THE ANTICIPATED IMPACT OF GATS ON THE FINANCIAL SERVICE INDUSTRY IN AFRICA

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UNIVERSITY OF THE WESTERN CAPE-CAPE TOWN, SOUTH AFRICA

2006/2007 ACADEMIC YEAR

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A THESIS SUBMITTED TO THE SCHOOL OF LAW IN PARTIAL FULFILLMENT OF THE REQUIREMENT OF THE DEGREE OF MASTER OF LAWS

UNIVERSITY OF THE WESTERN CAPE-CAPE TOWN, SOUTH AFRICA

2006/2007 ACADEMIC YEAR

STUDENT'S DECLARATION

I, the undersigned, declare that this is my original work and has not been submitted to any other college, institution or university other than the University of the Western Cape for academic credit.

Signed ______________

Date________________

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ABSTRACT

This study will be on the anticipated impact of GATS on the Financial Services Industry in Africa. This paper will examine the possible positive and negative impact of the GATS agreement on the financial services industry in the African countries. The research will focus on the banking sector and the insurance sector as the main financial sectors under investigation. A conclusion of the investigation will be whether the positive effects of GATS on the financial sector outweigh the negative effects or vice versa. The first chapter will give a general overview of GATS and the financial services trade liberalization negotiations. The second chapter will be a literature review on the impact of GATS on services in Africa. The chapter will then proceed to analyze the anticipated impact of GATS on the financial services industry in Africa. The third chapter will be a comparative analysis of the effects of GATS on the East Asian Countries as compared to the effects of GATS on the financial services industry in Africa. The research pays attention to the East Asian Financial crisis and analyses the contribution of the liberalization of the financial services industry to this crisis. This chapter then focuses on China's efforts to liberalize its financial industry in accordance to GATS requirements and the precautions it has taken to ensure it does not go through a financial crisis like its neighbours did. The fourth chapter will critically analyse the anticipated impact of GATS on the financial services industry in Africa. A conclusion is drawn as to whether the overall impact will be positive or negative. Finally, chapter five gives the proposals that have been put forth by African countries so as to improve their position in the financial services trade liberalization negotiations. This chapter will also give recommendations on the position that the African countries should adopt when in the financial services trade liberalization negotiations; a position that will minimize negative impacts and maximize positive impacts.

The methodology that will be used in this research will be analytical in nature. The researcher will gather data from previous research done on the subject of the paper and will analyse the same so as to come to logical conclusions to the stated research question.

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KEYWORDS

Africa- The Developing and Least Developed Countries in Africa

Banking- The Banking Sector

Development-

ESM- Emergency Safeguard Measure

FDI –Foreign Direct Investment

Finance- The Finance Industry

FSTLN-Financial services trade liberalization negotiations

FSA -Financial Services Agreement

GATS-The General Agreement on Trade and Services

Insurance- The Insurance Sector

ICESCR-International Covenant on Economic, Social and Cultural Rights

LDCs -Least Developed Countries

MFN-Most Favored Nation

NT-National Treatment

WTO- World Trade Organisation

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I acknowledge the support of my supervisor Mr John Hunt. I also wish to acknowledge the guidance received from Dr. Edwini Kessie in the compilation of this research. Last but not least I'd like to thank Mr. Ooko, Mr. Kiama Njoroge and Mrs Cathy Kithinji of the Kenyan Ministry of Trade.

DEDICATION

I dedicate this work to my Mother, Emily Mkaluma Mbashu.

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1.0 CHAPTER 1

1.1 Introduction

1.2 Background of the Problem

1.2.1 A GENERAL OVERVIEW OF GATS

The General Agreement on Trade in Services (GATS) is one of about 60 agreements and decisions reached at the conclusion of the Uruguay Round (UR) of the Multilateral trade negotiations (1986-1994) and signed in 1994. A key agreement among these was the agreement that established the WTO, a common institutional framework for the conduct of trade relations among members guided by the Uruguay Round. The organisation aims at promoting trade liberalization through a rule-based system founded on principles agreed upon by members. The WTO became the first global economic institution with capacity to legally enforce its agreements through the dispute settlement body with powers to authorise sanctions against violators.[1]

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The General Agreement on Trade in Services of the World Trade Organization (WTO) came into effect in 1995, as a result of the Uruguay Round of multilateral trade negotiations. The key objective of GATS is to promote the progressive liberalization of trade in services as a means of achieving economic growth for all countries and the development of developing countries (Preamble of the GATS). It seeks to do this by applying to services trade the basic rules of the WTO, with the necessary modifications to take into account the specific features and sensitivities of trade in services. While trade in goods has been governed by international trade rules since the General Agreement on Tariffs and Trade (GATT) came into effect in 1948, such an institution had never governed trade in services until GATS came into force. The drive to liberalize trade in services is strongly supported by global corporations and their associations, notably the US Coalition of Services Industries (US CSI).[2]

[1] Mutume, G. (2002). " Trading Services: an opening or a noose? Africa puzzles over the implications of trade in Geneva." Africa recovery Vol 16, No. !, April 2002.
[2] See 1 above

GATS covers trade in all "commercial services," categorized by the WTO in 12 groups: Business (including professional and computer) services; Communication (postal, courier and telecommunication) services; Construction and engineering services; Distribution services; educational services; Environmental services; Financial (insurance and banking) services; Health services; and other services not included elsewhere. The only two services not covered by GATS are air transport (although there are moves to bring them into the agreement)[3] and "services supplied in the exercise of government authority." The latter are defined as those neither provided in competition with other suppliers nor on "commercial basis." Unlike trade in goods, there is no harmonised system of classification for services and countries have a wide discretion.[4]

In structure, GATS is complex, lacks clarity on some definitions (for example, "commercial service" and not more burdensome than necessary") and limitations of its provisions, and its rules are still under development.[5] It differs from most other WTO agreements in two major ways[6]

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- It adopts a bottom-up or positive-list approach that allows countries to choose which sectors to liberalize, and the extent and speed of liberalization of the chosen sectors. In addition, countries are allowed to attach conditions (such as employment and technology transfer), which are necessary for promotion of growth and development, to their liberalization commitments. This makes GATS one of the best-designed WTO agreements, being both a trade and investment instrument.
- Negotiations proceed through a process of requests of, and offers for liberalization of specific sectors. The requests and offers are then taken up by bilateral bargaining between the countries involved.

[3] Ikiara M.M. (2003) " The implications of GATS on Kenya's Services Sector: Some Proposals on the Country's Position on GATS 2000 Negotiations." Background paper to assist the National Committee on the WTO (services Sub Committee) in the preparation of Kenya's position with respect to GATS 2000 Negotiations.
[4] Valckx, N., "WTO Financial Services Commitments: Determinants and Impact on Financial Stability" Revised. June 2002
[5] See 3 above
[6] Miller, R. and Gallacher, S. (2002). The GATS framework and Trade in Professional (legal) Services." Paper presented at the 24th International Trade Conference, Canberra, Australia, 9 October 2002.

GATS requires each member country to lower barriers against foreign service providers, in the service sub-sectors committed by the member, and to commit never to raise the barriers in the future, failure of which the member could be forced to compensate the affected countries.

There are several provisions in GATS that make it favourable for developing countries:

- Article IV on Increasing Participation of Developing Countries, which provides for the preferential treatment of developing countries.
- Article XIX (paragraph 2), which provides for the principle of progressive liberalization by developing countries in line with their development situation.
- Article V which allows countries in economic integration schemes to discriminate in favour of their partners so long as this is notifies to the WTO.[7]

GATS provisions, however, are in the nature of " best endeavour clauses" without any obligations on the part of Members to implement them.[8]

1.2.1.1 Negotiation Status

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The Uruguay Round (UR) managed to develop some of the rules to govern trade in services and also to liberalize a few service sectors, such as telecommunications and financial services. All developing and least developed countries limited their commitments to only 20% or less of the 160 or so service sectors, with the fewest commitments being in education and health and the most being in tourism.[9]

GATS provided for successive rounds of negotiations, to liberalize services trade further, beginning not later than 5 years after its signing. As a result, a new round of negotiations (the so called GATS 2000 negotiations or Millennium Round) was to be launched during

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[7] Valckx, N., "WTO Financial Services Commitments: Determinants and Impact on Financial Stability" Revised. June 2002

[8] UNCTAD (2000). " Multilateral Trading System Impact on National Economy and External Trade Policy Adaptation: Kenya." Report prepared by UNCTAD in the framework of the joint ITC/UNCTAD/WTO Integrated Technical Assistance Programme to Selected Least Developed Countries ((JITAP), Cluster 9, Geneva, March 2000

[9] Mutume, G. (2002). Trading Services: An opening or a noose? Africa puzzles over implications of trade in Geneva," Africa Recovery Vol. 16, No. 1, April 2002

the 3rd WTO Ministerial Conference (Seattle) December 1999. In the run up to the conference, including at the 2nd Ministerial Conference in Singapore in 1996, there was strong opposition by developing countries to the launch of a new round particularly because it sought to introduce new issues into the negotiations. The developing countries were increasingly frustrated because the benefits they had expected from the Uruguay round were not being realised. The opposition climaxed during the Seattle Conference, forcing it to collapse before the Millennium Round was launched.

The Seattle Conference had sought to extend the reach of global or multilateral trade rules into areas that had never been covered by WTO before, such as investment and labour. Even though GATS was considered as the least controversial element of the Seattle agenda[10], there are increasing concerns over the agreement's impact on government's provision and control of services in such areas as water, education and health.[11] Concerns revolve around equity implications of liberalizing important social services and possibility of erosion of integrity with adverse effects on public health.

1.2.1.2 The Millennium Round

GATS 2000 negotiations or the Millennium Round started at the beginning of 2000 despite the collapse of Seattle talks but were not launched until the 4th WTO Ministerial Conference held in Doha in November 2001. During the conference, considered then by developing countries as a success, a comprehensive work programme agreed upon, containing a great deal of areas of interest for developing countries, including other issues, implementation, special and differential treatment, agriculture, and the implications of TRIPS on public health. In fact, the Round became widely referred to as the Development Round.[12]

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[10] In comparison with, for instance, agriculture negotiations
[11] Mutume, G. (2002). Trading Services: An opening or a noose? Africa puzzles over implications of trade in Geneva," Africa Recovery Vol. 16, No. 1, April 2002
[12] Ikiara M.M. (2003) " The implications of GATS on Kenya's Services Sector: Some Proposals on the Country's Position on GATS 2000 Negotiations." Background paper to assist the National Committee on the WTO (services Sub Committee) in the preparation of Kenya's position with respect to GATS 2000 Negotiations.

1.2.1.3 Progress of GATS 2000 Negotiations

There has been little if any progress in the Doha work programme. On implementation issues, solutions were supposed to be sent to the WTO General Council by the end of 2002 but little progress has been made. On agriculture, there is also little progress with respect to the contentious issues of export subsidy and domestic support reduction. In the case of services, only few countries have made requests and offers and developed countries are not supporting the conclusion of work on GATS rules. [13] Only 30 countries have presented initial offers so far, most of them OECD countries. The offers made tend to address the interests, reflecting prior strategic consensus building. There is only minimal improvement in the market access and hardly any in the areas of interest for developing countries, principally made.

Other elements of the Doha work programme in which little progress has been made are market access for non-agricultural products, WTO Rules with respect to anti-dumping and countervailing measures, improvement of the Dispute Settlement mechanism, trade and environment, and special and Differential (S&D) Treatment. Progress was made with respect to TRIPS and public health on the eve of the 5th Ministerial Conference (September 2003) in a concerted last minute effort to avoid imminent collapse of the Conference.

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The progress of services negotiations in the ongoing round is tied to the progress in other key elements of the Doha work programme. In particular, developing countries view progress in agriculture negotiations as a key determinant of progress in service negotiations. Another major prerequisite for progress in services negotiations is the assessment of services sectors to determine the impact of previous liberalization and the potential impact of further liberalization. Developing countries are keen not to make the mistakes they made during the Uruguay Round when they committed sectors like tourism, banking and insurance services before impact analyses.

[13] See 10 above

Developed countries are pushing for commitments in such areas as public utilities, health, education, and environmental services (such as water for human consumption and waste management). Developing countries are concerned that some sectors of their populations may not be able to afford market prices for essential services, which are currently subsidised. They are also concerned that their service suppliers cannot compete with multinational firms that have massive financial strength, access to the latest technology and global infrastructure. Developed countries account for eighty percent (80%) of world service exports. Many countries in Africa lack the conditions required to build competitive service sectors; highly skilled human resources, technology, telecommunications infrastructure, competition regulations, government support for services, and national export service strategies.

It is in recognition of its rising importance that a multilateral framework for liberalizing trade and investments in the service sector was conceptualized in the form of the General Agreement on Trade in Services (GATS) initiated under the aegis of the WTO. Among the gamut of services, financial services have undergone the most active international negotiations with the aim of dismantling cross-border trade restrictions. The financial services agreement (FSA) has been the latest among the WTO agreements on financial services to come in force (in March 1999). This followed previous attempts in 1993 and 1995. The Financial Services Agreement includes commitments by 102 WTO members to reform their respective financial services market and provide increased market access through privatization and deregulation.[14]

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Financial services trade liberalization negotiations (FSTLN), under the General Agreement on Trade and Services (GATS), aims at reducing or even totally removing all trade barriers in financial services sector by allowing foreign financial firms in insurance, banking, securities industry and other related financial services sectors to enter a host country and enjoy national treatment. The GATS, launched in the Uruguay Round in 1986, was not able to reach any agreement until April 1994, several months after the

[14] Valckx, N., "WTO Financial Services Liberalization: Measurement, Choice and Impact on Financial Stability," *Research Memorandum WO no 705 October 2002*

conclusion of the Uruguay Round at the end of 1993[15] (Kono, et al …, 1997). Negotiations on financial services agreements were also extended far beyond the Uruguay Round and finally reached agreement in 1997. In the current and new Doha round of WTO negotiations, financial services and other services will be a "built-in" agenda, thus having the benefit of renewed emphasis [16](Key, 2003).

Financial Services Trade Liberalization Negotiations specifies general commitments, specific exemptions, and modes of supply of services. These commitments governing modes of financial services supplied and they can differ from country to country and can be phased in over time depending on the initial agreements. However, the general commitments of GATS also apply to FSTLN have the following features.[17] (Kono, et al …, 1997):

•Most-favored nation (MFN): All liberalization measures must be extended to all WTO members equally.

• Market access and national treatment: WTO member countries cannot discriminate between domestic and foreign firms, except when explicitly indicated at the time of joining the GATS.

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• Transparency: Local regulations should be published and made accessible to all.

• Progressive liberalization: Member states agree to increase the number of liberalized sectors and to eliminate exceptions within sectors by committing to future negotiating rounds.

• Dispute settlement mechanism: All commitments are legally binding. Harmed states can initiate an arbitration procedure. If found harmed, the country can impose sanctions against the violating country.

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15 Kono, M., P. Low, M. Luanga, A. Mattoo, M. Oshikawa, L. Schuknecht, 1997, "Opening Market in Financial Services and the Role of the GATS," WTO Special Report.

16 Key, S. J., (2003), *The Doha Round and Financial Services Negotiations*, (Washington DC: The American Enterprise Institute Press).

17 See 1 above

However, Financial Services Trade Liberalization Negotiations also has some important exemptions:

• Exemption for government services: Activities of the central banks or other government authorities carrying out monetary and exchange rate policies are excluded from GATS.

• Prudential carve-out: It is exempted from GATS and is designed to ensure that host country governments can protect their domestic financial system and participants of the financial system through the application of the host country prudential standards. These prudential measures in principle do not have to comply with the national treatment, market access commitments and its most favored nation responsibility.[18] .

However, the prudential carve-out is not meant to be an overriding exception to a member's obligations, as prudential measures should not be used to avoid a member's obligation or commitments.

•Some non-prudential related government regulations (for example, practices related to industrial policy to provide credit to certain industries) are also exempted from the commitments of the GATS unless such policies violate the general commitments as specified above.[19] (Kono, et al…, 1997).

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GATS establishes a framework of progressive liberalization in services trade, which allows countries substantial flexibility to determine: 1) which sectors of the service economy they wish to open up to foreign suppliers and competition and 2) what options, if any, they want to retain to restrict competition in these "open" sectors. GATS applies to all services in any sector except those supplied in the exercise of government authority, defined as supplied neither on a commercial basis nor in competition with one or more service suppliers.

