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Trade in Banking Services

Issues for Multilateral Negotiations

Alan Gelb
and
Silvia Sagari

The response of developing countries to the U.S. proposal to liberalize trade in financial services ranges from cautious to hostile. Opening borders to foreign competition — like the wide-ranging domestic reforms needed in most developing countries — must proceed, but at a moderate pace.

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This paper — a product of the Financial Systems and Policy Division, Country Economics Department — is part of a larger effort in PRE to analyze the process of liberalizing financial and other markets, the consequences of such liberalization, and complementary measures needed for its success. Copies are available free from the World Bank, 1818 H Street NW, Washington DC 20433. Please contact Wilai Pitayatonakarn, room N9-017, extension 37666 (33 pages).

When the General Agreement on Tariffs and Trade was instituted in 1948, its mandate excluded such industries as banking, insurance, and telecommunications.

These service sectors were highly regulated and protected in most countries, partly because of their sensitivity to national security and cultural identity. Under U.S. pressure, the Uruguay Round talks have included financial services, particularly banking.

The response of developing countries to the U.S. proposal to liberalize trade in financial services ranges from cautious to hostile. Partly this reflects concern about the perceived comparative advantage of industrial countries and the desire of strong vested interests (including governments) to continue to use the financial system as an instrument of public policy.

It also reflects the weak situation of the banking industry in many developing countries. In some there is no real banking industry; in many the banking sector is technically insolvent and needs costly restructuring and reform.

Opening borders to foreign competition is essential to liberalization. But this process must proceed at the pace appropriate to the wide-ranging domestic reforms essential in most developing countries.

Gelb and Sagari discuss many of the issues involved.

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Produced at the PRE Dissemination Center

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by
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FOREWORD

Trade in services has become an increasingly important issue as evidenced by its inclusion in the Uruguay Round of Multilateral Trade Negotiations. To contribute to the World Bank's efforts to disseminate existing research and policy work in this area, this paper discusses trade in banking services, and the international dimension of financial liberalization more generally. Banking services pose distinctive regulatory problems which have been addressed differently across countries. This raises very complex and specific issues that need to be taken into account in multilateral negotiations.

Trade in Banking Services: Issues for Multilateral Negotiations

Alan H. Gelb and Silvia B. Sagari[1]

I. Introduction

When the General Agreement of Tariffs and Trade (GATT) was instituted in 1948, its mandate excluded industries such as banking, insurance and telecommunications. These service sectors were highly regulated and protected in most countries for various reasons including, in some cases, their sensitivity with respect to national security or cultural identity. Financial services, to take one example, involve complex issues of prudential regulation, monetary policy and stability of financial markets.

Under prompting from the United States, Uruguay Round talks have turned to financial services, banking in particular. This has occurred in part because of the growing importance of formal finance as GNP per head rises and because a number of developing countries are now seen as sizable prospective markets. Another reason is the dramatic growth of trade in financial services between industrial countries over the last two decades, which has been partly spurred by rapid technological innovation.

Trade in financial services is defined here as:

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[1] The views and interpretations in this document are those of the authors and should not be attributed to the World Bank, to its affiliated organizations, or to any individual acting in their behalf. Thanks are due to Bela Balassa, Paul Meo and Patrick Messerlin for helpful comments. All errors are the sole responsibility of the authors.

The provision of financial services by an institution in one country to a consumer of those services in another country (i.e. provision of services across borders). This is a relatively pure form of trade.

The provision of services through the establishment of subsidiaries, branches or agencies by a financial institution in a country other than its home country; here, trade is associated with investment.[2]

In general, the latter issue has received more attention in discussions of barriers to trade in financial services. Cross-border trade, on the other hand, has generally been viewed within the context of removal of exchange controls, or liberalization of capital movements. The distinction may be important because each of these two forms of trade may call for different approaches and solutions in the multilateral trade negotiations.

Financial services may be defined as comprising (a) deposit taking and lending, whether in domestic or foreign currency, to governments, corporations, private individuals, and others; (b) specialized forms of lending, including trade financing, loan syndications and participation; (c) trading and dealing in domestic and foreign currencies; and (d) various advisory and brokerage services. This paper, however, will concentrate on those services most frequently provided by banking institutions.

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[2] A branch is a legal entity of the home country and is treated as an integral part of the parent bank. A subsidiary is a legal entity of the host-country; it is a separate corporation wholly or majority owned by the transnational bank parent. The difference matters because of regulatory treatment and, in particular, capital requirements.

A. Products, Agents and Markets

Banking and financial services interact with a very broad range of economic activities and agents and play an important role in the credit, monetary, and payments systems. They have close relationships with public policy, and their operation is strongly influenced by the regulatory environment and other aspects of the economy. The issue of opening them up to international trade is, consequently, very complex.

The first mode of trade in financial services, which involves international exchange of financial flows, and essentially the liberalization of the capital account, allows agents in one country to enjoy financial services provided by institutions in other countries.[3] The range of activities where this is possible is limited because of the need for a certain degree of proximity between intermediaries and their clients. Proximity between the supplier and the purchaser is usually more important for services than for goods. At first sight, it is not clear why proximity should be important for financial services, in the same way as, say, for haircuts. But, the characteristics of financial transactions--mainly the need for frequent information and trust--can make this a pressing need.

