roadmap’ in financial services. The 5 Central American countries had created a joint negotiating team vis-à-vis the US, and a coordination protocol and common objectives for financial services were agreed. These were sufficiently flexible to accommodate offensive interests, although Costa Rica (which acted as the secretariat of the negotiation process) only had defensive interests in this sector. Given Costa Rica’s institutional and cultural experience, extensive consultation mechanisms with the private sector and with civil society were utilized.

Figure 3: Market Access Commitments – Proportion of Financial Services Committed by Chile, Colombia and Costa Rica in the GATS and Subsequent FTAs



Source: Goncalves and Stephanou (April 2007), Contreras and Yi (December 2003), Contreras (2005), Saez (December 2006), Arbeláez., Flórez and Salazar (August 2006), and Echandi (September 2006).

Note: Three levels of market access commitments are applied in the above analysis by financial services sub-sector and mode: none (value of zero), partial (value of 0.5) and full commitment (value of 1). Mode 4 commitments, as well as all national treatment commitments and horizontal restrictions, are excluded. All pre-commitments to liberalize additional sub-sectors and/or modes in future years are included.

Financial services liberalization commitments compared to the GATS

An analysis of market access and national treatment commitments scheduled in the financial services chapters for the aforementioned sample of LCR FTAs provides evidence of significant additional liberalization commitments when compared to the GATS. This is not unusual given the time elapsed and the (unilateral) market opening undertaken by these countries since the mid-1990s. Additional commitments tend to span all financial sub-sectors, including those that were not well covered in the first GATS round, such as insurance, securities-related and other financial services. The same is true in modal terms, with significant new commitments particularly in mode 2. Commitments are in general more extensive across all modes for FTAs involving the US, particularly for mode 2. By contrast, mode 1 commitments, while better than what has been harvested to date under the GATS, remain relatively more timid (see Figure 3).

Financial services liberalization commitments compared to the status quo

***De novo* liberalization – which has chiefly taken the form of pre-commitments to future market opening – is relatively modest for the sample of LCR countries under review.** An analysis of individual LCR country experiences is much more difficult to undertake because of insufficient information on the regulatory *status quo* prior to, during and after the implementation of such trade agreements. Apart from Costa Rica's insurance sector that would have to open for the first time, real liberalization appears to have mostly taken place in the cross-border provision of some insurance services, as well as in asset management and auxiliary financial services. Although there is limited available data on the actual market size of these sub-sectors and modes, anecdotal evidence suggests that they are relatively less important than 'core' banking services. However, the abolition of numerical quotas (e.g. economic needs test) and certain juridical restrictions on forms of entry (e.g. insurance branching¹⁷) might also contribute to further liberalization in other sub-sectors under mode 3.

The above finding is a strong indication that, with a few exceptions, PTAs seem to be primarily used to consolidate and 'lock in' existing unilateral liberalization rather than as means to actively promote further market opening and the process of domestic regulatory reform. The fact that the LCR countries under review appear to have already largely liberalized their domestic financial systems on a unilateral basis prior to their engagement in PTA negotiations has also contributed to this outcome.

Of course, consolidation of the regulatory *status quo* and the application of certain disciplines in trade agreements remain important because they can limit the arbitrary use (and abuse) of 'policy space' by the authorities. New disciplines such as those on regulatory transparency, as well as the lock-in of the current policy regime via commitments, standstill and ratcheting clauses, enhance predictability, prevent

¹⁷ However, it should be noted that domestic authorities retain the right to regulate such branches as they deem necessary for prudential purposes, including via the establishment of local capital requirements.

potentially costly policy reversals, and can thus benefit both domestic and foreign financial services providers and local consumers. It is therefore conceivable that a PTA could exert significantly positive impact on the business environment (including for financial services) even if real liberalization commitments remain limited to the *status quo*. However, the issue of policy space is a double-edged sword, and policymakers need to decide on the level of policy flexibility and regulatory discretion (which might not be the current one) that properly balances policy considerations that go beyond trade liberalization objectives *per se*. Linked to this issue is the need for policymakers negotiating the financial services provisions of PTAs to be cognizant of the important nuances in disciplines and commitments that might create unintended consequences or limit policy space beyond what was envisaged. The short time span since the entry into force of most PTAs means that their contribution – whether anticipated or unanticipated – still cannot be fully assessed.