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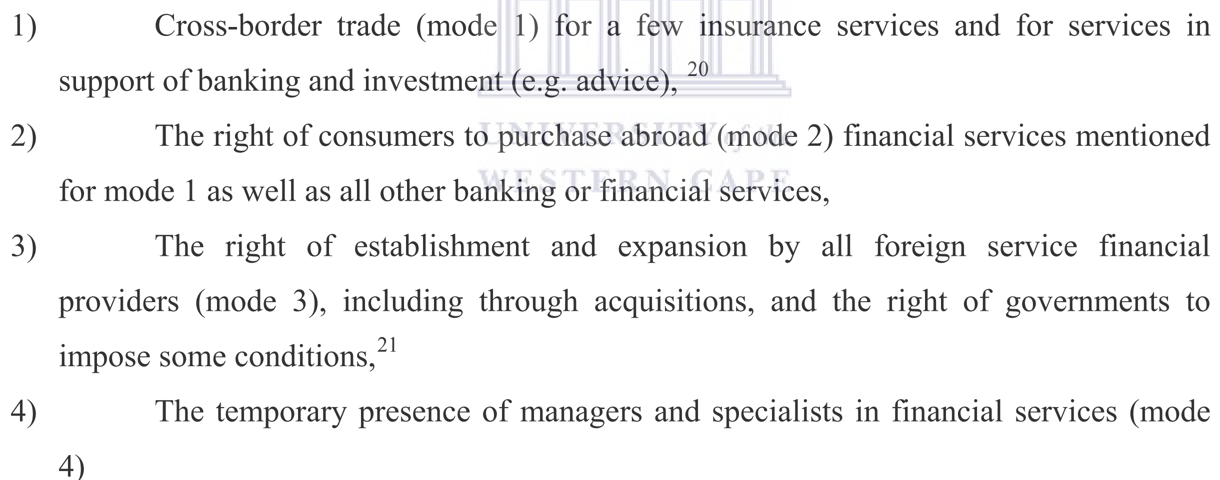
[18] Key, S. J., (2003), *The Doha Round and Financial Services Negotiations*, (Washington DC: The American Enterprise Institute Press).
[19] Kono, M., P. Low, M. Luanga, A. Mattoo, M. Oshikawa, L. Schuknecht, 1997,"Opening Market in Financial Services and the Role of the GATS," WTO Special Report.

WTO Members' commitments to allow for market entry in specific sectors of their choosing appear in schedules. These schedules spell out any restrictions on the extent of market access afforded to foreign suppliers, e.g. whether their numbers are restricted, and the degree of national treatment accorded to foreign companies. Once scheduled, these commitments are bound; meaning they can be modified or withdrawn if a country finds this necessary, but they are required to negotiate compensation with trading partners for the losses incurred. GATS commitments in any particular sector are undertaken with regard to four modes of supply, as defined in GATS: Mode l—cross border supply; Mode 2--consumption abroad; Mode 3-- commercial presence; and, Mode 4--temporary movement of natural persons. For any scheduled sector, countries may vary the level of commitments by mode to accommodate domestic policy objectives.

These four mode provide market openings to financial services in the following ways

Such market opening relates to:



1) Cross-border trade (mode 1) for a few insurance services and for services in support of banking and investment (e.g. advice), [20]
2) The right of consumers to purchase abroad (mode 2) financial services mentioned for mode 1 as well as all other banking or financial services,
3) The right of establishment and expansion by all foreign service financial providers (mode 3), including through acquisitions, and the right of governments to impose some conditions,[21]
4) The temporary presence of managers and specialists in financial services (mode 4)

One part of the GATS agreement deals particularly with liberalization of (financial) services, i.e. opening up markets to allow services and services providers to enter the country. A country can decide which (sub) sectors it liberalizes, or "makes commitments" in, by adding them to its GATS list ("schedule"). For instance, a country can fully or

[20] Valckx, N., "WTO Financial Services Liberalization: Measurement, Choice and Impact on Financial Stability," *Research Memorandum WO no 705 October 2002*

[21] See 20 above

partly liberalize its financial services under GATS. A country's GATS schedule specifies which (financial) sub-services are liberalized for which "modes", and can include exemptions to some GATS rules. Domestic financial liberalization may include a) interest rate liberalization through elimination of interest rate and price controls; b) removal of entry barriers through admission of new entrants both domestic and foreign based on transparent regulatory requirements; c) removal of barriers on the scopes of financial business; d) reduction of sector barriers to allow financial industry to compete each other's traditional scope of business; and e) Less state involvement through privatization of state-owned financial intermediaries and reduction of direct lending (Capiro, Honohan, and Stiglitz, 2001).[22]

A country can decide not to make a commitment in financial services by not adding financial services to the schedule.

The decision to open up, or not, certain services sectors is an important part of the GATS negotiations. A country receives "requests" from other WTO members, i.e. lists of services for which other countries demand market opening. A country then replies with an "offer", a list of services it is prepared to liberalize. Subsequently bilateral secret negotiations follow in which countries bargain between each other's offers and requests. At the end of the bilateral negotiations between the many WTO members, each country includes a schedule of services for which it grants new market openings in the GATS agreement and which is valid for all WTO members (Most Favoured Nation Principle).

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1.2.1.4 Kenya and GATS Financial Services Commitments

Kenya is the country that will be representative of the African countries in this study. It is therefore crucial that her commitments in GATS under the liberalization of financial services are scrutinised.

The following are the specific commitments made by early 1998.

[22] Caprio, G. Jr., P. Honohan, and J. E. Stiglitz (2001), "Introduction," in *Financial Liberalization: How Far and How Fast?* ed. by G. Caprio, P. Honohan, and J. E. Stiglitz, (London) Cambridge University Press, pp. 3-30.

Acceptance of deposits and other repayable funds from the public has no limitation for mode 1 on market access (MA) but unbound when it comes to National Treatment (NT). There are no limitations on mode 2 for both Market Access and National Treatment while for mode 3, only institutions approved as banks under the Banking Act are allowed to operate in Kenya while for the same mode, reads unbound on National Treatment. For both Market Access and National Treatment on mode 4, the Act specifies that it is unbound except as indicated in the horizontal commitments.[23]

When it comes to lending of all types, including consumer credit, mortgage credit, factoring and financing of commercial transaction for mode 1 and 2 there are no limitations for both Market Access and National Treatment while for mode 3 there is no limitation on Market Access while for National Treatment it is unbound. For both Market Access and National Treatment on mode 4, the Banking Act specifies that it is unbound except as indicated in the horizontal commitments.[24]

When it comes to participation in issues of all kinds of securities and provision of services related to such issues except underwriting mode 1, the Act provides that securities issued in a foreign jurisdiction cannot be offered or traded in the Kenyan market. This is a provision that points to Market Access. The same is unbound for National Treatment. There are no limitations on mode 2 for both Market Access and National Treatment while for mode 3, foreign portfolio investors can hold up to 40% of the shareholding of a locally listed company. They can also take up to 40% of any additional public offering by a foreign convened listed company. Meanwhile, it is unbound when it comes to limitations on National Treatment. For both Market Access and National Treatment on mode 4, the Act provides that the aforementioned are unbound, except as indicated in the horizontal commitments.[25]

Asset management except pension fund management has no limitation on mode 1 when it comes to Market Access while it is unbound for National Treatment. There are no

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[23] WTO, Trade Policy Review Kenya, 2004
[24] See 23 above
[25] WTO, Trade Policy Review Kenya, 2004

limitations for both Market Access and National Treatment for mode 2, while for mode 3, it is provided that 30% of paid up capital must be held by Kenyan nationals and it is unbound for National Treatment. Market Access and National Treatment for mode 4 is unbound except as indicated in the horizontal commitments.[26]

Advisory and auxiliary services has no limitations on both Market Access and National Treatment on mode 1 and 2 while it has no limitation on mode 3 under the Market Access column and it is unbound for National Treatment. Both Market Access and National Treatment is unbound for mode 4, except as indicated in the horizontal commitments.[27]

In the case of insurance services, Kenya has committed life and non-life insurance, brokering and agency services, auxiliary services including assessors, intermediaries and loss adjusters; and insurance and retrocession. However, there are limitations to market access, especially with respect to commercial presence, with foreign equity limited to 40%. National treatment and movement are unbound.[28]

In life insurance, mode 1 and 2 are unbound for both Market Access and National Treatment, while for Market Access in mode 3, one third of the paid up capital must be owned by Kenyan Nationals and there are no limitations on National Treatment under the same mode. Under mode 4 both Market access and National Treatment are unbound except as indicated in the horizontal commitments.[29]

When it comes to mode 1 on non-life for limitations on market access it is unbound, except for aviation, marine and engineering and it provides that National Treatment will be unbound. There is no limitation on mode 3 when it comes to market access. However

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[26] WTO, Trade Policy Review Kenya, 2004

[27] See 26 above
[28] Economic Review, Various Central Bureau of Statistics (CBS), International Centre for Economic Growth (ICEG) and K-Rep Holdings Ltd., "National Micro and Small Enterprises," Baseline Survey 1999.
[29] See 28 above

it is unbound for National Treatment. Mode 4 is unbound for both Market Access and National Treatment except as indicated in the horizontal commitments.[30]

Market access in agency services in Kenya is unbound except for re-insurance services while there are no limitations on National Treatment. Mode 2 is unbound for both Market Access and National Treatment while for mode 3, agency services are restricted to Kenyan nationals and is unbound for National Treatment. Both Market Access and National Treatment in mode 4 is unbound except as indicated in the horizontal commitments.[31]

For auxiliary services, assessors, intermediaries and loss adjusters under mode 1,2 and 3 there are no limitations on both Market Access and National Treatment while it is unbound for mode 4 for both Market Access and National Treatment, except as indicated in the horizontal commitments. In re-insurance and retrocession sub sector on mode 1, 2 and 3 under Market Access, mandatory cessions must be placed with Kenya Re 25%, Zep Re 10% and Africa Re 5% while there are no limitations on National Treatment for the three modes. Both Market Access and National Treatment on mode 4 are unbound except as indicated in the horizontal commitments.[32]

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1.2.2 The Problem Statement

One area of the Doha Development Agenda that has generated a lot of interest in the African Countries is the GATS. This is due to the different views held on the applicability of the agreement to the continent. Some hold the view that the agreement could only lead to the opening up of the financial services sector and finally efficient and customer responsive markets. Others are of the opinion that the GATS has come too soon for Africa; a continent that needs to first develop its domestic service industry before adopting a service liberalizing instrument like GATS.

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[30] Economic Review, Various Central Bureau of Statistics (CBS), International Centre for Economic Growth (ICEG) and K-Rep Holdings Ltd., "National Micro and Small Enterprises," Baseline Survey 1999
[31] See 30 above
[32] Economic Review, Various Central Bureau of Statistics (CBS), International Centre for Economic Growth (ICEG) and K-Rep Holdings Ltd., "National Micro and Small Enterprises," Baseline Survey 1999

The aim of this paper is to examine both positive and negative effects of the GATS agreement on the financial services sector in African countries and to finally conclude whether the benefits of the agreement outweigh the losses or vice versa.

1.2.3 The Purpose of the Study

The aim of this study is to examine the expected effects of the GATS on the financial service industry in Africa. The expected effect of GATS on the financial sector in Africa is a key concern in the continent. This is due to the importance of the industry to the development of the continent and its peoples.

Attention will be paid to the liberalizing effect that GATS will have and how this will impact on the financial sector in Africa. The study will aim at determining the effect of GATS on the financial sector in Africa.

1.2.4 Research Questions

1. How will the implementation of GATS impact the banking industry in Africa?
2. How will the implementation of GATS impact the insurance industry in Africa?

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1.2.5 Importance of the Study

The economic benefits of GATS on the financial services sector in Africa as espoused by the proponents of GATS have been set out very clearly in various articles and research papers; so are the expected losses as spelt out by the opponents of GATS. This paper will analyse both the merits and the demerits of GATS on the financial sector in Africa and will recommend the position that African nations should take in the Doha Development Agenda as regards GATS.

The study is significant in clearly pointing out the way that Africa should take in the Doha Development Agenda as regards GATS and the financial sector. It is of paramount importance that African countries come up with a good framework for negotiating the GATS agreement to ensure that they get terms that will lead to sustainable development in their markets.

1.2.6 Scope of the Study

The research will deal with the GATS and its expected impact on the financial services sector in Africa only. The study will be confined to the financial service sector in Africa. The financial services sector in Africa will be divided into two i.e. The Banking sector and the Insurance sector. The study will investigate both the expected positive effects and the expected negative effects of the GATS on the financial services sector in Africa.

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2.0 CHAPTER 2

2.1 Literature Review

An assessment of the expected impact of GATS on the service industry in Africa will give a direction as to the expected impact of GATS on the financial industry in the continent. A general overview of the expected impact of GATS on the service industry in Africa is necessary so as to give the general direction to African countries when engaging in future GATS commitment negotiations. This chapter will assess the impact of GATS on the service industry in developing countries. It will also focus on GATS and its expected impact on Human Rights in the continent of Africa. This is vital due to the increased focus of the impact of trade on human rights worldwide. It will then narrow down to the financial services industry and examine the expected impact of GATS on the same in the African continent.

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2.1.1 GATS and the Service Industry in Africa

2.1.2 BENEFITS OF GATS

IMF Balance of Payments statistics indicated that, in 1998, industrial countries had a 73 per cent share of world exports and imports in services, while Developing Countries had a twenty seven per cent share (27%)[33]. There are a number of reasons for this imbalance, including the greater emphasis in the developed world over the last two decades on market-oriented microeconomic reform in key service sectors, including privatization; the role of technology in facilitating internationally-competitive services exports; and the fact that the demand for services is naturally linked to the state of economic development in any country. Nevertheless, the imbalance is a significant issue, and one that will be addressed as a matter of course in the services negotiations.

Services are, however, not only important in terms of trade. A central consideration is that, "The developing countries have limited flexibility to offer less liberalization of services than developed countries but they are not allowed a free ride. The GATS is

[33] IMF Balance of Payments Year Book, 1999

based on the argument that if the national governments have concern for economic efficiency, the optimal policies would be the same both for developed as well as developing countries."[34]

Over the last few years, there has been extensive research into this argument. To use a summary by Mattoo[35], “Many services are inputs into production and inefficient production of such services acts as a tax on production - - -Well functioning services industries contribute to growth in different ways. An efficient financial sector allows resources to be deployed where they have the highest returns- - -Improved telecom efficiency generates economy-wide benefits as telecommunications are a vital intermediate input and are crucial to the diffusion of knowledge.”

Similarly, transport services contribute to the efficient distribution of goods within a country, and greatly influence a country's ability to participate in global trade. Business services such as accounting and legal services are important in reducing transaction costs; education and health services are necessary in building up the stock of human capital, a key ingredient in long run growth performance.[36]

An example which DFAT quoted in its 1999 publication on Global Trade Reform[37] is that provided by a 1998 World Bank study about the rise in agricultural output in India following banking liberalization:

Expansion of commercial bank networks and availability of financial services had a very substantial positive effect on private agricultural investment in India. Analysis of data from 85 districts in 13 Indian states revealed that expansion of commercial banks into rural areas increased both investment and productive output. Investment in tractors rose by 13 percent, in pump sets by 41 percent, in milk animals by 46 percent, and in draft animals by 38 percent.

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[34] Chadha, 2000

[35] Mattoo, Aaditya. 2000. "Developing Countries in the New Round of GATS Negotiations: Towards a Pro-Active Role" in *The World Economy* Vol 23, Number 4

[36] Mattoo, 2000

[37] Department of Foreign Affairs and Trade, *Global Trade Reform: Maintaining Momentum*. 1999.

Demand for fertilizer rose by about 23 percent, and aggregate crop output rose by nearly 3 percent.[38]

It is worth noting how the landscape of services sectors has changed even in the last five years. Technological advances, and greater competition in the sector arising from the privatization of former monopolies are contributing to this transformation.

The ability to collect, process and transmit information in real time has increased the possibility of introducing competition in many network-based infrastructure services, such as telecommunications, energy and transportation.