The second mode of trade involves direct foreign investment in financial institutions located in the country of residence of the user of the service. Most commonly, this investment is in the form of locally-owned subsidiaries or branches. The issue here is not liberalization of the capital account, but the

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[3] For example, much financial intermediation in Venezuela has historically been carried out offshore, through banks in Miami and the Caribbean. Another example is situations in which surplus countries have exported capital at the same time as they are borrowing abroad: in Botswana, for example, major projects are mostly not funded through the domestic financial system, although it has a surplus of loanable funds.

treatment afforded by host-country regulatory authorities to foreign banking affiliates.[4]

B. Ownership of Banks

Attitudes towards licencing foreign banks and other financial institutions vary widely across developing countries. Some totally exclude foreign financial institutions; others permit representative offices but not branches. The Bahamas, Bahrain, Hong Kong, Panama and Singapore view exports of financial services as a source of employment and foreign exchange, and in a few, usually small, developing countries foreign institutions account for nearly all financial a... Table 1 shows the range of experience. The three foreign banks operating in Botswana hold all commercial banking assets, although there are several smaller indigenous non-bank intermediaries which take deposits, make loans or do both. In Malaysia (which has traditionally had an open policy towards the financial system) sixteen foreign banks account for one quarter of banking assets; in the Philippines, Chile and Kenya the share of foreign banks was also appreciable. In Nigeria foreign shareholdings in banks have been tightly limited, to create a class of co-owned enterprises; in Tanzania, a foreign-owned banking system was nationalized after independence. The representative country of table 1 had eight foreign banks, which held 6 percent of system assets.

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[4] An important issue for licensing policy is whether to allow foreign branches or subsidiaries or both. Countries differ in this regard. For example, Botswana allows foreign subsidiaries, but not branches, whereas Uruguay permits branches. In Canada, financial reforms have, in effect, brought about conversion of foreign banking operations from branch to subsidiary operations, with both positive and negative effects for the banks concerned.

Table 1. Foreign Commercial Banks in Developing Country Markets

Country and date	Number of foreign banks	Percentage share in total bank assets
Argentina - 1987	32	20
Bangladesh - 1986	7	6
Bolivia - 1987	3	3
Botswana - 1986/1987	3	100
Brazil - 1987	17	6
Chile - 1987	21	17
Colombia	8	6
Indonesia - 1986/1987	10	6
Kenya - 1986/1987	11	37
Malaysia - 1988	16	25
Nepal - 1988*	3	6
Nigeria - 1987/1988*	15	74
Pakistan - 1987/1988	20	12
Peru - 1987	5	2
Philippines - 1986/1987	4	19
Senegal - 1986/1987	2	4
Thailand - 1988	14	4
Tunisia - 1985	7	1
Turkey - 1986/1987	18	4
Uruguay - 1987	8	10
Venezuela - 1987	3	1
Median	8	6

* Joint Venture Foreign Banks
Source: World Bank Reports.

Historically, the establishment of branches and subsidiaries by international banks followed closely the location of major international clients and the finance of trade. Today, the main activities of foreign banking affiliates in developing countries are still largely in these areas, even though the doubling of international bank lending that has taken place since 1980 has occurred against a background of virtually no increase in world trade.

The case of Uruguay illustrates another common characteristic of developing countries--the overwhelming presence of government in many domestic banking systems. In Uruguay the indigenous banking system is, in fact, totally government-owned as a result of the rescue operation mounted by the authorities in the mid-1980s. In India, Tanzania, and in many other countries, the indigenous banking system is state-owned because of nationalization. Even in free-market Chile, government's effective participation in the financial system through the Banco del Estado is about 25 percent. This implies that in many cases trade liberalization in banking services--as in certain other service sectors--might amount, in effect, to breaking a government monopoly. In most African countries, banks are either government owned or foreign owned. Nigeria was the only country in Africa to develop indigenous commercial banks before the late 1940s.

Although there are some exceptions, foreign banks are much less likely than domestic banks to have an extensive branch network. This implies that they are usually more dependent on wholesale funds or on funds from abroad and that they are more likely to provide services to larger clients in the main urban centers than to small farmers. The cost structure of foreign banking affiliates may therefore differ quite significantly from that of indigenous banks. In particular, they may have a higher cost of funds because of fewer demand

deposits, but have far fewer staff per unit of assets. They may also rely more on fee-based income.

This bias towards larger clients--and in most cases, toward subsidiaries of multinational corporations--segments the financial markets and clearly limits the benefits that might immediately be derived from the presence of a sophisticated, and perhaps relatively more efficient, financial intermediary.[5] Many residents of the host country who are clients of foreign bank affiliates might in any case have had access to the banking services from the corresponding bank headquarters abroad. Conversely, smaller savers and borrowers may be left as captives of the indigenous financial intermediaries, and their range of products and services. But it is also true that the threat of foreign competition, even if only for a limited sphere of business, may cause domestic intermediaries to improve their services and products.