Preferential nature of de novo liberalization commitments

An interesting additional finding of the analysis is that many *de novo* liberalization commitments are actually not preferential in nature. While some commitments (e.g. the abolition of an economic needs test for Chile) are country-specific and benefit the financial services providers of the FTA counterpart, others (e.g. permitting branching or opening up the insurance industry to private providers for Costa Rica) require new ‘horizontal’ regulations or laws that would presumably apply to the entire industry and could actually benefit financial service providers from third countries. In that respect, it is also important to note that the extent to which commitments were preferential was not primarily determined by the denial of benefits clause (rules of origin) *per se*. This result would seem to suggest that there might not always be important first-mover advantages or serious economic distortions created by using PTAs to promote market opening in financial services, although much depends on whether the relevant liberalization commitments are actually preferential in nature.

Comparing ‘architectural’ models for liberalization purposes

The choice of modality used to negotiate and schedule liberalization commitments can conceptually be an important contributor to the actual level and quality of liberalization attained. Although both the negative and hybrid list approaches can achieve the same level of liberalization, the former is considered in theory to be more conducive to liberalization as it introduces a strong element of regulatory transparency and a potentially higher level of commitments to the extent that it typically locks in the regulatory *status quo*, except in those sectors where Members are explicitly allowed to retain the power to introduce new non-conforming measures. The detailed inventories of non-conforming measures that are appended to PTAs following a negative list approach, while technically more onerous to prepare, allow foreign investors and trade negotiators alike to obtain a comprehensive picture of a country’s regulatory landscape¹⁸. By

¹⁸ This is not always the case: certain negative-list FTAs in Latin America during the 1990s have not developed inventories of reservations but, given the existence of standstill clauses, commit to the actual liberalization level; the development of lists in such cases becomes primarily a matter of transparency. In addition, the superior transparency properties of negative listing and the ability of PTAs adopting such a

contrast, only the measures that apply to the sectors, sub-sectors and modes of supply entered in a country's schedule are listed under the hybrid approach, which often differ from the regulatory *status quo* prevailing at the time that the commitment is scheduled (so-called “*status-quo minus*” commitments). While neither of the two approaches inhibits the ability of host countries to preserve “policy space”, the hybrid approach has the advantage of greater latitude in determining overall commitments and related regulatory conditions which, as noted above, might differ from actual practice, allegedly making it more flexible or “development-friendly” than the negative list approach.

Based on the experience of the 3 countries that were analyzed, it is unclear whether GATS- or NAFTA-type ‘architectural’ models actually lead to greater liberalization in financial services. A simple review of the FTAs mentioned above would seem to favor the negative list approach and broader rules and disciplines embedded in NAFTA-type agreements, primarily on grounds of heightened regulatory transparency, but this can be largely attributed to the involvement of the US in them. In addition, one could argue that the direction of causality between scheduling approaches and the level of liberalization commitments can run both ways. Moreover, even NAFTA-type agreements have tended to use a hybrid list for financial service commitments – in fact, both models have introduced new features in recent years that borrow from each other, revealing signs of convergence around a more hybrid approach.

However, it is important for the authorities to be cognizant of important nuances in disciplines and commitments between the two main templates in order to avoid unintended consequences or limit policy space beyond what is desired. These include, for example, the definition and coverage of financial services supplier versus (regulated) financial institution in NAFTA-type agreements; the relationship between financial services and other chapters; the denial of benefits clause; limits to state aid and to preferential arrangements for state-owned financial institutions; restrictions on the imposition of capital controls, which become particularly important in times of crisis; existence of ratcheting and/or standstill clauses; and the use of a negative list approach, with its concomitant need to include all reservations in an Appendix (“list it or lose it”).