It has made it possible to separate the management of the physical infrastructures such as telephone lines, electric power grids, and pipelines from the services provided through those facilities. Different service providers can use the same infrastructure, yet compete with each other in supplying the services involved to consumers.[39]

Commentators have noted the increasing trends towards privatization of network based services sectors, and the implications for competition and tradability. In the telecoms sector, Low and Mattoo have observed that, "For the most part, traditional state-owned monopoly suppliers have not been successful in providing low-cost, efficient or even widely available services in many countries".[40] A study by the Norwegian Michelsen Institute, circulated at the Council for Trade in Services this year, indicated that "a comparison of prices on communication services show that Tanzanians pay 50 per cent higher connections charges and 11 per cent higher local call rates relative to the USA despite having less that 1 per cent of its purchasing power"[41]

In the APEC Group on Services this year, economies have exchanged information on the impact of liberalization of services sectors, eg Thailand has indicated that it has unilaterally increased market access to its commercial banking sector and increased

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[38] Binswanger, Khandker and Rosenzweig., 1993. World Bank, *Making Services an Engine of Growth.* 1998.
[39] Feketekuty, Geza. 1998. "Principles of Sound Regulation in Services: the Key to Long Term Growth in the New Global Economy", presented at the International Symposium on 'Trade in Services: China and the World'.
[40] Low, Patrick and Mattoo, Aaditya. 1997. "Reform in Basic Telecommunications and the WTO Negotiations: the Asian Experience"
[41] Hodge, James and Nordas, Hildegun, "Liberalization of Trade in Producer Services: the Impact on Developing Countries". Michelsen Institute

foreign equity provisions.[42] The Peruvian Ministry of Industry assessed the benefits of services liberalisation in financial and telecoms in particular as:

- More competition
- Introduction of new products
- Foreign investment
- Reduction in services prices.[43]

In short, services liberalization can be beneficial to DCs in and of itself, since it reduces the costs of services inputs to other sectors of the economy, and thereby enhances allocative efficiency and international competitiveness.

Australia supports comprehensive negotiations; that is, we consider no service sector should be excluded from the negotiations. Like every Member, Australia has its own sensitive sectors, ours being audiovisual, and public health and education. But we believe every sector should be on the table, to allow open debate about the least trade restrictive ways to defend our national interests. Sectors of interest to DCs, eg maritime, construction and tourism, will be paid due attention only through comprehensive negotiations. We recognize that, despite all the evidence that points to the advantages of reform and liberalization, the nature of multilateral negotiations is such that DCs will require trade-offs. In multilateral negotiations, DCs have the capacity to form powerful coalitions and to hold out for packages of benefits.

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Because of the substantial scope for productivity improvements in the services sector, liberalization would be expected to result in big gains. Modeling commissioned by the Australian Government in 1999 indicated a substantial annual gain in world welfare of US$250 billion if global distortions in the provisions of services were reduced by 50 per cent. All economies would stand to gain and, in proportion to the size of GDP, the gains

[42] APEC Secretariat, Group on Services website http://www.apecsec.org.sg/ 2000

[43] See 42 above

would be spread fairly evenly. In this area, the modeling significantly understates the dynamic effects of services reform.[44]

The overall goal for services in the new WTO Round must be to maximize the benefits of efficient service sectors for all countries. Multilateral trade rounds allow the world economy to keep growing on a sustainable basis. The GATS negotiations are an important opportunity to underpin further expansion of services trade, generate intersectoral gains for the merchandise trade sector, and contribute to the economic and employment growth and technological innovation that improves people's lives.

Hereunder is a summary of the benefits of GATS to the service industry as put forth by the Office of the United States Trade Representative in its Trade in Services Policy Brief of March 2006:

2.1.2.1 Financial Services:

A recent World Bank report indicates that countries with open financial services sectors grow on average one percentage point faster than other countries. Improved commitments send a strong signal to foreign financial services companies that they should devote their resources and technologies to particular countries and that needed infrastructure will be in place to support their exporting objectives. Financial services suppliers provide essential finance, risk transfer and investment management tools to help economies grow and diversify and become competitive suppliers of goods and services. Foreign presence also contributes to the stability of financial markets by providing deeper pools of capital, risk management techniques and technologies not available on the domestic market.[45]

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2.1.2.2 Telecommunications:

A competitive telecommunications market brings many benefits to businesses and consumers including lower costs, efficient and innovative services, and expanded opportunities and choices. Network expansion has been a key driver of economic growth

[44] DFAT, 2000
[45] Office of the United States Trade Representative, Services Facts www.ustr.gov Trade in Services Policy Brief – March 2006

for many countries, and private investment has been the main catalyst for such expansion; much of it in the developing world. According to the World Bank, the private sector invested $230 billion in telecommunications infrastructure in the developing world between 1993 and 2003, with the greatest investment in those countries that were open to competition. Indeed as more markets become competitive, expansion into other markets will become essential. Thus, all countries seeking to benefit from the gains of a competitive global telecommunications market have a stake in seeing market opening commitments in this sector.[46]

2.1.2.3 Express Delivery:

Whether delivering commercial contracts, financial agreements, a replacement part for an electric power turbine, or even merchandise exports to support just-in-time manufacturing, express delivery services play a critical role in supporting the competitiveness of domestic industries. Express delivery services also serve as an important source of local employment and economic development, employing nearly 1 million people in over 200 countries. The vast majority of those personnel are hired locally to provide the vital link to the domestic market. GATS commitments on express delivery services signal a stable, commercially friendly regulatory regime in which potential investors will be able to maintain close contact with their suppliers and customers all around the world.[47]

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2.1.2.4 Computer and Related Services:

Computer and related services are a key services sector, providing support for many other industries. Without a robust computer services sector, many industries fail to realize the efficiency and productivity gains that computer services provide. In addition, this sector is one in which many countries, including developing countries, have keen export

[46] Office of the United States Trade Representative, Services Facts www.ustr.gov Trade in Services Policy Brief – March 2006

[47] See 46 above

interests. Thus, full market access opportunities create benefits for many Members' industries.[48]

2.1.2.5 Environmental Services:

Environmental services commitments help to support sustainable development goals by providing greater access for lower cost to key environmental services, including: sewage services; solid and hazardous waste management; protection of biodiversity and landscape; protection of ambient air and climate; and remediation of soil and water. Increased access to affordable and effective environmental technologies and services was called for by Leaders at the World Summit on Sustainable Development (WSSD) in 2002. Environmental services markets are forecast to grow quickly in the coming decade. For example, the World Bank estimates that annual investments in water supply and sanitation would likely to need to double from the historical level of $15 billion per year to $30 billion per year to meet future demand. In addition, GATS commitments contribute to employment of local personnel and transfer of technology and know-how in this important services sector.[49]

2.1.2.6 Distribution Services:

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Virtually every exported commodity makes its way to the market through distributors. Wholesalers, retailers, commissioned agents and franchisers provide the domestic infrastructure for moving goods to consumers. But inadequate competition in distribution markets raises prices and reduces the volume of goods sold. Excess profits enjoyed by uncompetitive middlemen come at the expense of both consumers and producers. GATS market access commitments bolster appropriate policies in support of competition.[50]

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[48] Office of the United States Trade Representative, Services Facts www.ustr.gov Trade in Services Policy Brief – March 2006

[49] See 48 above

[50] Office of the United States Trade Representative, Services Facts www.ustr.gov Trade in Services Policy Brief – March 2006

2.1.2.7 Energy Services:

Energy services commitments increase energy security by introducing new technology to enhance, for example, production of declining oil fields. New technology can also promote the development of renewable energy sources such as solar and wind power. Energy services commitments also encourage investment in infrastructure development and promote regional integration. In Africa, for example, a proposed gas pipeline project will transport flared gas in Nigeria to Ghana to supply an electric power plant. Energy services commitments also foster competition thereby creating jobs, enhancing skills and providing training opportunities.[51]

2.1.2.8 Higher Education:

Properly regulated, increased trade in private higher education services opens the door to great economic, social, cultural and political benefits. Trade in private education complements public university systems by offering greater choice at global standards of quality, thereby helping to level the playing field in the knowledge-driven economy.[52]

2.1.2.9 Audiovisual Services:

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Opening the audiovisual services market benefits the domestic industry by introducing new technologies, skills and business methods, which in turn lead to the development of a multitude of new services, and foster local creativity and innovation. A growing number of countries have come to recognize that opening the audiovisual sector to foreign participation has broad, positive spillover effects for the local economy, including for such sectors as tourism, education and local manufacturing.[53]

2.1.3 GATS: PRO-DEVELOPMENT OR ANTI-DEVELOPMENT?

At a time when many developed country governments are trying to present the WTO's Doha work programme as a 'development round', GATS is often cited as one of the most

[51] Office of the United States Trade Representative, Services Facts www.ustr.gov Trade in Services Policy Brief – March 2006

[52] See 51 above

[53] See 51 above

development friendly agreements. The architecture of GATS, it is argued, allows developing countries more flexibility than many other WTO agreements – indeed, developing countries made clear during the original negotiation of GATS that they would only accept an agreement based on a 'positive list' approach, whereby each country can determine which sectors it is ready to commit to liberalization, and under which conditions. In addition, the needs of developing countries are specifically identified as priorities in Articles IV and XIX of GATS, and again in the negotiating modalities agreed for the current round of GATS negotiations in March 2001.[54]

Yet the reality of the GATS negotiation process undermines the development-friendly architecture of the GATS agreement.[55] The 'progressive liberalisation' of trade in services, which GATS requires, is achieved through successive rounds of market access negotiations, in which WTO member countries engage in secret discussions with each other in order to open up new service sectors to competition from Foreign Service providers.[56]

While developing countries formally retain the right to choose which services they will offer up to GATS, they come under intense pressure in these negotiations to meet the demands of more powerful WTO members.[57] The fact that the negotiations are held on a bilateral basis, and in secret, sets the weakest countries against the strongest on a wholly unequal footing. The negotiation process thus turns the 'development-friendly' architecture of GATS against developing countries, and exposes them to exactly the type of bilateral pressure the WTO was supposed to avoid.[58]

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No one disputes that power politics play a major role in the WTO. Former WTO Director General Mike Moore himself acknowledged that, despite formal equality between WTO

[54] Hilary, John (2003) "GATS AND WATER: THE THREAT OF SERVICES NEGOTIATIONS AT THE WTO" Published by Save the Children UK

[55] Hilary, John (2003) "GATS AND WATER: THE THREAT OF SERVICES NEGOTIATIONS AT THE WTO" Published by Save the Children UK

[56] See 55

[57] Hilary, John (2003) "GATS AND WATER: THE THREAT OF SERVICES NEGOTIATIONS AT THE WTO" Published by Save the Children UK

[58] See 57 above

members, "there is also no denying that some members are more equal than others when it comes to influence"[59]. As well as enjoying far greater negotiating capacity, in terms of both material and human resources, richer countries have in the past exerted extra pressure on poorer WTO members by raising the prospect of loss of aid or trade preferences if they do not drop their opposition to rich countries' positions[60].

In the context of services negotiations, experience has shown that the overwhelming bargaining power of rich countries can pressure developing countries into surrendering key service sectors to GATS even when it is not in their interest to do so. UNCTAD's recent survey of developing country trade delegates confirms that the process of services negotiations is itself hampering their ability either to benefit or protect themselves from GATS: *Of particular concern to developing countries is the lack of transparency of the ongoing request/offer process within the GATS, which hinders their capacity to evaluate the requests submitted to them by developed country trading partners, and the formulation of their own requests and offers, which is a particularly complex task.* [61]

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Partly as a result of this imbalance of power at the WTO, developing country representatives point out that there has been little progress towards realizing the pro-development objectives of Articles IV and XIX. Article IV of GATS sets the goal of increasing the participation of developing countries in services trade, but WTO statistics reveal that their share in both exports and imports of services remains substantially the same today as it was when GATS came into force in 1995 [62]. The global services market itself has expanded significantly over the past eight years, and developing countries' trade in services has grown accordingly in absolute terms, but there are concerns that these economic benefits have largely been limited to increased participation by certain Asian economies.

[59] Moore, M. (2000) 'World Trade Needs Atlantic "Big Boys" to Get Together'. In *European Affairs*, vol. 1, no. 3, summer 2000.

[60] Jawara, F. and Kwa, A. (2003) *Behind the Scenes at the WTO: The real world of international trade negotiations*. Zed Books, London (forthcoming).

[61] UNCTAD (2002a) *Trade in Services and Development Implications: Note by the UNCTAD Secretariat*. Document TD/B/COM.1/55. UNCTAD, Geneva.

[62] WTO (2002) *International Trade Statistics 2002*. World Trade Organisation, Geneva.

In addition, there are concerns that GATS commitments have not led to any rise in the overall level of foreign direct investment (FDI) in services to developing countries. This prospect of increased FDI flows is still cited as a primary reason why it should be in the interest of those countries to make GATS commitments rather than simply to undertake liberalization of service sectors and use other channels to signal their openness, independently of GATS. As revealed by UNCTAD's assessment of developing countries' experience of trade in services, this signaling through GATS commitments has not had the desired effect:

There is no empirical evidence to link any significant increase in FDI flows to developing countries with the conclusion of GATS.[63]

In frustration at the lack of progress in realizing development objectives in respect of services trade, a group of Latin American and Caribbean countries put forward a proposal to the WTO's Council for Trade in Services that a new mechanism should be established to monitor achievements in advancing towards the goals set out in Article IV, with a stocktaking of progress that was to be held at the WTO's Cancun Ministerial Conference in September 2003[64].

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In order to minimize the negative effects of GATS, Article XIX establishes that developing countries are to be granted greater flexibility in the GATS liberalization process in order to respect their level of development. As a means to identifying what flexibility is needed, Article XIX also stipulates that there should be an assessment of the impact of services liberalization prior to each new round of negotiations in order to inform the guidelines and procedures of that round. Yet this latter requirement was not honored in the development round, and assessment has instead become a standing item on the agenda of the Council for Trade in Services.

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63 UNCTAD (2000) *A Positive Agenda for Developing Countries: Issues for Future Trade Negotiations*. UNCTAD, New York and Geneva.

64 Bolivia et al. (2002) *Implementation of Paragraph 15 of the Guidelines and Procedures for the Negotiations on Trade in Services (S/L/93)*. Communication from Bolivia, Barbados, Colombia, Cuba, Ecuador, Nicaragua, Peru and Trinidad and Tobago. Document TN/S/W/7. WTO, Geneva

Developing country representatives and civil society organizations have united in calling for assessment as an essential precondition of making offers in the development round of services negotiations[65]. This call for an evidence-based approach to the negotiations stands in contrast to the accelerated negotiating timetable engineered at the WTO's Doha Ministerial Conference – in the face of opposition from many developing countries – which sought to rush through the tabling of initial GATS offers by the end of March 2003.

In addition to this failure to realise the pro-development elements of GATS, there are also provisions within the agreement that have a negative impact on national efforts to maximise the developmental benefits of foreign investment.[66] Many countries welcome foreign investment in individual service sectors, and employ a range of measures to ensure that this investment contributes to economic development and other policy objectives. Such measures include: requirements that foreign investors establish a joint venture with a domestic partner; equity ceilings on foreign capital participation; conditions of minimum capital investment; performance requirements in areas such as technology transfer, public service provision, employment or training of local staff.[67]

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Yet these standard methods of managing foreign investment in services to the maximum benefit of the host country are threatened when a sector is bound under GATS. Article XVI of GATS prohibits WTO members from using requirements on type of legal entity (such as joint ventures) or limitations on foreign capital participation, unless such measures have already been specified in that country's national schedule of GATS commitments. Article XVII prohibits WTO members from employing any measures, which favour domestic over Foreign Service providers – either explicitly (*de jure*) or in practice (*de facto*) – unless those measures have already been specified in the country's

[65] Mashayekhi, M. and Julsaint, M. (2002) *Assessment of Trade in Services in the Context of the GATS 2000 Negotiations*. South Centre, Geneva.

[66] Hilary, John (2003) "GATS AND WATER: THE THREAT OF SERVICES NEGOTIATIONS AT THE WTO" Published by Save the Children UK

[67] See 66 above

national schedule. This would include many of the performance requirements listed above[68].