The impact of the entry of foreign financial institutions on the balance of payments is not clear.[6] On the positive side, these institutions may stimulate inflows of capital, including funds to establish their own capital bases if they are subsidiaries; they may also act as a conduit for foreign funds, especially if the international standing of indigenous banks is inadequate to sustain correspondent relationships; and they may be able to supply services that would otherwise have to be imported. On the negative side, it is sometimes

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[5] A common argument for multinationalization of banking cites the benefits to be derived from integrating capital and financial markets. Terms and availability of credit will not necessarily be equalized within different countries.

[6] This is true even without considering the complex problems resulting from the protection of an input--such as the financial services--that is intensively used by the productive sectors of the economy. See "A General Equilibrium Approach."

alleged that foreign banking affiliates facilitate the export of capital in circumstances in which foreign returns exceed domestic returns or there are major uncertainties facing domestic savers.[7]

C. Banking Systems in Developing Countries

The above discussion takes for granted that the main function of the financial services industry is to provide financial services to clients efficiently and on a more or less competitive basis. But this is not true in all countries. There are important differences between the industrial and developing countries and very large differences among developing countries that bear on the question of liberalizing entry.

Role

Despite some trend towards reform, in a large number of developing countries, financial intermediaries are still expected to distribute subsidies by means of below-market credit, to cross-subsidize across clients, and to finance the government through forced investments and high reserve requirements. This role may be part of broad development policy, or it may be imposed to satisfy special interests. To give some idea of the size of such impositions, subsidies to government and others through financial systems frequently amount to 3-4 percent of GNP and may reach 7-8 percent of GNP--this for a sector in which normal value added amounts to only 5-6 percent of GNP. For a set of ten developing countries the inflation tax averaged 2.6 percent of GNP in 1987 (World

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[7] According to IMF data, over 1981-87 gross flows of foreign investment to developing countries were $118 billion, but net flows, taking into account dividend remittances, were negative $10 billion. For non-oil developing countries, gross and net flows were $85 billion and $21 billion, respectively.

Bank (1989), box 4.5); the inflation tax in developed countries is typically below 1 percent of GNP.

There is inevitably some conflict between these objectives and the entry of foreign banks that expect to operate according to the principles of their home countries. Foreign banks will expect to hold and price assets on the basis of risk and return, rather than according to government direction. Indeed, governments are sometimes reluctant to permit entry because they recognize that it will be more difficult to persuade foreign institutions to fall in line with their objectives.

Condition

Technical insolvency is widespread among financial systems in developing countries. Although it is not possible to obtain a complete picture of the situation of banks in either industrial or developing countries, there is little doubt that insolvency problems loom far larger in the latter. These problems are often not apparent, owing to inadequate systems of prudential regulation and supervision, but when they surface (sometimes as a liquidity crisis), it is not uncommon for losses to amount to a multiple of the capital of intermediaries and to a sizeable fraction of (GDP)--from a few percentage points to, occasionally, 25 percent.

In general, financial liberalization increases stress on ailing intermediaries. The entry of new and more efficient financial institutions that are not burdened with portfolio problems tends to further undercut existing, distressed, financial institutions. To compensate for loan losses, the latter must try to recover income from good clients by raising spreads and charges (as occurred with the savings and loan industry in the US). But they are likely to

face severe competition from new entrants not burdened with bad loans. Of course, the objective of liberalizing markets and opening them up to foreign entry is precisely to cause stress to established firms through increased competition. But this needs to be handled carefully in the case of banks; large losses by depositors are invariably unacceptable, and it will finally be the government which will have to bear the loss.

II. Protectionism

Protectionism in banking services may be defined as the absence of equality of competitive opportunities for foreign vis-a-vis domestic banks. This can occur through exchange controls or restrictions on foreign investment.

Exchange restrictions typically constrain domestic savers from acquiring financial assets abroad (although external debt problems have led to constraints on domestic borrowers, as well). Pension and life insurance funds in developing countries typically cannot save abroad and therefore cannot be serviced by foreign investment firms. Capital restrictions may also prevent institutions located in foreign countries from offering other types of services. For example, it may be difficult for a foreign institution to underwrite a domestic security issue in the presence of exchange controls. (It should be noted that for much of the postwar period, most industrialized countries have also maintained exchange controls.)

Restrictions to the establishment of foreign banking affiliates take the form of discriminatory barriers to entry and discriminatory operating constraints. The issue concerning entry is not the existence of barriers *per se*; with rare exceptions entry into domestic banking sectors has historically not been free in any country. In liberalized, market-based systems, entry

restrictions typically specify minimum capital requirements, management integrity and competence. In other systems, entry restrictions are varied, ranging from absolute prohibition of any foreign presence, to limitations on capital participation in domestic institutions.