4. CONCLUSION AND POLICY IMPLICATIONS

The liberalization of trade in financial services is helpful to, but is not a panacea for, domestic financial system modernization. As previously mentioned, trade liberalization in financial services is merely a subset of the broader financial liberalization agenda. Many of the required measures go well beyond the strict ambit of trade policy and involve regulatory reform – namely the adoption of international prudential standards, the elimination of financial repression measures, and the strengthening of the enabling ‘financial infrastructure’ environment. In order to fully realize the benefits of foreign entry by improving efficiency and the allocation of

negotiating modality to generate (at least) status quo commitments can be undermined by sweeping reservations (for example, of all sub-national measures) or by allowing PTA parties to maintain the right to introduce new non-conforming measures in some sub-sectors.

resources via healthy competition and knowledge transfer by foreign providers, it is critical for China to continue the regulatory reform process in the financial system.

The means of liberalizing trade in financial services may also determine the extent of the benefits that can be attained. In particular, countries can choose to liberalize unilaterally, multilaterally via the WTO, or bilaterally in the context of a PTA. The latter option remains relatively rare – as the LCR country case studies illustrate, most PTAs are primarily used to consolidate and ‘lock in’ existing unilateral liberalization. Although autonomous market opening has been the most common form of liberalizing trade in financial services, China’s liberalization was undertaken under the aegis of WTO accession and is therefore non-preferential. To the extent that financial markets are characterized by first-mover advantages, the order of entry becomes important and the benefits of liberalizing trade on a preferential basis via a PTA are more doubtful. China should therefore consider the potentially negative implications of preferential financial market opening in future trade agreements.

Any trade commitments in financial services will need to be aligned with China’s financial system condition and policy objectives. Given the characteristics and recent evolution of the domestic financial system, trade liberalization should aim at improving the efficiency of capital allocation by increasing competition and expanding product variety and financial access. This has to proceed in a gradual and controlled manner so that domestic financial institutions build up their expertise and commercial orientation in order to avoid any crisis.

China can also draw useful policy lessons from the LCR experience when negotiating financial services in PTAs.

Firstly, the inclusion of financial services depends greatly on the existence of offensive interests and of asymmetric bargaining powers between the negotiating counterparts. This should not be surprising: a FTA is essentially a mercantilistic exercise, so *de novo* liberalization commitments typically reflect the perceived interests and negotiating strengths of the partners. In such cases, a country includes financial services commitments either because it is forced to do so by the negotiating partner (perhaps as a *quid pro quo* for securing market access in another sector), or because it has offensive interests in financial services and is able to impose them on the counterpart. This implies that China needs to carefully define its offensive and defensive interests in financial services, and determine whether it is willing to advance the former, or exchange the latter against interests in other sectors, by including a financial services chapter.

Secondly, the case studies strongly indicate the importance of initial conditions and historical experience in shaping a country’s financial services trade strategy. As mentioned above, in each of the 3 LCR country cases, the strategy, negotiating structure/process and outcome were shaped by the state of the financial system, location of expertise in financial services, state-civil society relations, and by historical experience. As such, there is no one model that China can aspire to when negotiating financial services in future PTAs.

Thirdly, the scheduling approach of the (typically self-contained) financial services chapter both contributes to, and is determined by, the willingness to liberalize. In fact, most financial services chapters in recent PTAs in LCR have been ‘hybrids’ of the GATS and NAFTA templates. As such, the choice of template for the financial services chapter in future China PTAs should be commensurate with its level of comfort with market opening in different modes and sectors, rather than the other way around.

Finally, it is important for the authorities to be cognizant of important nuances between the two main negotiating templates. In particular, Chinese negotiators need to be aware of important differences in disciplines and commitments between the GATS and NAFTA templates as they relate to financial services, in order to avoid unintended consequences or limit policy space beyond what is desired. The differences of opinion that have recently arisen as to China’s implementation record of its WTO financial services liberalization commitments serve to illustrate this point.

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