Even when countries have specified these requirements in advance, their very presence in national GATS schedules sets them up as targets for removal in the services negotiations at the WTO. This is well demonstrated by the requests submitted by the EU to 109 other WTO members in the development round of negotiations, which were leaked and published online in February 2003[69]. These documents requested the removal of joint venture requirements and limitations on foreign equity participation in countries such as Indonesia, Pakistan, Thailand, China, Cuba, the Philippines, Egypt and India – as well as a host of performance requirements on investors in these and other countries. All these countries must now expend precious negotiating capital in trying to protect their own pro-development policies from elimination.

The need to protect those policies in the present, however, is made more urgent by the fact that GATS makes it effectively impossible to reintroduce them again in the future, should it be considered prudent or necessary to do so. The 'progressive liberalization' programme of GATS allows only for the removal of access conditions and performance requirements on foreign investors, not the restoration of old ones or the introduction of new, while the disciplines on modification of national schedules (Article XXI) require countries to provide acceptable compensation to any WTO member whose benefits "may be affected" by the proposed modification before it can be introduced. In practice, these terms are so punitive that GATS commitments are – to quote David Hartridge, former Director of the WTO's Trade in Services Division – "irreversible".[70]

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2.1.4 DOES GATS LEAD TO PRIVATISATION?

Committing a service to GATS means assenting to competition in that sector in accordance with GATS disciplines, and binding it for the future. When a country binds

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[68] Hilary, J. (2002) *Foreign Investment in Services: The threat of GATS 2000 negotiations*. Save the Children UK, London.

[69] **(see www.gatswatch.org)**

[70] Hilary, John (2003) "GATS AND WATER: THE THREAT OF SERVICES NEGOTIATIONS AT THE WTO" Published by Save the Children UK

liberalization of a service sector in its national schedule of GATS commitments, there is no requirement that it should distinguish as to whether the service is currently provided as a public service throughout that country, whether it is exclusively the domain of the private sector, or whether – as is the case in many services – public and private provision coexist, either in different localities or side by side.

It is the sector itself that is committed to liberalization under GATS.

This approach has fuelled concern that public services, which have a direct significance for children, especially poor children, might fall under GATS disciplines when a particular sector is bound under GATS. While Article I:3 excludes "services supplied in the exercise of governmental authority" from the provisions of GATS, its definition of those services is a narrow one, requiring that they be supplied "neither on a commercial basis, nor in competition with one or more service suppliers". It has been widely accepted that such a definition has very limited application in today's world, where almost all public services are supplied either in competition with other suppliers or on a commercial basis, or both[71]. Indeed, the act of liberalising a service sector introduces competition by definition.

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There is already broad consensus that some public services do fall under GATS disciplines. Peter Carl, Director General for Trade at the European Commission, provided confirmation of this in his statement to the European Parliament's public hearing on GATS in November 2002 when he noted that: "Many public services are not subject to the GATS" – a significant shift from previous claims that all public services were excluded[72]. Similarly, UK Government trade negotiators have acknowledged that many public services provided in the UK with the increased participation of the private sector would already fall under GATS.

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[71] Krajewski, M. (2003) 'Public services and trade liberalization: Mapping the legal framework'. In *Journal of International Economic Law*, vol. 6, no. 2, summer 2003 (forthcoming).

[72] Carl, M.P. (2002) *The EU and Services Negotiations in the WTO*. Contribution by Mogens Peter Carl to the Hearings of the ITRE Committee, European Parliament, 26 November 2002.

Liberalization of a service under GATS thus represents a binding commitment to permit competition in that sector, irrespective of how the service might have been provided in the past.

This competition allows for the continued presence of public services, but in cases where the service has previously been provided by the public sector alone, the process of liberalization will lead to a transfer of at least part of the service into the private sector. As noted by International Financial Services London, one of the most active lobbying groups promoting services liberalization:

[O]pening service markets to foreign providers is self-evidently inconsistent with retaining public monopolies.[73]

Irrespective of whether they have held a monopoly in the past, public services face new challenges once the sectors in which they operate have been opened up to competition through GATS – in particular, the challenge from some of the world's largest multinational companies.

Even for countries in which the public sector has long faced competition from domestic providers, the strength of this foreign challenge can be a direct threat to the very existence of public services.

As noted by a group of developing countries in a key submission to the WTO Council for Trade in Services:

For developing countries, privatization by foreign companies is very much a 'natural' consequence of service sector liberalization, since the government and local suppliers will not be able to withstand the competition.[74]

This tendency for multinational service companies to undermine the public sector has been documented across several service sectors of importance for the disadvantaged in

[73] IFSL (2002) *The Case for Liberalising International Trade in Services*. International Financial Services London, London.

[74] Cuba et al. (2001) *Assessment of Trade in Services*. Communication from Cuba, Senegal, Tanzania, Uganda, Zimbabwe and Zambia. Document S/CSS/W/132. WTO, Geneva.

Africa. In the case of health insurance, for example, which has grown into a multi-billion dollar worldwide industry, competition from multinationals threatens the viability of state social insurance programmes designed to spread costs across society and provide affordable health care for all. Fragmentation of the sector as a result of greater competition "segments and destabilizes the market and undermines the ability to build larger, more equitable risk pools that spread costs between rich and poor, healthy and sick" [75]

Yet the best example of the close connection between liberalization and privatization of services can be found in relation to water. The special status of water services as a natural monopoly means that liberalization to secure private sector involvement entails privatization of the service in the locality in which liberalization has taken place, as there is no possibility of competition in the physical delivery of the service through the one network.[76] While the public sector may continue to provide water in other localities, therefore, opening up the service to the private sector automatically entails privatization in the locality concerned.[77] Crucially, too, the attempt to increase the involvement of the private sector in the provision of basic services such as health, water and education in developing countries has become a high priority of donor and lending agencies at the start of the 21st century. The World Bank's Private Sector Development Strategy, approved in 2002, identifies increased private sector involvement as a priority across its lending bodies, and sets out the mechanism whereby future lending will be tied to a country's attractiveness to private investors. Individual arms of the World Bank Group have developed their own plans for increasing private sector involvement in social services: also in 2002, the Bank's International Finance Corporation published its strategy for extending private sector involvement in social sectors which have traditionally been free of private investment. The IMF has also made much of its lending conditional upon

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[75] Lipson, D. (2001) *GATS and Trade in Health Insurance Services: Background Note for WHO Commission on Macroeconomics and Health*. World Health Organisation, Geneva; see also WHO 2000, Chapter 5

[76] Hilary, John (2003) "GATS AND WATER: THE THREAT OF SERVICES NEGOTIATIONS AT THE WTO" Published by Save the Children UK

[77] 'Privatisation of the service' in this briefing refers to the private sector's assumption of responsibility for service provision, whether through a transfer of ownership of public assets or through a concessionary or contractual arrangement. This standard understanding of the term is in contrast to the World Bank's current attempt to restrict the word 'privatisation' to mean only the divestiture of public assets.

privatization: a random review of IMF loan agreements signed with 40 countries during 2000 revealed that water privatization or full cost recovery was a condition in 12 of them.[78]

GATS provides both a formal framework for registering the liberalization of services and a process for securing the liberalization of more sectors. More importantly still, committing a sector to GATS binds a country or locality to that liberalization in the future. Thus any liberalization undertaken as a result of pressure from donor or lending agencies becomes effectively irreversible, even if the decision to involve the private sector turns out to have been a mistake. This has particular relevance in the case of water services, where the involvement of the private sector has in many instances not delivered the benefits hoped for. Once a service has been committed to liberalization under GATS, it is contrary to the market access disciplines of GATS Article XVI to return the sector to public monopoly provision, as this would represent a quantitative restriction of the market and thus a reversal of the liberalization commitment.

2.1.5 GATS and Human Rights

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The proponents of liberalization of services have endeavoured to put forth the benefits of GATS to the developed countries and their developing counterparts. However there have been concerns of GATS and its expected impact on Human Rights by opponents to liberalization of services, especially in developing countries. There is serious concern that GATS undermines a number of rights. One such example is the right to health. Health services are included under GATS in several sectors and across all four modes, and many countries have already committed some of their health services to liberalization in their national GATS schedules. Moreover, the 'progressive liberalization' envisaged by GATS drives WTO member countries to make more such liberalization commitments in future rounds of GATS negotiations.

[78] Grusky, S. (2001) 'IMF and World Bank Push Water Privatization and Full Cost Recovery on Poor Countries'. In *News & Notices for IMF and World Bank Watchers*, vol. 2, no. 4, spring 2001.

The right to the highest attainable standard of health is enshrined in Article 12 of the International Covenant on Economic, Social and Cultural Rights (ICESCR). Its application is further developed in General Comment No 14 of the UN Committee on Economic, Social and Cultural Rights, which states that the right to health demands that functioning, good quality health care facilities be available and accessible to all without discrimination. The Committee on Economic, Social and Cultural Rights (CESCR, or Committee) is the UN expert body that monitors the implementation of International Covenant on ESC rights. Most particularly, General Comment 14 affirms that States parties to the ICESCR have a non-derogable, core obligation "to ensure equitable distribution of all health facilities, goods and services."[79]

Under mode 3 of GATS, liberalization in the health sector involves allowing construction of foreign hospitals or dental clinics catering to rich urban patients, or opening national health insurance systems to multinational insurance companies. Opening up health services to Foreign Service providers in this way can lead to a range of problems. These are:

• Fragmentation of a country's national health system. Private sector facilities run by foreign providers typically draw the most skilled and experienced staff away from the public sector by means of higher pay and other inducements, leaving poor and remote areas without the personnel needed to run essential health care facilities. GATS liberalization thus works in opposition to progressive programmes undertaken by countries such as Thailand, which has addressed its human rights obligations by developing a sophisticated system of incentives to attract medical personnel to work in poorer rural areas.[80]

• Private health insurance schemes tend to focus on the richest and healthiest customers only, destroying the possibility of cross-subsidization on which national insurance systems depend.

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[79] SOMO, *Challenges for the South in the WTO Negotiations on Services*, 2002 www.somo.nl/somo_ned/projecten/Challenges.pdf
[80] Suwit Wibulpolprasert and Paichit Pengpaibon, 'Integrated strategies to tackle the inequitable distribution of doctors in Thailand: four decades of experience' *Human Resources for Health, 2003*, available at www.human-resources-health.com/ content/1/1/12

As noted by WHO research, liberalization of insurance systems "segments and destabilizes the market and undermines the ability to build larger, more equitable risk pools that spread costs between rich and poor, healthy and sick."[81] For countries such as Indonesia, Vietnam or the Philippines that are attempting to build sustainable health systems on the basis of social insurance schemes, such liberalization poses a real threat.

Ultimately, by promoting the liberalization of trade in health services, GATS works against the equitable distribution of health facilities and threatens to undermine the right to health of those communities, which lose out.

Another human rights concern is water. The right to water is indispensable for the realization of the right to health and the right to food, but as shown above, privatisation in this sector does not always protect these rights. The Committee on Economic, Social and Cultural Rights has unequivocally stated that the right to water falls within the category of guarantees essential for enjoying the rights protected by the ICESCR. Specifically, the Committee points out in a General Comment that 'water should be treated as a social and cultural good, and not primarily as an economic good. Water, and water facilities and services, must be affordable for all. The direct costs and charges associated with securing water must be affordable for all, including socially disadvantaged groups.' And 'unaffordable increases in the price of water' amount to a violation of human rights. Importantly, the Committee reminds governments that "agreements concerning trade liberalization should not curtail or inhibit a country's capacity to ensure the full realization of the right to water". The Committee has applied similar reasoning in its General Comments on the Right to Food and on the Right to Health.

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In addition, several aspects of the way new liberalization commitments are agreed to or implemented are inconsistent with human rights obligations.

• Firstly, there is inadequate public participation in privatization processes and inadequate public information and participation in negotiations about trade liberalization. Although

[81] Debra Lipson, *GATS and Trade inHealth Insurance Services: Background Note for WHO Commission on Macroeconomics and Health*, 2001, available at www.cmhealth.org/docs/ wg4_paper7.pdf

some countries, such as India, are now seeking broader input on services negotiations, the processes still lacks transparency.[82]

This lack of transparency gives little opportunity for civil society, including human rights groups and individuals to alert governments to possible dangers of the violation of human rights. Public participation in policy-making, including economic policy, is a human right. For this reason, human rights advocates should speak out if their governments refuse to share information with them about the requests they have received or the offers they are making in the GATS negotiations.

• Second, most governments engage in privatization and liberalization without a sense of whether these policies will be of benefit or harm the country at large, or whether they will benefit some sectors of society and leave others worse off.

Human rights law requires governments to have a policy in place towards realization of human rights. Whilst the International Covenant on Economic, Social and Cultural Rights acknowledges that not all human rights recognizes that countries will not be able to ensure the realization of the right to food, health, water or housing immediately, it does impose a number of obligations on States which are of immediate effect:

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1. States must ensure that there is no discrimination with regard to enjoyment of human rights. However, liberalization of trade in essential services has **frequently favored the wealthier inhabitants of a country, leaving those who were already poor or excluded worse off**. Human rights advocates should consistently remind their economic policymakers of the obligation to ensure that new trade liberalization commitments do not result, in law or in practice, in discrimination in access to basic services.

2. Human rights law requires that a State have a strategy in place to ensure the protection and realization of human rights. It follows from this that any new commitment affecting human rights – in the area of access to health care, education or water, say – must, according to human rights law, be assessed for its conformity to the strategy and its likelihood to further the realization of human rights. In particular, any new or planned

[82] See 81 above

commitment must at a minimum not cause any regression from the existing level of enjoyment of relevant human rights.

In spite of the provisions in GATS that an assessment of trade in services should be undertaken for guiding each round of negotiations, and that developing countries should have flexibility in liberalizing fewer sectors, no real assessment of the impact of trade in services on access to basic services or on human rights has been undertaken; nor have developing countries been given greater flexibility in the GATS negotiations. This means that the predominantly poor population in the developing countries, especially in Africa is in danger of having their human rights violated by virtue of the commitments made by their governments under GATS.

The Committee on the Rights of the Child has recommended "States undertake assessments of the potential impact of global trade policies concerning the liberalization of trade in services on the enjoyment of human rights, including children's rights." In particular, the Committee recommended that these assessments should be undertaken prior to making commitments to liberalize services within the context of WTO or regional trade agreements. Further, if commitments to liberalize trade in services are made, the effects of those commitments on the enjoyment of the rights of the child should be monitored and the results of the monitoring should be included in State reports to the Committee.

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The current services negotiations at the WTO have also led to fears that countries could be pressurized into commitments that will limit the ability of governments to regulate and ensure affordable and equitable access to essential services: it is unrealistic to expect profit-seeking private companies operating under market forces to meet the needs of the less financially endowed sections of the population. This is partly because it is hard – particularly for governments that are not strong – to regulate a powerful private sector and partly because making commitments to allow foreign service providers access to the domestic market can reduce the scope a government has to regulate in the public interest (known in trade-related jargon as **policy space**).

Moreover, the bilateral format gives more scope than multilateral fora for arm-twisting by, powerful countries, to persuade smaller countries to open more service sectors to international competition. A 2002 study by the Commonwealth Secretariat[83] found that newly acceded WTO Members, all of which are developing countries, were pressurized to open more service sectors during accession negotiations.

2.1.6 GATS and the Financial Industry in Africa

As noted[84] provisions regarding the trade in financial services as provided for in GATS are a source of anxiety for the non-industrialized countries generally.[85] This concern is because the consequences of the GATS is not well understood and there is a sense among these countries that they are being pressurized to sign something that may end up harming them. Most developing countries and Least Developing Countries in Africa-have so far not submitted initial GATS requests to trading partners.

The reluctance to enter into the GATS is based on the reasons that follow. Firstly, most African economies have very rudimentary and fragile financial sectors.[86] It is therefore a matter of concern how these financial sectors will cope with the increased competition brought about by GATS. Secondly, African countries also differ because of their relatively diverse colonial histories, and the interests of Multinational Corporations have typically led to a significant, but sometimes restricted, foreign presence in these countries. Thirdly, most African economies are at the same stage of economic development and tend to produce similar goods and services. In order to diversify their economic base, these countries face the dilemma of linking their investment strategy to their trade regime; for example, investing in the key sectors like manufacturing and services or the current main sectors like agriculture and mining, or trying to export

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83 Roman Grynberg, Victor Ognivtsev and Mohammad A Razzaque, *Paying the Price for Joining the WTO: A Comparative Assessment of Services Sector Commitments by WTO Members and Acceding Countries*, Commonwealth Secretariat, 2002

84 Murinde and Ryan (2000) the Implications of the WTO and GATS for the Banking Sector in Africa paper no. 23 Birmingham University Published by the Institute for Development Policy and Management, University of Manchester http.www.man.ac.uk/idpm
85 See 84 above
86 Murinde (1998) Domestic sources of finance for Africa: what are the prospects?, *21st Century Policy Review*, Vol. 3, Nos. 3-4, 1997, pp. 1-40.

abroad versus investing in "newly engineered" home industries. Finally, these countries have a particularly strong desire to see their financial industry survive and prosper.