There are many ways in which operating constraints affect the ability of foreign banking affiliates to compete with domestic banks. For example, they may influence the affiliates' funding possibilities by mandating differential access to the Central Bank discount window, prohibiting the receipt of deposits from the public, limiting the number and location of branches. National banks may handle all government and parastatal business, which assures them of large volumes of low-cost deposits. Government may not require dividend payments from nationalized banks,[8] and they may impose special requirements on the nationality of top management and directors. They may constrain the type of services that can be offered, and so on.

Operational constraints can further be classified as intentional and accidental (see appendix A for examples). Intentional operational constraints explicitly discriminate against foreign banking affiliates. They are frequently designed to limit foreign bank operations to certain segments of the financial market while preserving other segments entirely for indigenous banks. Accidental operational constraints are those regulations or national economic policy measures which, even though applied equally to foreign and indigenous banks, have a differential and negative impact on the ability of foreign banks to compete in the host-country banking market because of the different nature of their

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[8] In Uruguay, for example, the National Bank, which accounts for about seventy percent of the system's assets, handles all government accounts and is not required to pay dividends. Reforms in these areas are a prerequisite for the evolution of a competitive financial system.

operations.[9] One of the most common constraints of this kind emerges from maximum permissible asset/capital ratios and limits on the size of loans to individual borrowers relative to capital. Both of these constraints are imposed by most countries for prudential reasons, to ensure minimum levels of capitalization and portfolio diversification and so enhance the safety of the institutions. Also for prudential reasons, many nations treat foreign banking affiliates in the host-country as independent entities. This means that asset/capital ratios and lending limits are based exclusively on the foreign banking affiliate's capital which is typically just a small fraction of the total capital of the parent organization. As a result, their volume of operations and individual loan sizes can be seriously constrained.

In other cases, competitive inequities result from measures related to general economic and balance of payments policies. Given the international orientation of foreign banking affiliates' operations, limitations on foreign exchange transactions have a greater negative effect on them than on their domestic counterparts. Many developing countries control the expansion of credit through bank-by-bank credit ceilings rather than through broad tools of monetary policy such as open-market operations. Such measures discriminate against new entrants, and against banks with limited branch networks if allocations are made on the basis of deposits collected. This constraint is not always easy to

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[9] This notion is linked to the concept of effective market access, which emerged in the context of the Uruguay Round midterm review. This concept seems to be related to two issues: (a) the potential differential impact on foreign and domestic institutions of a highly regulated host-country environment, and (b) the potential market distortions created by differences in the laxity of the regulatory framework for banking services in the host-country vis-a-vis the home-country. The former issue implies that in a highly regulated environment it may be more difficult to achieve national treatment for foreign banking affiliates than in a more open system. The second calls for the harmonization of regulatory structures, as discussed later.

abolish. Concerns about losing control over monetary and credit policy if direct controls are given up are related to the level of sophistication of the domestic financial system and in some cases are well-founded.

Some governments have deliberately reduced competitive inequities affecting foreign banking affiliates by applying regulatory requirements flexibly or by granting the affiliates privileges not extended to domestic banks. For example, foreign banks might be exempt from onerous obligations to lend to small farmers, because of their limited branch networks.[10] In some cases, measures that apply equally to both groups of competitors can have a favorable impact on foreign banking affiliates because of the nature of their operations. All these measures may be classified as preferential treatment measures. (See appendix A).

As in the cases of minimum capital/asset ratios, or maximum lending limits discussed above, many other constraints to banking operations are of a prudential nature, especially in developed countries. Prudential regulations establish the outside limits and constraints placed on banks to ensure the safety and soundness of the banking.[11] The issue then is not with the constraints themselves but equality of treatment between foreign and domestic banks. This is the national treatment principle discussed at the Montreal meeting. In most developing countries, however, national treatment does not prevail, and, in many of these

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[10] In such cases, foreign banks might need to deposit an equivalent amount of funds into a low-interest account at the central bank. If loan losses on farm loans are high (as is frequently the case), the penalty of low interest may be preferable to lending.

[11] The key components of a banking prudential regulatory framework focus on licensing and other corporate, exposure limits, loans to insiders, capital adequacy, asset classification and provisioning, submission of false financial information by borrowers, enforcement powers, treatment of problem and failed banks, permissible or prohibited activities, and scope, frequency and content of audit programs. For a comprehensive description of these aspects see Polizatto (1999).

countries, the regulatory framework is not transparent which worsens the problem. For example, certain countries have no explicit policy of not licensing foreign banks, yet no foreign banks have been licensed for 20 years. This important dimension of liberalization--transparency of regulation--has been emphasized by representatives of industrial countries. In this context, transparency is defined as the ability of all participants in a market to have equal knowledge of and access to regulatory and legal changes.[12]

In some cases, difficulties in achieving nondiscriminatory treatment between domestic and foreign participants are the outcome of significantly different foreign and domestic banking structures. (Any constraints resulting from such differential structures would be classified as "accidental".) For example, in the United States, banking and commercial activities are largely separated, as are banking and securities activities by the Glass-Steagall Act (1932), but in many other countries, commercial activities may be conducted by companies affiliated with banks and banks can operate in securities markets. This has made it difficult to implement the U.S. policy of national treatment with respect to direct investment by foreign banking organizations and their nonbanking affiliates.