However, one of the difficulties faced by African governments in choosing to diversify is to identify sectors that will yield sustainable economic growth. For this reason the financial sector, due to its appeal as a high skilled, high-income industry, is sometimes identified by these countries as a potential source of future economic activity. Hence, the effects of freer trade in financial services under the GATS have special significance for African economies.

However the benefits of liberalization of the financial sector have been enumerated in other studies.[87] Matoo (2001) postulates that a liberalized market will lead to more competition.[88] Francois and Schuknecht (1999) find a strong positive relationship between growth and financial sector competition. Openness and liberalization is indicated by a country's commitment to the GATS provisions.

African countries cite their infant financial service industry and fear that its liberalization will lead to its demise. African country governments are worried that complying with GATS provisions on financial services will lead to consolidation in terms of alliances and mergers of the Multinational financial institutions. These mergers will in turn spell the end of domestic financial services providers.

The liberalization negotiations on financial services in GATS fit neatly with the consolidation strategy of the world top financial industry and will reinforce it. The GATS negotiations do not only provide the financial industry with access to more markets and improved chances of full ownership of banks worldwide through mergers and acquisitions. The GATS agreement also guarantees that this liberalization is difficult to reverse (Art. XXI) and those national measures that hamper profit making and consolidation are being restricted (e.g. Art. VI, XVI and XVII). The 'Understanding on Commitments in Financial Services' clearly underpins the interest of financial

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[87] Matoo, Radhindran and Subramanian (2001) Measuring Trade Liberalization and its Impact on Economic Growth: An Illustration
[88] see 87 above

conglomerates that are engaged in cross-border and cross-sector consolidation. The EU requests many developing countries to open up according to this 'Understanding'.

Concentration of financial services leaves governments – which need private finance – and customers with too little choice. It opens the way to abuse of economic and market power such as tacit price-fixing and high prices that are detrimental to development. Secret price-fixing occurs but seldom comes to light as happened in Germany by the insurance companies and in Kenya where a cartel of foreign banks fixed high interest rates.[89]

The GATS agreement has only very weak instruments to tackle problems related to concentration and consolidation. GATS Art. IX recognizes that business practices may restrict competition and trade in services but does not contain real competition policy measures. Only when restrictive business practices occur at the national level by Foreign Service providers can the domestic authorities ask for consultations. The home country should only give "sympathetic consideration" to such requests and non-confidential information. Moreover, the negotiations on emergency safeguard measures to protect the local (financial) services industry from being overwhelmed by foreign services is being opposed and constantly postponed by Western countries.

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2.1.6.1 Positive impacts of GATS on the Financial Services Industry in Africa:

2.1.6.1.1 Improving efficiency, functioning and management In Sub-Saharan Africa, experience of increased foreign participation in the domestic banking sector to date has shown such benefits as improved quality, pricing and supply of financial services and in risk management, accounting and transparency as well as increased competition.[90] Especially in poorer developing countries where the banking system is considered inefficient and unreliable, the entry of foreign banks is claimed to make domestic banks

[89] SOMO, *Challenges for the South in the WTO Negotiations on Services*, 2002 www.somo.nl/somo_ned/projecten/Challenges.pdf
[90] . Murinde & M. Tefula, A foreign affair? How far does Africa need foreign banks? in Finance matters - Finance liberalisation: too much too soon?, id21 Insights #40, March 2002 (at: www.id21.org/insights/insighths40/insights-iss40-art02.html)

more efficient and avoid the high economic cost of inefficiency that prevent development, trade and investment.[91]

Research findings differ whether domestic banking efficiency increases by a large number of new foreign entrants or by (a few) new entrants with large market shares.[92]

2.1.6.1.2 Increased access to foreign capital

In Africa foreign financial firms have and will increase foreign capital inflows and the investment environment has improved.

2.1.6.2 Negative Impacts of GATS on the Financial Services Industry In Africa:

2.1.6.2.1 A Pick and Choose Approach by Foreign Banks-Market Segmentation

In Sub-Saharan Africa and elsewhere, foreign firms use their financial power and international status to focus on the most lucrative transactions and lure rich and middle class customers. This means that the under privileged population will not have access to the financial products that the foreign firms have on offer. This negative effect is further exacerbated by the dominance of the foreign firms in the African financial market.

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An important question is whether this cherry picking by foreign financial firms mobilizes more domestic savings or rather increases capital flight.

2.1.6.2.2 Undermining lending to non-wealthy borrowers

In case local banks do not survive the competition from large foreign banks, their expertise and capacity to lend to small producers and poorer households will be lost. This can enhance the divide between small and rich producers, make poverty eradication more

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[91] . see for more examples: World Bank, Finance for growth: Policy choices in a volatile world, Policy research report, May 2001: summary of the report, at www.worldbank.org/research/interest/policyresrpt.htm

[92] H. Huizinga, S. Claessen & A Demirgüç-Kunt, How does foreign entry affect the domestic banking market?, World Bank Working paper nr. 1918, June 1998: based on the experience of 80 countries between 1988 and 1995; G. Bies, Financial liberalisation in Latin America, in Developing countries and GATS, Ed. C. Jepma & E. Kamphuis, University of Groningen, 2003, p. 64: based on research in Latin America.

difficult, and have an impact on the whole economy. The foreign firms will, on the other hand concentrate on lending to the rich clients.

2.1.6.2.3 Undermining poverty eradication

This cherry picking and market segmentation is undermining poverty eradication as foreign financial firms are hardly interested to expand their [93] services to the poor. As was researched in Kenya, the situation is similar for foreign health insurance companies. These firms tailor their services to the[94] wealthy city-dwellers who are already able to pay their hospital bills. They charge high premiums, unaffordable to poor patients. They refuse to accept patients who suffer from illnesses such as HIV/AIDS. This is in sharp contrast to the government's public health insurance system, which is obligated to accept all patients.

2.1.6.2.4 GATS 'flexibilities' not used

During the previous GATS negotiations, Kenya agreed to liberalize its financial services without fully realizing that it was also subjecting the health insurance sector to the GATS rules. Article XVI prohibits governments from taking six specific kinds of measures to place limitations on companies, such as economic needs tests and restrictions on the number of service suppliers. During the negotiations, the Kenyan government could have reserved the right to impose a universal service requirement for foreign insurers only, but did not do so. The government can now require foreign companies to insure poor and vulnerable (HIV-positive or terminal) patients only if it also sets the same requirement for Kenya-based insurers, according to the GATS principle of non-discrimination and national treatment (Article XVII). Whether countries will impose universal service

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93[93] Challenges for the South in the WTO Negotiations on Services - Summaries and Conclusions from Three Case Studies: Health Care (Kenya), Electricity (Colombia), Tourism (India), edited by SOMO & WEMOS, Amsterdam, January 2003 (see www.somo.nl).

[94] See: Yung Chul Park, Kee Hong Bea, Financial liberalisation and integration in East Asia, in Financial stability and growth in emerging economies - The role of the financial sector, Ed J.J. Teunissen & M. Teunissen , The Hague, 2003, p. 166-167, 178-179

obligation is another matter, as it is considered to have an unfavourable impact on the financial firms' profitability and stability, and thus discourage investments.[95]

2.1.6.2.5 Widening the gender gap

If cherry picking is common practice by foreign financial firms, it has also gender implications in developing countries. Women constitute the majority of the poor and are often very small producers or entrepreneurs. Although the female rate of repayment of loans is high, their lack of collateral means that they often have to rely on micro-credit systems for financing. If financial services liberalization does not provide them with better access to finance while larger entrepreneurs are better financed, their fight against poverty might be undermined and the gender gap increased. The experience of 80 countries between 1988 and 1995 shows that foreign banks in developing countries tend to have greater profits, higher net interest margins and higher tax payments than domestic banks.[96]

2.1.6.2.6 Transferring wealth from poor to rich countries: Foreign financial firms that make profits from richer clients in developing countries and transfer that profit abroad, are thus transferring some of the wealth from developing countries to the rich home countries. Moreover, Art. XI of GATS does not allow restrictions on profit repatriation.

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2.1.6.2.7 Swift expansion of foreign financial services

During the second half of the 1990s[97], there has been a dramatic and very rapid increase in foreign ownership of banks and foreign banking activities in many developing countries. In Tanzania, liberalization for foreign banks increased their presence from 5% before 1980 (when policies where restrictive) to 76% in 2002.

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[95] J. Marchetti (WTO Economic Affairs Officer, Trade in Services Division), letter of 25th June 2003

[96] H. Huizinga, S. Claessen & A Demirgüç-Kunt, How does foreign entry affect the domestic banking market?, World Bank Working paper nr. 1918, June 1998: based on the experience of 80 countries between 1988 and 1995; G. Bies, Financial liberalisation in Latin America, in Developing countries and GATS, Ed. C. Jepma & E. Kamphuis, University of Groningen, 2003, p. 64: based on research in Latin America.

[97] See: Yung Chul Park, Kee Hong Bea, Financial liberalisation and integration in East Asia, in Financial stability and growth in emerging economies - The role of the financial sector, Ed J.J. Teunissen & M. Teunissen , The Hague, 2003, p. 166-167, 178-179

It is difficult to establish whether the GATS agreement on financial services (1997) had an influence on this large increase of presence of Western banks. There was a general trend towards opening up financial sectors during that period -which was reflected in some GATS schedules[98]- alongside the strategy of many internationally operating financial firms towards global consolidation.

The European Union requests during the current GATS negotiations to eliminate restrictions on full foreign ownership in small or poor developing countries can easily lead to domination by foreign banks. What are the consequences for monetary and development policy when foreign financial service providers control more than 75% of the banks, as is the case of Tanzania?

Moreover, dominance by foreign banks makes these countries vulnerable to strategies of financial conglomerates that leave the country when profits decline. This makes it more difficult for the authorities to monitor the financial system.

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2.1.6.2.8 Difficulties in Africa to keep up with the rapid changes

Rapid increase of foreign financial firms makes it difficult for domestic financial firms to meet the fierce competition, while the supervisory and regulatory authorities have trouble keeping abreast of the developments and their risks. The supervisory authorities find it a challenge monitoring new products brought into the market by foreign firms due to lack of existing rules covering these products. They (supervisory bodies) also find it a challenge coming up with the rules and regulations to regulate the same.

2.1.6.2.9 Allocating more savings of developing countries to the rich countries

Foreign financial conglomerates have more expertise on how to allocate domestic savings and capital in Western investments than the domestic financial firms in African countries countries. It might be too costly for foreign financial service providers to fully explore new investment opportunities in the host country. When developing countries have liberalized their financial services and capital account, more of their savings get allocated

[98] A. Cornford, The multilateral negotiations on financial services : current issues and future directions, 2003, p. 5, 11-12

to the North (e.g. Northern company shares) and not in domestic investments. In this way, domestic economic development opportunities are lost and the global imbalance of capital allocation reinforced. As more and more developing countries' banks are being privatised, governments have fewer opportunities to prioritise the financing of domestic (service) industries.

2.1.6.2.10 Little capacity to export financial services

In Africa, the insurance sector has so far remained underdeveloped and without the necessary backing from governments. Lack of capacity and expertise has prevented the sector from starting viable commercial relations among African countries and making them fully prepared for international competition at home and on international markets.[99]

2.1.6.2.11 How much progress in efficiency?

In Sub-Saharan Africa, the presence of foreign banks increases loans by both domestic and foreign banks, but the variability of the loan supply decreases. Foreign banks in Sub-Saharan Africa do not necessarily have fewer bad performing loans nor are they better capitalized than local banks – although better capitalization is often claimed as an advantage they enjoy, making them more resistant to financial crises. Foreign banks can out-compete locally owned banks in smaller economies because they can recover their high set-up costs from profitable operations elsewhere.[100]

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2.1.6.2.12 Risks of financial instability

The risks of financial instability in developing countries resulting from financial services liberalization and GATS rules are being analysed below as follows:

1. Too little awareness that new financial services require new prudential measures

[99] Africa`s insurance industry needs assistance, in Addis Tribune, 7 June 2002.

[100] V. Murinde & M. Tefula, A foreign affair? How far does Africa need foreign banks? in Finance matters - Finance liberalisation: too much too soon?, id21 Insights #40, March 2002 (at: www.id21.org/insights/insighths40/insights-iss40-art02.html).

2. Foreign financial services increase cross-border capital flows and financial instability
3. GATS articles advance cross-border capital flows and capital account liberalization
4. GATS articles challenge measures to deal with destabilising capital flows
5. GATS articles undermine prudential measures and regulations domestic authorities take
6. GATS articles affect the management of the financial industry and instability risks

2.1.7 The risks of financial instability in developing countries

While the GATS negotiations in financial services are about liberalization of financial services, they affect the national (de)regulation of financial markets and financial services, as well as measures that manage large capital transactions ("capital account"[101]). The latter two sets of measures are nonetheless the domain of finance authorities and affect the financial stability and economic situation of a country, especially in developing countries. Foreign banks contribute to a financial crisis by using capital account liberalisation for imprudent short-term lending policies and "herding behaviour", and by hoping –mostly successfully- that governments will support repayment of commercial debt.

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Developing countries have already expressed their concerns that market opening and GATS rules might result in capital movements that create financial instability and affect governments' decisions to institute prudential measures to avoid a financial crisis. The devastating effects of a financial crisis, which are discussed in the next chapter, while focusing on the East Asian financial crisis, should prioritise negotiators' attention to assess the risks and address the concerns. However, these concerns are not much publicly discussed and hardly acknowledged by developed countries. As the World Bank puts it: Access to financial services is what matters for development, not who provides it.[102]

[101] The capital account covers capital movements for investments while the current account covers (the payment of) imports and exports of goods and services
[102] World Bank, Finance for growth: Policy choices in a volatile world, Policy research report, May 2001: summary of the report, p. 4 at www.worldbank,org/research/interest/policyresrpt.htm

2.1.6.2.14 Too little recognition of the need for new prudential measures

During the current GATS negotiations, many developing countries are not well informed what policy responses and prudential measures to take that avoid the risks of greater liberalization of financial services.

However, many developing countries have no capacity to participate in the Committee or to engage all relevant financial authorities back home. There is no widely accepted framework to make econometric estimates of financial services liberalization, and statistical data are inadequate to predict future impacts.[103]

Sudden intensification of competition by foreign new comers may encourage previously protected domestic financial institutions to take shortsighted risky responses[104], such as reckless lending. Also foreign financial firms might engage in risky strategies to gain new shares of the market.

In order to compete and attract more clients, financial conglomerates constantly introduce new products and more complex hybrid financial products. After GATS negotiations, foreign financial firms are likely to sell new and complex financial services in developing countries. If countries liberalise under GATS according to he Understanding on Commitments in Financial Services, the host countries have to give permission to "any new financial service" that foreign financial service providers introduce.[105]

New services might include banking through internet and e-mail, 'e-banking', which poses problems of supervision on money laundering and fraudulent activities, consumer protection and avoidance of systemic failure.[106]

Other new services might be derivative products and mutual fund management, instruments that involve a significant speculative component.

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[103] A. Cornford, The multilateral negotiations on financial services : current issues and future directions, 2003, p. 20
[104] Eichengreen, Toward a new international financial architecture: A practical post-Asia agenda, Washington (Institute for International Economics), 1999, p. 48.

[105] Art. 7 and Art. 11.D.3. of the Understanding on Commitments in Financial Services. Ironically, in the US, the Securities and Exchange Commission often scrutinises financial products before they are introduced
[106] The potential problems were discussed in different meetings of the Committee on Trade in Financial Services held in 2003.

Regulators and supervisors in developing countries will be challenged to take the necessary measures and avoid the problems that occurred in Western countries, which are supposed to have the best regulatory and supervisory regimes. As explained above, Western countries had to revise regulations after problems of too much speculative investment by pension funds and insurance companies. They also had to impose fines for scandals of misusing knowledge, the creation of a stock market bubble and charging too high fees.

In the future, Basel II rules might transform financial services markets in developing countries. For instance, Basel II rules might make it more difficult for domestic banks to compete against international banks that enter their market under GATS commitments. Authorities will have to adapt to the situation and take necessary measures.

2.1.6.2.15 Foreign financial services increase cross-border capital flows and instability

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One way by which foreign banks tend to import financial instability is by lending in foreign currencies. The payment and repayment of loans in foreign exchange increase the rate of inflow and outflow of international capital. When this results in an imbalanced exchange between local and foreign currencies, it puts the exchange rate and foreign exchange reserves under pressure, particularly if those loans are short-term.

Too much demand for foreign exchange increases the balance of payments deficit and with it the risk of exchange rate and financial instability.

Other products that foreign financial firms introduce with financial market opening are for instance "capital market products" such as **investment instruments** (e.g. mutual funds, advise for management of shares portfolio). These instruments often offer domestic residents to diversify their investments in shares and bonds issued by companies abroad in addition to domestic ones.[107] Such services result in more cross-border capital

[107] Yung Chul Park, Kee Hong Bea, Financial liberalisation and integration in East Asia, in Financial stability and growth in emerging economies - The role of the financial sector, Ed J.J. Teunissen & M. Teunissen , The Hague, 2003, p. 153

movements and can move in and out swiftly, especially when no capital movement restrictions are in place.

New risk mitigation services and derivatives can also involve allocating money abroad. While such services diversify risks, they are also speculative and it is difficult to estimate by how much capital movements will increase and change direction.

When cross border capital flows reach significant volumes and a high velocity, or lead to a balance of payments deficit, they can increase financial instability in the host country. Speculative financial products can also import financial crises from abroad.

In addition**,** cross-border e-banking and buying foreign products -or even securities- through internet ("mode 1" under GATS), typically involve cross-border capital movements and foreign currencies. The lack of transparency in e-banking makes countries uninformed how it will facilitate large destabilising cross-border capital movements, especially in small countries.[108]

What is difficult to predict[109] is how branches or subsidiaries of foreign financial firms and their headquarters will behave in times of financial crises in developing countries. Would they panic and move out all at once at the first sign of crisis as they did in East Asia in 1997? Or will they be able to resist the crisis with capital flowing in from the headquarters? In the current Argentinean crisis, foreign banks refuse to recapitalize their branches and subsidiaries.[110] Most East Asian countries have not been able to borrow in their own currency, which means that they are continuously exposed to problems that triggered the crisis in 1997. Smaller economies such as in Sub-Saharan Africa are more vulnerable to capital movements that result in financial volatility and destabilization of domestic bank credit.

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[108] A. Cornford, The WTO negotiations on financial services : current issues and future directions, Paper for the Financial Markets Center, 2004, p. 14.
[109] Yung Chul Park, Kee Hong Bea, Financial liberalisation and integration in East Asia, in Financial stability and growth in emerging economies - The role of the financial sector, Ed J.J. Teunissen & M. Teunissen , The Hague, 2003, p. 186
[110] L.R. Reynoso, Argentina: la justicia inhibida, la Argentina de pie, in Correos para la emancipacion, nr. 234, 12 February 2004

2.1.6.2.16 GATS articles promote cross-border capital flows and capital account liberalization

Some articles of the GATS agreement play a role in increasing the risks of destabilising financial flows related to foreign financial service providers.

GATS Artircle XI.1.[111] does not allow countries to restrict international transfers and payments for current financial transactions that are related to services in sectors that were liberalized under the Agreement. That means, first of all, that a country cannot prevent profit repatriation by Foreign Service providers in sectors in which a country has made GATS commitments.

For instance, the EU requests from Chile in the current financial services negotiations that Chile eliminates the "restriction" that prior authorization by the Central Bank is required before transferring dividends from Chile abroad because this is in breach of Article XI. Thus, if a country has liberalized the financial sectors, foreign banks and insurance companies can transfer their profits abroad without reinvesting them in the country. In countries that have small economies and/or large foreign investors in all sectors, profit transfers affect negatively the balance of payments and exchange rate. In case of a financial crisis, its effects will be further emphasised by the inability of the local regulatory bodies to deal with the sudden and massive outflow of the profit transfers.

Moreover, Art. XI.1. has a special effect in relation to financial services provided by foreign banks, insurers, investment bankers and asset managers which have established themselves in countries that made GATS commitments in these services (Mode 3). These financial service providers might view cross-border financial flows as "related to" or essential to their services in cases such as:

- lending in foreign currency;

[111] Art. XI.1.: " Except under the circumstances envisaged in Article XII,"(see further below) "a Member shall not apply restrictions on international transfers and payments for current transactions relating to its specific commitments."

- buying securities abroad to balance the risks in pension fund management or to increase the rate of return of asset management services (e.g. mutual funds) for local clients or insurance companies;
- providing investment bank services related to foreign stock exchanges (underwriting shares of domestic firms listed abroad) or related to foreign companies (acquisitions abroad);
- offering international derivatives; and
- using international credit risk mitigation mechanisms.

Such cross-border capital flows can go beyond current account transfers and undermine management of the capital account aimed at avoiding financial instability and crises. If certain capital account restrictions frustrate the transactions of committed services sectors, they could be challenged under GATS XI. In countries that have already liberalized their capital account, GATS commitments in certain financial sub-sector will increase unstable capital flows. They might also discourage reversing capital account liberalisation where considered necessary to avoid financial crises. Developing countries that keep a high level of capital control are not likely to attract foreign financial firms as the latter avoid unpredictable local currency convertibility and capital withdrawals.[112] In light of this, the question begs: Is the liberalization of financial services industry in Africa, envisaged by GATS provisions beneficial or detrimental to the African countries' economies.

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[112] Yun-Hwan Kim, Financial opening under the WTO Agreement in selected Asian countries: progress and issues, Asian Development Bank, Economic and Research Department, Working Paper No.24, September 2002.

3.0 CHAPTER 3

3.1 THE IMPACT OF GATS ON THE FINANCIAL SERVICES INDUSTRIES OF THE EAST ASIAN COUNTRIES: A COMPARISON WITH AFRICA

An assessment of the expected impact of GATS on the financial industry in Africa can be carried out by engaging in a comparison of the impact of GATS liberalization on the East Asian countries. Emphasis will be laid on the East Asia financial crisis, which was said by some experts to have been caused by the liberalization of the East Asian financial markets under the auspices of GATS. Firstly focus will be on the pre- 1997 GATS commitments by the East Asian countries. This will be followed by an examination of the post 1997 GATS commitments made by the East Asian countries. The countries that will be the representative sample for the countries under study in this chapter are Indonesia, Malaysia, Thailand and Philippines. China will come in later in the chapter as a country that has made commitments to the GATS in the post 1997 period. The purpose of focusing on China is to look at measures it has taken to avoid a financial crisis similar to the East Asian financial crisis as a result of liberalization of its finance industry.

3.1.1 Indonesia

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3.1.1.1 Banking: The Ministry of Finance is responsible for the general policy framework governing banks, including the rules and regulations on the conditions of establishment of banks in Indonesia. However, international negotiations with respect to market access are carried out jointly with Bank Indonesia, which is responsible for the daily supervision of banks and prudential control.[113] Thus, while the Ministry of Finance has complete jurisdiction over the licensing (or withdrawal of licenses) of banks, the decision is subject to the letters of recommendation of Bank Indonesia.[114] African countries that are in the financial industry liberalization negotiations should make a note of this. The Central bank is the organ that is most familiar with the operations in the banking sector and can best inform the negotiators on the commitments that will be

[113] Rajan S.R. and Sen R.(2002) Liberalisation of International Trade in Financial Services in Southeast Asia: Indonesia, Malaysia, Philippines and Thailand, Cies discussion paper 0217

[114] See 113 above

favorable to a country. The Central Bank of a country is able to decipher the expected impact of any proposed commitments on the country's banking sector.

As a part of its financial sector liberalization, the banking sector in Indonesia began a process of deregulation in 1988 wherein foreign banks were allowed to operate in the form of joint ventures, with minimum Indonesian equity of 15 percent, or via the acquisition of a maximum equity share of 49 percent through an existing listed local bank in the stock market. These joint ventures were granted national treatment in the sense that they could engage in the same commercial operations as locally owned banks. Nonetheless, restrictions continue to be imposed on the number and location of branches, initially set at one per large city, as well as on the presence of natural persons (these limitations were reflected in Indonesia's GATS 1994 and 1995 Schedules). The banking sector in Indonesia witnessed a rapid expansion in the early 1990s; the number of banks approximately doubled while branches tripled.

However, in the early 1990s, there were concerns about the soundness and safety of the banking system in Indonesia, with the increasing share of non-performing loans in total lending for state-owned banks. The 1997-98 regional financial crisis hit Indonesia particularly hard, resulting in the virtual decimation of the banking sector[115]. The emphasis has since been on restructuring the sector[116].

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Indonesia improved upon its GATS commitments under the FSA (the fifth Protocol to the GATS) concluded in December 1997 and undertook further supplementary commitments in the context of the IMF programme in January 1998.

These new GATS and IMF commitments include: (i) enhancing foreign participation in existing joint venture banks and increase by one the number of branches operated by

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[115] Dobson, W. and P. Jacquet (1998). *Financial Services Liberalization in the WTO*, Institute for International Economics: Washington, DC.

[116] Bird, G. and R. Rajan (2001b). "Still the Weakest Link: The Domestic FinancialSystem and Post-Crisis Recovery in East Asia", *Development Policy Review*, 19, pp.355-366.

foreign-owned banks and joint-venture banks in Indonesia's main cities[117]; (ii) eliminating the economic needs test that was hitherto applied to the presence of natural persons and removing limitations on national treatment pertaining to capital requirements of foreign joint ventures; (iii) removing restrictions on foreign ownership in listed banks by June 1998 and allow foreign investors to increase (up to 100 percent) its ownership of a listed local bank and further; and (iv) revoking restrictions on branching, to allow foreign banks and joint-venture banks to operate nation-wide, with unlimited number of offices and branches.

A Lesson for Africa

Indonesia has imposed restrictions on the number and location of branches of foreign banks. African nations that have not fully liberalized their financial industry should also impose some restrictions in terms of ownership and operations on Foreign Service providers getting into their markets. These restrictions are particularly important to ensure the sequenced, gradual and ordered transition from a controlled economy to a fully liberalized one.

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3.1.1.2 Insurance: The Ministry of Finance is responsible for the general policy framework, supervision, regulation and licensing of new companies in the insurance sector in Indonesia. All insurance products are to be supplied through a locally incorporated insurance company that may be either Indonesian or foreign owned, except for products not available in the Indonesian market. Foreign commercial presence in Indonesia in the insurance service sector can take place via a joint venture with an Indonesian firm or through participation in the capital of a listed company.

As at mid-1997, there were 103 general insurance companies in Indonesia, including 18 joint ventures with foreign participation, and 58 life insurance companies, including 17 joint ventures. Prior to the FSA, foreign ownership in joint ventures was restricted to 80 percent and to 40 percent in a listed company, and restrictions on intra-corporate

117 According to Indonesia's GATS Schedule, branching is also subject to geographical limitation (limited to eight cities or regions in Indonesia).

movement of personnel and discriminatory capital requirements were in existence. However, under the Fifth Protocol to the GATS, Indonesia committed to the removal of ownership limits on foreign insurance companies and binding of up to 100 percent foreign ownership in domestic companies. Indonesia has also committed to promote greater flexibility in the movement of intra-corporate personnel for insurance companies and to the removal of remaining discriminatory capital requirements.

A Lesson for Africa

The more liberalized approach to its financial industry by Indonesia can be attributed to the financial crisis of 1997. Prior to 1997, foreign investors faced restrictions on entry into the Indonesian market. This made it easier for them (foreign entrants) to exit from the market on the onset of the crisis. The more liberalized post 1997 approach ensures that the foreign entrants have more at stake in the Indonesian market and are highly unlikely to make a quick exit. This lowers the risk of having foreign exchange and balance of payments problems. However, on a more precautionary note, with limited domestic ownership or lack of it, there's a risk of unrestricted profit repatriation by the foreign owned companies. To counter this, African countries should come up with a sound domestic incentive framework; one that will motivate the foreign financial service providers to re-invest in the domestic markets.

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3.1.2 Malaysia[118]

3.1.2.1 Banking: All applications to provide any financial services including banking require the in-principle approval of the country's central bank, Bank Negara Malaysia (BNM). The operation of banking institutions is overseen by the Banking and Financial Institutions Act 1989, while the Islamic banks are governed by Islamic Banking Act 1983. All foreign banks need to be locally incorporated to operate in Malaysia. Their parent banks are allowed to hold 100 percent interest in their Malaysian subsidiaries except for companies involved in insurance, fund management and securities brokerage. Foreign banks can extend loans only in partnership with domestic banks. Foreign banks

[118] This section draws on information from WTO (1998a,b and 2001b).

are not allowed to establish new branches, including off-site ATMs. Although banking has remained the largest sub-sector, non-bank intermediaries have also been increasing their presence in Malaysia's financial sector.

As of June 2001, there were 27 commercial banks (including 2 Islamic banks), 12 finance companies, and 10 merchant banks licensed in Malaysia[119], nearly half of which were foreign owned and controlled about a quarter of total assets, gross loans, and deposits in the commercial banking sector.

There are significant restrictions on market access pertaining to commercial presence and hence foreign equity holdings in the financial service sector in Malaysia, depending upon the specific activity involved.[120] Thus, financial companies involved in insurance, fund management, and securities brokerage are allowed up to 51 percent foreign equity and at least 30 percent equity from Bumiputras (indigenous Malays). A useful lesson is on the offing for African countries that are intent on liberalization of their financial service industry. African countries should ensure that the foreign entrants ensure sizeable domestic equity in their banks. This will reduce capital flight and in turn will reduce balance of payment and foreign exchange imbalances.

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However, for companies involved in finance/banking and venture capital, Bumiputras (indigenous Malays) must locally hold 70 percent of equity with at least 30 percent equity. 100 percent foreign ownership is permitted for those companies involved in asset management provided that the companies manage only foreign investors' funds, else only 70 percent of foreign equity is permitted. Similar restrictions apply to companies that are engaged in offering investment services to the companies other than those within the same group.

[119] In 1995, there were 37 commercial banks, 40 finance companies, and 12 merchant banks licensed in Malaysia. No new banking licenses have been awarded since 1997 other than for offshore banking licenses.

[120] Rajan S.R. and Sen R.(2002) Liberalisation of International Trade in Financial Services in Southeast Asia: Indonesia, Malaysia, Philippines and Thailand, Cies discussion paper 0217

A Lesson for Africa

Local equity requirements have benefited the Malaysian economy and its people. The local people are able to participate in the local banking sector and local equity does stem capital outflows to foreign lands. This is because the locals choose to invest in their local economy. Therefore local equity requirements should be prioritized by African countries yet to make deep commitments to liberalize their financial services.

3.1.2.2 Insurance: The insurance industry in Malaysia is regulated by the Insurance Act 1996, and offshore insurance is regulated by the Offshore Insurance Act 1990. As in the case of Banking sector, the BNM is in charge of the overall supervision of the insurance sector. The Labuan Offshore Financial Services Authority supervises offshore insurance activities. The Malaysian insurance industry regulatory machinery displays a more hands on role of the government to ensure stability of the sector and its benefits to the economy of the country. A striking example is the supervision of off shore financial services; an aspect that is absent in the previous case study of Indonesia.