As noted above, foreign ownership of banking institutions is frequently a politically sensitive topic in developing countries. This is especially so when the banking industry is seen as a policy arm of the government, which can exert far greater control and moral suasion over national institutions, but it is also a result of the banks' role in implementing monetary policy and financing government out of seigniorage. Banks are typically not popular institutions

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[12] Bankers frequently complain about changes in regulations that take place without their knowledge or advice.

(many ethical systems have an aversion to interest), and in some cases a fear of foreign banking affiliates is said to add to the unpopularity of banks, regardless of nationality. The poor financial condition of many indigenous financial institutions is also an invitation to protection by governments unprepared to face the fiscal cost of financial reform.

III. Political Economy and Welfare Aspects

Sagari (1989) has shown that skilled labor is a source of comparative advantage in financial services. This explains why the United States, which is well-endowed with skilled labor wishes to extend GATT to financial (and other) services, and why developing countries have given a less than enthusiastic welcome to such proposal. Within the principal industrial economies--which in general are interested in liberalization--inclusion of finance in the GATT is probably less relevant for smaller banks than for the major multinational banks.

The issue of the potential gains for developing countries from free trade in financial services is clearly complex. Major developing country banks often have branches in the main money centers to effect payments speedily, to fund positions in foreign currencies through the interbank markets and in some cases (such as the Banco do Brasil) to attract short-term credit to help support the balance of payments. Developing country nationals also manage in a number of international banks, such as the Bank of Credit and Commerce, Librabank, Bladex, and Arlabank. Banks from certain countries such as Thailand and Korea are starting to show signs of moving into industrial country markets, and it was not so long ago that Japanese banks, now major international players, confined their operations to their home country. These examples suggest that there is a real possibility that developing countries can export banking services. Further, the

dynamic efficiency gains forced by opening domestic markets to competition will probably be needed to spur developing country banks to try to export their services. However, for most developing countries, the potential gains from the opening of banking are still seen to be those deriving from the presence of foreign banking affiliates in their markets.

A general equilibrium approach. An in-depth cost/benefit analysis of this topic should, of course, take into account the fact that financial services are largely intermediates. This increases the already large problem of measuring their quantity and quality. In principle, the effects of protecting intermediate services are similar to those of increasing the cost of intermediate goods such as steel. Some authors (for example Bhagwati, 1987) have argued that in the case of financial services the negative effects may even be more severe than in that of goods. In denying access to efficient banking services, the protective policies may deny domestic exporters of goods access not only to cheaper credit, but to the entire vector of services--such as hedging facilities and swaps--that modern international banks can provide to facilitate international commerce. General equilibrium welfare analysis of protection suggests that barriers to trade in financial services result in inefficiencies in the allocation of productive resources, distorted consumption patterns, and significant static and dynamic welfare losses. Over time, the impact of liberalizing trade in financial services can be substantial in breaking down established oligopolistic and corporatist structures and stimulating change in other sectors. It will be especially interesting to observe the experience of Europe in the 1990s.[13] But, as discussed above, to the extent that the clients which benefit from the local

[13] A proposal for the rules governing banking in the EC is summarized in Appendix B.

presence of foreign banking affiliates are largely enterprises which could have accessed the similar services in international markets, overall welfare gains may be smaller.

The critical question is therefore the extent to which foreign banking affiliates can constitute an actual or potential source of competition, and reduce the power and wastefulness of national banking oligopolies. The answer, as well as the willingness of host-country authorities to welcome foreign banking affiliates may well be dependent on the relative degree of sophistication of the indigenous banks, and their desire to become more active internationally. In less sophisticated markets, it is likely that foreign multinational banks will not upset the prevailing level of competition in most retail markets, and will merely insert themselves into typical market niches.

This points to a general characteristic of direct foreign investment: that gains are less likely when markets remain oligopolistic and segmented and are most likely when foreign entry contributes to a effective increase in the number of competitive firms or, perhaps, the breaking of a government monopoly. The extent to which opening the banking industry will have such a favorable, and widely felt, impact varies considerably between developing countries.

However, foreign banking affiliates can also make a significant dynamic contribution to the development of domestic financial markets. They can introduce modern, sophisticated banking techniques and systems more quickly than many indigenous institutions can develop them. Foreign banks frequently innovate. For example, they have introduced a bankers' acceptances market in Spain, credit cards and ATM's in some countries, and so on. In some countries, such as Kenya, foreign banks have established venture capital affiliates. Another important contribution of foreign banks is on-the-job management

training. Managers of indigenous banks in developing countries are increasingly drawn from the ranks of host country nationals who have risen to executive level in foreign banks. The experience of these nationals combines exposure to modern banking techniques with understanding of the local market. In the longer run, this infusion of skills might be the most important spinoff to the entry of foreign banks, especially given the difficulty that most developing country banks would now face in trying to establish themselves in developed markets.