The insurance sector in Malaysia comprises life and general insurance, insurance brokers, adjusters, and registered agents. According to the latest available data, out of 63 insurers, 23 were foreign owned. Foreign shares accounted for 72 percent and 36 percent of total life and general premium, respectively.[121] As at December 2000 there were 83 offshore insurance as well as insurance-related companies in Labuan. Entry of foreign insurers into the Malaysian insurance market is currently allowed through investment in existing insurance companies that are subject to an aggregate foreign shareholding limit of 30 percent.[122] For existing joint venture companies in the insurance business, foreign shareholders that were the original owners of the companies are allowed to own up to 51 percent of the total shares. For the insurance sector as a whole, foreign equity ownership of up to 51 percent is permitted with at least 30 percent of Bumiputra held equity. As of

121 Noy, Ilan, "Banking Crises in East Asia: The Price Tag of Liberalization?" Analysis from the East-West Center No. 78, November 2005

122 Noy, Ilan, "Banking Crises in East Asia: The Price Tag of Liberalization?" Analysis from the East-West Center No. 78, November 2005

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October 2000, 7 new licenses for non-life reinsurance business and 1 license for life reinsurance business were issued to foreign reinsurers since 1995. In July 1999, BNM invited applications for 6 licenses for professional life reinsurance business offered under Malaysia's GATS Schedule. Apart from these regulations, the industry itself practices self-regulation through market agreements, rules and codes issued by the four mandatory associations representing general insurers, life insurers, insurance brokers, and loss adjusters.[123]

Malaysia has attempted to liberalize the financial services sector in a graduated and progressive manner under the GATS framework. As part of its membership commitments to the WTO, Malaysia signed and ratified the Financial Services Agreement that encompassed financial services. Malaysia has *not* made any horizontal commitments covering cross-border supply and consumption abroad[124]. Its commitments to permit commercial presence have generally been limited to joint ventures in which the maximum foreign equity permitted is 15 percent by a single or grouped foreign interest or to an aggregate foreign interest of 30 percent (though holding of more than 30 percent foreign equity may be allowed on a case-by-case basis). National treatment provisions are in place for all land and real estate related transactions with tax incentives and preferences offered to Bumiputras.[125]

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A Lesson for Africa

It is therefore evident that Malaysia has adopted an ordered and gradual liberalization process that ensures equity ownership by the locals (Bumiputras). This is a way of ensuring that the local people benefit from the liberalization process. This ensures sustainable economic growth that is not easily eroded by the withdrawal of the foreign owners from the market. Malaysia also has a more detailed supervisory and regulatory mechanism, thus ensuring a close monitoring of the financial services industry. This

[123] Noy, Ilan, "Banking Crises in East Asia: The Price Tag of Liberalization?" Analysis from the East-West Center No. 78, November 2005

[124] Horizontal commitments refer to those commitments, which apply to all service sectors in a given mode of service provision.

[125] See 123 above

makes it possible for the supervisory bodies to detect irregularities and to anticipate financial crises and to deal with the same if it is already affecting the economy. This is an approach that African countries should consider while keeping in mind the uniqueness in their markets.

3.1.3 Philippines[126]

3.1.3.1 Banking*:* The Philippines central bank, the Bangkok Sentral Ng Pilipinas (BSP), is responsible for controlling and supervising the financial services sector in the country. Although reforms were introduced in the financial sector in the Philippines in the 1980s, restrictions on entry into the banking sector stymied competition. It was only in the 1990s that controls on branching and entry of new banks in the financial system was relaxed. The BSP passed the Republic Act (R.A.) 7721 in 1994 that allowed for the entry and scope of operations of foreign banks in the country. Thus, the number of branches of foreign banks operating in the country grew from 4 to 14 by 1997. These new banks were permitted entry either as a branch or a subsidiary only if they ranked among top 5 banks according to their assets, in their home countries, or were ranked among the top 150 banks in the world[127]. Another 4 foreign banks were allowed to establish subsidiaries and/or purchase up to 60 percent of the voting stock of existing banks. These measures resulted in an expansion of the operating network of the financial system in the country, and by 1999, banking institutions in the Philippines accounted for 41 percent of the total financial institutions operating in the country.[128]

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Such liberalization measures in the early 1990s, coupled with the deregulation of the foreign exchange market in 1992, attracted large amounts of foreign capital inflows, most of which was directed into the real estate sector, creating an asset "bubble" which ultimately adversely affected the economy during the financial crisis in East Asia in 1997-98. As with other regional economies, the pursuance of financial liberalization by

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126 This section draws on WTO (1999a).

127 Dobson, W. and P. Jacquet (1998). *Financial Services Liberalization in the WTO*, Institute for International Economics: Washington, DC.

128 See 127 above

the Philippines without the prior institution of an effective regulatory or supervisory framework was one of the root causes behind its vulnerability to the crisis[129].

In response to this, the BSP has concentrated significantly on improving upon the regulatory and supervisory framework for banking operations in the country, as well as enhancing their competitiveness through privatization and modernization of banking facilities. As part of it, capital adequacy requirements have been raised, rules for non-compliance have been strengthened, and an early intervention mechanism for possible bank failures has been adopted. Steps are also underway to strengthen the legal and regulatory systems related to corporate governance and restructure financial institutions and bankruptcy laws[130]. For the African countries that have liberalized their financial services industry, without the necessary regulatory apparatus, the way forward is to strengthen the supervisory body as evidenced by Philippines.

As part of its horizontal commitments under GATS for financial services liberalization, the Philippines has restricted the participation of foreign investors, which is limited to proportionate share of foreign capital invested. It has, however, committed to maintain a minimum foreign equity participation level of 40 percent.

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These requirements were maintained even in areas where the Constitution has allowed as much as 100 percent foreign equity participation. In 1994, it raised the foreign ownership limit in banking sector to 60 percent, although foreign participation in Philippine owned banks were restricted to 30 percent. Under the FSA of 1997, the Philippines made commitments to allow up to 51 percent foreign equity ownership for banks.

A Lesson for Africa

A vital lesson for African countries stands out. African countries seeking to liberalize their financial services industry should first of all strengthen their regulatory and

[129] Gochoco-Bautista, M. (1999). “The Past Performance of the Philippine Banking Sector and Challenges in the Post-crisis Period”, in *“Rising to the Challenge in Asia: A Study of Financial Markets*: *Philippines*”, Asian Development Bank: Manila.

[130] See 129 above

supervisory apparatus of the financial services industry. This will go a long way in averting or reducing the effects of any financial crisis that may threaten to occur.

3.1.3.2 Insurance: The insurance sector in the Philippines comprises two government owned institutions, the Government Service Insurance System (GSIS) and the Social Securities system (SSS), along with a few other government and private insurance companies. The Insurance commission is the main regulatory agency overseeing the activities in the insurance market. The market is heavily reliant on reinsurance, with almost half of the assets of insurance companies being invested in government securities, stocks and bonds.[131]

Since 1991, banks have been allowed to have an ownership stake of up to 35 percent in an insurance company. Foreign commercial presence in this sector is yet to be significantly established, although the government allowed up to 40 percent foreign ownership in insurance companies in the early 1990s. However, under the FSA, the Philippines agreed to increase the limit of foreign ownership in insurance companies to 51 percent from 1999. With the allowance of foreign banks to own a stake of up to thirty five percent (35%) of an insurance company, foreign entrants are able to increase their dominance of the financial services sector by having a stake in both the banking and the insurance sectors. This means that domestic firms will face stiffer competition, gain less profits and the possibility of them running a loss and finally collapsing becomes more of a reality.

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3.1.4 Thailand[132]

3.1.4.1 Banking: The Bank of Thailand (BOT) is responsible for regulation and supervision of the commercial banking sector in Thailand under the Commercial Banking Act of 1962 (last revised in 1992). In the aftermath of the East Asian crisis, the government has been opening up this sector to foreign investment in order to attract

[131] Rajan S.R. and Sen R.(2002) Liberalisation of International Trade in Financial Services in Southeast Asia: Indonesia, Malaysia, Philippines and Thailand, Cies discussion paper 0217

[132] This section is based on WTO (1998a,b and 1999b).

foreign capital and expertise, and enhance competition in this sector[133]. Thus, Thailand's banking sector has been undergoing a period of intense consolidation[134]. The number of banks was expected to decrease from 15 to 13 at the end of the consolidation process.[135]

With regard to cross-border supply and consumption abroad, there have been no changes in Thailand's market-access commitments in the financial sector save insurance. These remain unbound with the possible exception of financial advisory services and financial data processing.

With regard to commercial presence, no limitations are placed on representative offices of banks. Thus, 21 foreign banks operated fully licensed branches in Thailand in mid-1999, up from 14 in 1995, while 15 foreign bank branches operated as offshore International Banking Facilities (IBFs) in Thailand under specified terms and conditions.

Foreign bank branches are subject to certain operational restrictions. In principle they can operate up to three branches, but in practice, none of the foreign banks have yet been granted approval to open more than one branch.

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According to the authorities, there has not been any demand for licenses to open additional branches, notably as four local banks have been put up for sale. A limited number of foreign personnel allowed per foreign bank office are allowed and is governed by a specific set of conditions. Locally incorporated banks in Thailand enjoy a significant advantage over their foreign counterparts, as they are not limited in the number of branches. This implies that the Foreign Service providers are able to have a wider reach to customers in the country. This is a lesson to African countries that are yet to make a commitment on the number of branches that foreign banks are allowed to have in the host

[133] Montreevat, S. and R. Rajan (2001). "Banking Crisis, Restructuring and Liberalization in Emerging Economies: A Case Study of Thailand", *CIES Discussion Paper No.0131*, Centre for International Economic Studies, University of Adelaide.

[134] Rajan, R. (2001a). "(Ir)relevance of Currency-Crisis Theory to the *Devaluation* and *Collapse* of the Thai Baht", *Princeton Studies in International Economics No.88*, International Economics Section, Princeton University.

[135] Bird, G. and R. Rajan (2002). "The Evolving Asian Financial Architecture", *Princeton Essays in International Economics No.226*, International Economics Section, Princeton University.

country. African governments should restrict them to reduce their dominance in their local market.

Following legislative amendments in 1997, foreign investors are now allowed to hold up to 100 percent of shares in commercial banks, finance, and "credit foncier" companies for a period of ten years, and thereby operate locally incorporated banks[136].

Thereafter, foreign investors will not be obliged to divest their holdings but may not purchase additional shares until the proportion of total foreign shareholding falls to within 49 percent. Foreign banks that purchase a majority share in a local bank are allowed to continue operating that bank under the rules pertaining to locally incorporated banks. The amendments of 1997 also maintain the requirement that maximum foreign equity participation should remain limited to up to a quarter of paid-up registered capital, and that the combined shareholding of an individual and related persons should not exceed 5 percent of a bank's paid-up registered capital, and that at least three fourths of the directors are of Thai nationality. However, the Minister of Finance may relax any of the above conditions for a particular bank if deemed suitable at its discretion. . A similar decree was also issued concerning finance companies and credit foncier companies.

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A Lesson for Africa

Many African economies are characterized by political patronage, manipulation and corruption. If an African country takes up the Thai model of the Minister of Finance having the discretion to relax specific conditions for foreign entry into the market, these said conditions may be prone to abuse. The liberalization commitments taken up by African countries should not be subject to waiver by the decision of an individual.

3.1.4.2 Insurance: The Ministry of Commerce in Thailand is the main regulatory body for overseeing the activities of the insurance sector. Thailand adopted a three-stage approach to the liberalization of the insurance industry from 1997. In the first stage, 25

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136 Credit foncier companies are essentially non-banking financial intermediaries dealing in immobile properties (Dobson and Jaquet, 1998).

percent of foreign equity participation in domestic insurance companies was allowed and approval granted for setting up 25 new insurance licenses, out of which 12 were in the life-insurance business, and 13 were engaged in non-life insurance business. As a second stage, foreign equity participation is expected to be allowed up to 49 percent of registered share capital. In the third stage, foreign equity is allowed beyond the 49 percent limit after appropriate legal institutions are in place and have been in effect for five years.[137]

Foreign insurance companies have played a significant role in the Thai insurance market, accounting for nearly half of total direct premia in the life insurance sector (as of mid 2001). Foreign insurance companies are able to sell life insurance policies to Thai residents, reflecting a high degree of liberalization of this sector.[138]

However, there are limitations on national treatment for life insurance services, with life insurance premia being tax deductible up to 10,000 baht only for holders of policies that are issued by locally licensed companies, that may be either domestically or foreign owned. Cross-border supply of non-life insurance services has remained unbound, except for international marine, aviation, and transit, together with all classes of reinsurance in Thailand's insurance service sector. Market access conditions for intermediaries and suppliers of auxiliary services have not changed, viz. a branch of a foreign insurance company cannot conduct the business of insurance brokerage and insurance agent; while foreign commercial presence remains limited to twenty five (25) percent of equity.[139]

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Apart from the initial commitments made by Thailand in 1993 under the GATS, new commitments on Financial Services agreed to in July 1995 with respect to insurance, banking and other financial services have been made through the Second Protocol to the GATS (the so-called Interim Agreement) and via the WTO's FSA concluded in December 1997 in its Schedule annexed to the Fifth Protocol. This also included the

[137] Noy, Ilan, "Banking Crises in East Asia: The Price Tag of Liberalization?" Analysis from the East-West Center No. 78, November 2005

[138] Valckx, N., "WTO Financial Services Liberalization: Measurement, Choice and Impact on Financial Stability,"*Research Memorandum WO no 705 October 2002*

[139] Noy, Ilan, "Banking Crises in East Asia: The Price Tag of Liberalization?" Analysis from the East-West Center No. 78, November 2005

elimination of the MFN exemption of according differential treatment of other members on a reciprocal basis.

The above experiences of financial services liberalization in the four middle income economies among the Southeast Asian countries indicates that both Indonesia as well as Thailand have been active in opening up their respective banking and insurance sectors to competitive market forces. This is indicated in their improved market access commitments in the Financial Services Agreement in 1997 (which was concluded during the onset of the financial crisis in both these countries), compared to their initial offers under the GATS schedule in 1994-95.[140] It is evident that the crisis was a major factor in hastening the pace of multilateral financial services liberalization under GATS in the two countries. Although Malaysia was also adversely affected by the crisis, its current financial services regime in some cases appears more restrictive to foreign competition and commercial presence, compared to the other neighboring economies. Despite the need to encourage foreign investment, African countries should adopt the Malaysian approach that is a more measured and restrictive approach to making GATS commitments in Financial Services. This is because the financial industry regulatory bodies will be able to deal with any financial crisis that occurs since the liberalization will not be drastic and therefore its effects can be easily handled. This approach also enables the governments to make more informed decisions on whether to liberalize further or not.[141]

As with a number of other countries, these countries have bound their multilateral obligations at less than *status qu*o. The binding of commitments below status quo is a reflection of governments' dual objectives of trying to encourage foreign investments into the financial sector while simultaneously avoiding a repeat of the turmoil and instability following the premature and ill-sequenced liberalization prior to the regional crisis of 1997-98, not to mention providing some degree of protection to the incumbent

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[140] Bird, G. and R. Rajan (2002). "The Evolving Asian Financial Architecture", *Princeton Essays in International Economics No.226*, International Economics Section, Princeton University.

[141] Noy, Ilan, "Banking Crises in East Asia: The Price Tag of Liberalization?" Analysis from the East-West Center No. 78, November 2005

national suppliers from immediate competition.[142] This said, all the countries, especially Thailand, have continued to take important steps towards the *de facto* relaxation foreign equity limitations. There appears to be a clear policy preference for promoting foreign equity investments (ownership/divestment) over the promotion of market competition.[143]

With regard to the insurance sector, entry limitations have been accompanied by restrictions on foreign equity. There appears to be a relatively greater willingness to undertake more liberal commitments in the banking than the insurance sector, and there has been a relatively greater willingness on the part of these countries to commit to liberal consumption abroad than to cross-border supply.

3.2 The East Asian Financial Crisis

The role of liberalization in the East Asian financial crisis must be underscored. Attention must be paid to the liberalization regime in East Asia and its contribution to the East Asian financial crisis. Therefore, one of the most common assertions within this section is that recent liberalization of the domestic financial sector is found to significantly increase the likelihood of a banking crisis.

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Failures of the banking sector in East Asia during the last decade have been spectacular. *The Economist* magazine estimated the cost of the Indonesian banking crisis to that country's taxpayers at US$75 billion, and quoted an analyst who called it "the most expensive bail-out in world history."[144] Recent episodes of banking crises in Asia are listed in Table 1. Apparent is both the prevalence of the problem in the region and its very heavy cost.