IV. An Analysis of Liberalization Options

The full liberalization of banking and financial services requires both free capital movements and non-discriminatory entry and operating conditions for foreign banking affiliates as compared with indigenous banks. Allowing foreign financial institutions to offer their services to residents of a country is of little use if such operations are subject to conditions that preclude all competition with indigenous institutions, and limit profitability.

Total liberalization would also require--and, indeed, exert strong pressure for--the harmonization of national legislation and policies which determine the operating environment of financial intermediaries. Differences in regulatory standards are likely to translate into a competitive advantage for banks subject to a particular regulatory regime. However, harmonization is difficult; it can be expected that each country will prefer its own system. The politically sensitive nature of the financial sector slows the process of modifying banking laws and regulations, which is subject to lengthy and complicated political debates. The process followed by the European Economic Community in its

integration efforts offers examples of some of these difficulties.[14] Santomero (1989) notes that the United States itself had a tradition of regulation centering on product restrictions and geographic limitations, resulting in a fragmented industry with an excessive number of participants. He describes the "long and tortuous road" followed by the industry in its efforts to move closer to full interstate banking.

The case of the developing countries is even more complex: few have a tradition of free capital movements and the foreign debt crisis has rendered their foreign exchange problems even more serious. Their indigenous banking systems have frequently grown within a framework of distorted signals, due to a combination of protection and governments' use of the banks as instruments to achieve non-economic targets. In most, prudential regulation and supervision are woefully inadequate. In such circumstances, adjustment to a fully competitive setting cannot be too abrupt. The speed of adjustment will reflect the costs of reorganization, of learning, and in general, of developing new instruments and practices within institutions.[15] Liberalization of domestic financial markets may need to take precedence over liberalization of capital movements (i.e. external liberalization). Blejer and Sagari (1987) elaborate on the issues of sequencing in financial liberalization. What is needed are

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[14] For instance, as of April 1989, only four European countries--Denmark, the Federal Republic of Germany, the Netherlands, and the United Kingdom--had fully liberalized capital movements with respect to both other EEC members and third countries. France still prohibited nonbank residents not involved in international commercial activities from holding deposits at banks in foreign countries or holding foreign currency deposits, other than those denominated in ECUs, at banks in France.

[15] For an example of the magnitude of institutional reforms needed by large Indonesian banks, see World Bank (1989), box 7.5.

evolutionary mechanisms within which steady and phased adjustment of national policies and institutions can take place.[16]

Another issue related to the opening of the capital account is a propensity of international lenders to pursue developing country governments to assume ultimate responsibility for the debts of the private sector. The case of Chile in the 1980s provides an interesting example.

Given the unique characteristics of financial services, is the Uruguay Round the right forum to discuss the liberalization?[17] When the GATT was established in 1948, banking was explicitly excluded from its mandate. But the principles and concepts of the GATT--for example, the national treatment principle discussed above--might form part of a general framework for agreements pertinent to trade in financial services. Moreover, the GATT codes and principles are selective, gradual in process, and flexible enough to allow a great degree of bilateral adjustment and communication, which will be crucial in negotiations on services.

The problem with the Uruguay Round forum is the importance of the legal and regulatory framework in shaping financial systems, and the highly specialized knowledge needed to modify and harmonize different countries' frameworks. An alternative, and perhaps a natural complement to GATT, is negotiate trade and investment issues in the financial sector in an international forum supported

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[16] Even in the case of the EEC, the accession treaties of the new member states (Greece, Portugal, and Spain) provide for derogations or time lags in which to implement the directives in the area of freeing capital movements.

[17] The U.S. position has clearly been to prefer augmenting the GATT to include services. By contrast, the group of ten developing countries led by Brazil and India wished to separate any potential services agreement from the GATT. Within this approach, the negotiations would be undertaken by the governments themselves, not by the GATT contracting parties.

by agreements among the pertinent Central Banks. For example, the Basle risk-based capital framework constitutes an accord among the banking authorities of the major industrial countries rather than a formal international agreement or treaty. Bringing the developing world on board will probably require the progressive replacement of national laws and regulations with those promoted by this international agency. These measures could then be enforced by the national authorities.

But such regulatory harmonization can not be expected to be successfully implemented within a short time. A promising approach may be that adopted by the EC: mutual recognition, whereby each country recognizes the laws, regulations, and administrative practices of other member states as equivalent to its own. This approach precludes the use of differences in national rules as a means of restricting access. Clearly, however, a prerequisite to mutual recognition is the harmonization of the most essential aspects of legal systems, statutory provisions, and regulatory and supervisory practices.

Moreover, as discussed above, the distinction between the provision of financial services by subsidiaries of foreign banks, on one hand, and their provision through branches or across borders on the other hand, may be pertinent to the design of the preferred approach. In the case of the European Community, operations of subsidiaries of financial firms headquartered in other member states will continue to be covered by the principle of national treatment; that is, subsidiaries of foreign financial institutions are treated in the same manner as other incorporated entities in the host state. This "dual" solution is, to a certain extent, counter-intuitive, since at least in the short-run, it is bound to bring about some competitive inequalities and fragmentation of markets, in contrast to the objectives supposed to be achieved though "liberalization".

However, over the longer run it is expected that market forces will create pressure on governments that will lead to the convergence of those national rules and practices that have not been explicitly harmonized at the EC level.

Nonetheless, one should be careful not to overestimate the applicability of the experience of the EC to a global approach to multilateral trade negotiations on services. The economic, institutional and political characteristics of the EC differ greatly from those that might be observed in a grouping that includes both developed and developing countries. EC decisions are made in the context of a fairly powerful supranational legislature and judiciary to which the member states have already transferred a significant degree of sovereignty and of acceptance of the prevalence of Community law over national law.

V. Conclusions

The United States' proposal for the liberalization of trade in financial services has met with a response varying from cautious to hostile on the part of developing countries. As with other sectors, to some extent this reflects concern over the perceived comparative advantage of industrial countries and the power of strong vested interests, including the interests of governments, which may seek to use the financial system as an instrument of public policy, rather than a market-based intermediary. But it also reflects recognition of the peculiar situation of the banking industry in many developing countries. In some countries there is essentially no banking industry in the sense understood in industrial countries; in many, much of the banking sector is technically insolvent, and massive and costly efforts are needed to restructure intermediaries' balance sheets, reform the management of banks, and improve--or

indeed, build--systems of prudential supervision and regulation. These measures are frequently necessary before financial systems can operate on a market basis, but they cannot be effected immediately. The opening of borders to foreign competition, while it is an important and necessary part of liberalization, must proceed in line with wide ranging domestic reforms, which, in many developing countries, must proceed at a moderate pace.

Appendix A. Discriminatory Operating Constraints

Constraints that discriminatorily affect the operations of foreign banks once established in the host-country's markets may impede the ability of foreign banking affiliates (FBAs) to compete with domestic banks in several ways. For instance, they may increase their cost of funds or their general operating costs, in relation to those of domestic competitors or may constrain expansion of their operations within the country. The U.S. Department of the Treasury Report to Congress on Foreign Government Treatment of U.S. Commercial Banking Organizations (1979) suggests that these regulations can be grouped into three types: intentional operational constraints, accidental operational constraints, and preferential treatment measures. We have further divided each of these sets of regulations according to the facets of banking activity they affect.

A. Intentional Operational Constraints

Constraints that are established explicitly to discriminate against foreign banks are common in developing countries. In many cases such constraints are designed to limit foreign bank operations to certain segments of the financial market, while preserving other segments entirely for local banks.

Regulations related to private sources of funds are among the most prevalent intentional operational constraints. They restrict FBAs' solicitation of some kinds of deposits--for example, retail deposits, or deposits of specific business sectors--or limit borrowing from non-banks. Deposits are one of a bank's lowest-cost sources of funds, and to the extent that deposit-taking restrictions force foreign banks to use more expensive sources, the result is a significant competitive disadvantage for these banks.

Frequently, the government's policy is to hold its own financial accounts exclusively with indigenous institutions, in many cases government-owned ones. Among other consequences, this provides a comparative advantage to those banks typically by making available to them large volumes of low cost deposits.

Regulations that affect the number or location of FBAs limit the sources that FBAs can tap for local deposits. The combination of constraints on acceptance of certain types of deposits and on the expansion of branch networks severely restricts FBAs' access to inexpensive local sources of funds.[18]

Regulations that affect FBAs' access to central bank discount facilities are rather common. They put FBAs at a disadvantage in dealing with their liquidity needs, generally forcing them to hold a larger proportion of their assets in lower yield reserves.

Restrictions on the services that FBAs can offer, other than those related to deposit-taking and lending make it difficult for FBAs to expand their market share because they cannot offer the full line of services offered by domestic banks. Frequently seen examples of these restrictions have to do with security management and underwriting business, limits for guarantees, and the types of currencies that FBAs can deal in.

Restrictions related to the loan and security portfolio may limit the type of borrowers FBAs can service or may force them to hold a larger proportion of their loan portfolios in low-yielding longer term loans than is required of domestic banks.

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[18] In some cases official pressures go in the other direction, forcing foreign bankers to branch into specific regions more widely and more quickly than they consider economically reasonable.

Tax-related regulations normally lead to higher costs of doing business. Examples are a tax rate on foreign branch profits remitted to the parent bank larger than the tax rate on dividends, the analogous payment for domestic banks, exemptions for domestic banks of withholding taxes on interest paid to non-residents, and so on.

Sundry operational constraints explicitly discriminate against FBAs. For example, ceilings on the annual repatriation of FBAs' profits, differential initial capital requirements, differential foreign currency reserve requirements, restrictions on the sources of funds for capital increases, restrictions on the ability to hold liens on real property, and regulations concerning the nationality of FBA executives.

B. Accidental Operational Constraints

In many cases operating regulations or national economic policy measures applied equally to foreign and domestic banks have a differential negative impact on the ability of foreign banks to compete in the host-country banking market.

Limits to the volume of assets, liabilities or size of loans to individual borrowers are among the most prevalent of the measures that effectively discriminate against FBAs. The constraints emerge from maximum permissible asset-capital ratios and limits on the size of loans to individual borrowers. They are imposed by most countries for prudential reasons with the objective of ensuring minimum levels of capitalization and portfolio diversification and so enhancing the safety of depository institutions. Also for prudential reasons many nations treat FBAs in the host-country as independent entities. Consequently, asset/capital ratios and lending limits are based exclusively on the FBA's capital which is typically just a small fraction of the

total capital of the parent organization. As a result FBAs' total volume of operations and individual loan sizes are seriously constrained. Competitive inequities are exacerbated if this type of measures are imposed simultaneously with the enforcement of limits on imports of capital.

Credit ceilings imposed for purposes of domestic monetary policy may apply to both foreign and domestic banks, but if foreign banks are relatively late entrants in the market, they have had less time to build up their domestic business and are consequently more constrained in expanding their portfolios. In some cases, lending limits are based on domestic deposit liabilities. When this type of constraints is enforced simultaneously with regulations affecting FBAs' access to local deposits, the resulting competitive inequities are even more significant.

Other restrictions resulting from general economic and balance of payments policies may lead to competitive inequities. Because of the international orientation of FBAs' operations, limitations on foreign exchange transactions affect them more negatively than they affect their domestic counterparts. Constraints on business with nonresidents, which typically represents a larger share of the FBAs' operations than of local banks, also has a differential effect. Capital controls tend to be more restrictive for foreign banks that are funding their operations by borrowing from their parent institution.

Other accidental operational constraints stem from measures completely divorced from the banking sector such as requirements for alien work permits, or nationality requirements. FBAs may be affected more severely than domestic banks because they may desire staff of their own nationality and because

difficulties in obtaining work permits may limit their ability to develop their staff.

C. Preferential Treatment Measures

Some governments have deliberately reduced competitive inequities affecting FBAs by applying regulatory requirements flexibly or by granting them privileges not extended to domestic banks. In some other cases, measures applied equally to both groups of competitors have a favorable impact on FBAs because of the nature of their operations.

Regulations concerning reserve requirements on deposits or funding in the interbank market, such as lower reserve requirements on foreign currency or nonresident deposits than on domestic deposits, decrease FBAs' cost of deposit funds, since they hold normally a greater proportion of foreign currency liabilities than domestic banks. Anther example is the waiver of reserve requirements on funds raised in the interbank market, which FBAs use more extensively than do domestic banks.

Preferential measures related to directed lending include flexibility in the application of credit controls and exemptions from the obligation to support government bond issues, to participate in rescue operations of failing firms, or to extend loans to the priority sectors identified in government development plans.

Sundry preferential measures include a variety of regulatory features that explicitly or accidentally favor FBAs. Examples are access to special swap facilities not available to domestic banks (to compensate for the impact on foreign bank operations of the denial to access the discount window, for example), flexibility in the application of foreign exchange controls, and the

like. In some cases governments have offered inducements for the establishment of foreign banking affiliates in the form of special tax concessions, or preferential tax treatment.

Appendix B. EC Bank Legislation

The EC's Second Banking Directive is viewed as the centerpiece of EC banking legislation for the post-1992 era. A comprehensive proposal for the Directive, dealing with the powers and geographic expansion of banks within the Community, is discussed by Key (1989). Among the most important aspects of this complex proposal are the following:

- Branches of EC banks established throughout the Community under this directive would be authorized and supervised by the home country (single license and home-country control).

- The directive, however, specifies certain conditions that an EC bank must fulfill in order to establish branches without host-country licensing (minimum initial capital requirements and provisions relating to the identity, extent of holdings, and suitability of major shareholders).

- The directive introduces a list of "universal" banking powers for EC banks, which includes underwriting and trading, for customers or for own account, of practically any type of security, the participation in share issues, money brokering, leasing, issuing of credit cards, but not insurance activities. Branches of banks chartered by individual EC member states would be permitted to engage in any of the listed activities provided that the EC home country permits such activities.

- The directive acknowledges the public interest exception to the principle of home-country control and establishes in addition three specific exceptions: (i) the host-country retains exclusive responsibility for measures resulting from the implementation of monetary policy, (ii) until further coordination the host country retains primary responsibility for the supervision of liquidity, and (iii) until further coordination the host country is permitted to require credit

institutions authorized in another member state to make sufficient provision against market risk with respect to operations in host-country securities markets.

The approach to the question of access for non-EC institutions tends to follow the principle of reciprocity; details on the type of reciprocity (reciprocal national treatment, mirror-image reciprocity[19]), and other concepts (such as the better-than-national treatment approach under which the Community would seek to have a non-EC country offer EC banks treatment comparable to that accorded banks within the Community) are under discussion.

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[19] Reciprocal national treatment means that the Community would offer national treatment to a non-EC bank provided that its non-EC home country offered national treatment to banks from all EC countries. Mirror-image reciprocity involves an attempt to achieve a precise balancing of the treatment that is accorded EC and non-EC banks in each other's markets.

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