The fiscal cost to taxpayers of the Thai banking crisis (1997–2002), for example, was estimated to be a staggering 35 percent of gross domestic product (GDP). That amounts to about three-and-a-half years of total government consumption or more than two years

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[142] Noy, Ilan, "Banking Crises in East Asia: The Price Tag of Liberalization?" Analysis from the East-West Center No. 78, November 2005

[143] See 142 above

[144] 2003. "How Not to Sell Banks." *The Economist* 369: 73–76.

of total government revenues from taxes, tariffs, and other income sources.[145] Equally similar financial sector crises in other geographical regions.

In recent years, much research comparing crises in a variety of countries has attempted to construct early warning systems or consider the causes of banking crises—countrywide failures in the banking sector— especially in developing countries. This research has empirically identified a set of economy-wide, financial, and microeconomic measures that predict the occurrence of banking crises or enable estimation of their probable costs.[146]

The two leading hypotheses used in academic circles to explain the relationship between financial liberalization and banking crises in developing countries are herein referred to as the "lax supervision" and the "monopoly power" hypotheses. Understanding the relative importance of these two possible pathways from liberalization to crisis should provide policymakers with insights that may help avert future banking crises in Asia and elsewhere. The discussion that follows attempts to distill general patterns about liberalization and crises in nondeveloped countries.

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Country-specific details are not included, so any attempt to derive country-specific conclusions should incorporate examination of the relevant case.[147]

3.2.1 Financial Liberalization and Crises

A pre-liberalized banking-financial sector is typically one in which only a small number of domestic banks operate. Foreign banks, and sometimes even new domestic ones, cannot enter the market because of a complicated licensing requirement or outright prohibition on foreign ownership of banks. There is usually also a ceiling on the interest

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145 On the fiscal costs of the crisis to the Indonesian and Thai governments, see Rosengard, J. 2004. "Will Bank Bailouts Bust Budgets? Fiscalization of the East Asian Financial Crisis." Faculty Research Working Papers Series, Harvard University John F.Kennedy School of Government

146 A recent survey of this literature is Demirgüç-Kunt, A. and E. Detragiache. 2005. "Cross-Country Empirical Studies of Systemic Bank Distress: A Survey." International Monetary Fund Working Paper, May 1996. The literature on the costs of banking crises is surveyed in Hutchison, M. and I. Noy. 2005. "How Bad are Twins? Output Costs of Currency and Banking Crises." *Journal of Money, Credit and Banking* 37(4): 725–752. Case studies of the 1990s liberalizations in East Asia can be found in Lee, Chung H. (ed.). 2004. *Financial Liberalization and the Economic Crisis in Asia.* London and New York: Routledge.

147 This paper's discussion of the two hypotheses is based on the author's findings reported in Noy, I. 2004. "Financial Liberalization, Prudential Supervision and the Onset of Banking Crises." *Emerging Markets Review* 5(3): 341–359

rate that banks are allowed to offer depositors so as to prevent competition among banks operating in a particular geographical region. Sometimes other interest rates, such as for loans and mortgages, are also specified by regulatory authorities and are not determined by markets.

Often, there are also restrictions placed on the geographical or functional areas in which banks are allowed to operate. In some cases, these institutions are not allowed to sell insurance, investments, consulting, or other services. Another typical characteristic of preliberalized banking sectors is that government often plays a central role. The banks may operate as oligopolies with implicit government support. In other cases, the government itself may own all or many of the banks and therefore have an explicit stake in the profitability and stability of the sector.

While this is the general state of preliberalized banking sectors, considerable variation is found across the countries of Asia. In some, many small domestic, banks operate, while in others only a very limited number of banks are allowed. Other differences in the trajectory of liberalization, in addition to differences in the initial state of the sector, can also be observed.

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A complete liberalization of the domestic financial banking sector will entail the removal of all the restrictions discussed above. In a fully liberalized sector, banks are not restricted in their scope of operations nor are they restricted in their geographical location or ownership. Interest rates are determined by the demand and supply of deposits and loans. In most Asian countries that have liberalized, some forms of restrictions typically remain even after the liberalization, most notably in restrictions on functional areas of operation or in the degree of government involvement in the sector.

3.2.2 'Lax Supervision' and 'Monopoly Power' Pathways

Financial liberalization implies a change in the rules and regulations under which banks operate. It also forces bank managers to manage risk in a new environment —one in which they are not yet familiar with the consequences of their decisions. In a pre-liberalized financial sector, the government—typically through the central bank—

regulates and prevents excessive risk taking. But, following liberalization, these regulatory constraints and their enforcement through supervisory practices may no longer be viable. The changing environment may render insufficient the already limited capacity of regulators to understand the banks' balance sheets.[148]

Under this scenario, financial liberalization will enable risk-taking behavior and a consequent crisis if it is not accompanied by new rules and regulations and capable enforcement to monitor the risk taking behavior. If, on the other hand, an adjusted supervisory framework is put in place, excessive risk taking will not occur and financial liberalization is unlikely to have adverse effects on the stability of the banking sector. This is due to the ability of a regulatory body to detect events that may lead to instability in the banking sector. The regulatory body is then able to take measures to counter the adverse effects. The Philippines is said to have suffered a financial crisis due to the lack of an effective regulatory body.

In spite of the prevalence of discussion of this "lax supervision" pathway in academic and policy literature, there is almost no available evidence supporting its validity as a pathway to crisis. An alternative pathway, one less commonly considered, relates to the degree of monopoly power that a pre-liberalized banking sector enjoys.[149]

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In a pre-liberalized sector, existing banks typically experience considerable monopoly power. Competition is limited to a small number of licensed domestic banks and they are not allowed to compete on the interest rates they offer depositors and charge to borrowers.

Liberalization of domestic interest rates, therefore, shrinks profit margins as banks start competing by increasing deposit rates and decreasing lending rates.

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148 Noy, Ilan, "Banking Crises in East Asia: The Price Tag of Liberalization?" Analysis from the East-West Center No. 78, November 2005

149 Noy, Ilan, "Banking Crises in East Asia: The Price Tag of Liberalization?" Analysis from the East-West Center No. 78, November 2005

At the same time, the entry of foreign banks presents domestic banks with increased competition for customers.

As competition between new foreign banks and profitable domestic banks intensifies, institutions that use their resources less efficiently face large losses and, ultimately, bankruptcy. The resulting decrease in profits also puts banks in a more vulnerable position in the presence of adverse macroeconomic shocks.[150]

Under this scenario, systemic problems in the banking sector are an almost inevitable result of financial liberalization. A crisis might occur even if liberalization is accompanied by proper regulation and its enforcement. This therefore means that even though liberalization of the financial services industry in African countries is accompanied by proper domestic supervision and regulation, a financial crisis might still occur.[151]

The argument that the "monopoly power" pathway is independent from the institutional arrangements that regulate and supervise the financial system enables empirical differentiation between the two channels.

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Emphasis on the first pathway ("lax supervision") suggests that liberalization should be undertaken only once effective supervision is in place, while the second ("monopoly power") casts doubt on the wisdom of the liberalization program itself. Going by the arguments propounded under the monopoly power pathway, African countries are highly likely to face a financial crisis if they do liberalize their financial services industries even if they have in place proper supervisory and regulatory bodies to oversee the operation of the financial services sector.[152] The competition faced by the local African financial institutions from the more efficient foreign financial service providers will lead to them (local financial institutions) facing a decrease in profits and a higher probability to make

[150] Noy, Ilan, "Banking Crises in East Asia: The Price Tag of Liberalization?" Analysis from the East-West Center No. 78, November 2005

[151] See 150 above

[152] Noy, Ilan, "Banking Crises in East Asia: The Price Tag of Liberalization?" Analysis from the East-West Center No. 78, November 2005

losses. These local institutions, which previously had monopoly power, may eventually collapse leading to a financial crisis.

3.2.3 Assessing Importance of the Pathways

In order to assess the relative importance of lax supervision versus monopoly power in creating banking crises, Noy I. (2005)[153] developed an empirical model of the probability of the occurrence of banking crises.[154]

The model estimates quantitative probabilities for of banking crises. By differentiating the two channels through the regulation and supervision component, estimation of the importance of each pathway became feasible.[155]

The model requires measuring both domestic liberalization and the strength of the supervisory regime.

The domestic financial liberalization measure used denotes the presence or absence of interest rate control on bank deposits. This is the most commonly used measure for liberalization, as interest rate decontrol is usually one of the most significant steps in the liberalization process.

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The strength of the supervisory regime is not directly observable for two reasons: first, it depends on the legal framework in place and its enforcement and second, because governments are typically and understandably reluctant to provide any information that will show weakness in the governing institutions. Noy I. (2005)[156] thus resorted to three alternative proxies for the strength of the supervisory regime.[157]

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[153] Ilan Noy (2005),"Banking crises in East Asia: The Price Tag of Liberalization Analysis" from the East-West Center No. 78
[154] This paper's discussion of the two hypotheses is based on the author's findings reported in Noy, I. 2004. "Financial Liberalization, Prudential Supervision and the Onset of Banking Crises." *Emerging Markets Review* 5(3): 341–359.
[155] See 154 above
[156] Ilan Noy (2005),"Banking crises in East Asia: The Price Tag of Liberalization Analysis" from the East-West Center No. 78

[157] These three proxies for the effectiveness of the supervisory authorities are far from perfect. A discussion of this difficulty and the data limitations that caused Noy (2004) to rely on these measures is found in that paper

The first proxy is a measure of the degree of corruption taken from Transparency International, as corruption is associated with the extent of enforcement of rules and with the degree of corruptibility of inspectors. For the second alternative, an annual assessment of the state of political freedom published by Freedom House was used, as the existence of effective supervision is most likely also dependent on the presence of a free press and freedom of expression.[158]

A third proxy measures the independence of the central bank from political interference. An independent authority is assumed to be more likely to enforce the governing rules. Banking supervisory bodies often reside within the central bank and even if they do not, the degree of independence of the central bank is correlated with the degree of independence from political interference of the supervisory agency. The data used covered the years 1975–1997 for the 61 non-developed countries for which at least 10 years of consecutive GDP, banking crises, and liberalization data were available.

An obvious observation from this data is that almost all banking crises occurred when there was no interest rate control (liberalized markets) and most of these took place within a few years of the liberalization itself.

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Of the 47 banking crisis episodes studied, only 11 occurred in pre-liberalized sectors and 27 occurred within the five years immediately following liberalization.

In direct contrast to what is perceived by many academics, policymakers, and regulators, the "monopoly power" pathway appears more important than the "lax supervision" pathway in the short term. For a longer horizon (3–5 years), there is weaker evidence that a combination of domestic liberalization with lax supervision by the authorities may yield a significant increase in the likelihood of financial crises.[159]

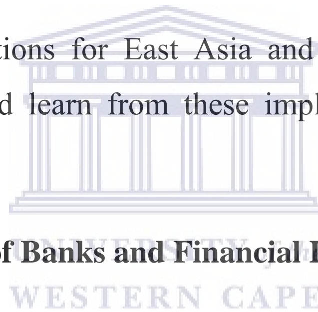
These results suggest that the "monopoly power" hypothesis deserves more serious attention. Nevertheless, arguing that "lax supervision" is unimportant, as a source of

[158] Freedom House publishes an annual assessment of the state of freedom in most countries. See www.freedomhouse.org.
[159] Noy, Ilan, "Banking Crises in East Asia: The Price Tag of Liberalization?" Analysis from the East-West Center No. 78, November 2005

danger in the immediate aftermath of financial liberalization, is most certainly not warranted.

An interesting possibility is that the narrowing of the bank monopolies' profit margins (the "monopoly power" hypothesis) is an immediate result of liberalization and therefore an immediate threat to the health of the banking industry. In contrast, the increased risk taking that might result from liberalization combined with insufficient regulation and supervision (the "lax supervision" hypothesis) is dangerous, but only for a longer time-horizon. It can cause banking sector instability that will become evident years later. It is therefore prudent to note that African countries should put in place mechanisms to deal with financial crises that are caused by the monopoly power pathway in the short term and then go ahead to set up supervisory and regulatory bodies to deal with financial crises in the long term.

The conclusions have implications for East Asia and particularly for China. African countries can in turn draw and learn from these implications as they liberalize their financial industry.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3.2.4 Prudential Supervision of Banks and Financial Liberalization

Although the onset of financial liberalization seems to be a significant destabilizing force for the financial industry, there appears to be professional consensus that, in the long run, a liberalized financial market will be stabilizing, will channel investment and saving more productively, will enable maintenance of steady consumption levels, and will be conducive to more rapid and sustainable growth.[160] In view of these long-term benefits, and however one evaluates the importance of each of the two hypotheses to the relationship between liberalization and crises, it is clear that there is still a distinct role for liberalization and a banking supervisory agency. This is especially true for the economies of African countries that are mostly known to be fragile.

[160] For recent discussion of these views see Bekaert, G., C.R. Harvey,and C. Lundblad. 2004. *Does financial liberalization spur growth?* Manuscript. Abiad, Abdul, Nienke Oomes, and Kenichi Ueda. 2004. "The Quality Effect: Does Financial Liberalization Improve the Allocation of Capital?" International Monetary Fund Working Paper WP/04/11. Levchenko, A.A. 2005. "Financial Liberalization and Consumption Volatility in Developing Countries." International Monetary Fund Staff Papers 52(2).

A supervisory agency should regulate banks activities and provide insurance to small depositors. This is necessary in order to prevent the instability that inevitably results even in pre-liberalized financial sectors.

Regulatory practices should include: development and maintenance of honest and impartial legal systems; mandating strict information disclosure practices; establishment of limits on the rate at which banks can lend or on the rate of increase in their exposure to riskier sectors (so-called "speed bumps"); requiring diversification of bank portfolios; strict capital and liquidity standards that account for different degrees of risk exposures; strict and transparent accounting of non-performing loans; and rigorous mandatory balance sheet adjustment once a loan is determined to be non-performing.

3.3 The East Asian Banking Crisis

Notable case studies are the banking crises that hit East Asia in 1997–1998. All the East Asian countries that suffered a drastic depreciation of their currency (a currency crisis) during that turmoil also experienced systemic banking sector failure. A recent study of the evolution of the overall East Asian crisis, which was accompanied by large-scale banking problems,[161] supports the suggestion made here that the decrease in monopoly power may play the most important role in the emergence of a financial crisis following liberalization. For example, the study found that during the East Asian crisis, foreign-owned banks were less likely to get into a liquidity crisis and none of the foreign-owned financial institutions were shut down. Furthermore, the institutions that were connected with industrial groups or influential families were more likely to be distressed during the crisis. Additional support comes from a study showing that foreign-owned banks tend to have higher profit margins and, more significantly, that foreign presence is correlated with lower profit margins for domestically owned banks in developing countries.[162]

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[161] Bongini, P., S. Claessens, and G. Ferri. 2001. "The Political Economy of Distress in East Asian Financial Institutions." *Journal of Financial Services Research* 19(1): 5–25.
[162] Claessens, S., A. Demirgüç-Kunt, and H. Huizinga. 2001. "How Does Foreign Entry Affect Domestic Banking Markets?" *Journal of Banking and Finance* 25: 891–911. More research on these issues is found in a 2004 special issue of the *Journal of Money Credit and Banking* 36(3), which is devoted to a discussion of banking concentration and competition.

Table 2 shows the years in which various liberalizing actions took place in the five East Asian countries that were hit most severely by the crisis: Indonesia, Korea, Malaysia, the Philippines, and Thailand. It appears that the sequence of liberalizations was different in each of these countries and that no single liberalizing act can be clearly associated with the crisis.

Three observations are noteworthy. First, banking sectors in the East Asian countries are now generally more concentrated, more foreign-owned, and face more restrictions on their areas of operations.

Second, the legal powers accorded to auditors have increased. Third, the amount of non-performing loans, as a percent of total assets, has decreased in all these countries. In reporting the results of a recent survey, the International Monetary Fund noted, "[Asian] Banks…have to varying degrees increased provisioning and write-offs to strengthen their balance sheets…. However, significant vulnerabilities persist in the banking systems in a number of countries faced with high levels of distressed assets, under provisioned bad loans, and significant exposure to interest rate increases."[163] Interestingly, Korea appeared to have reformed its banking sector the most. Yet, even in the case of Korea, there is some doubt about the efficacy of these changes as long as the primary institutional arrangements remain the same, with the supervisory authorities subservient to the policy-making body within the government.[164]

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These conclusions underscore the fact that economists are still far from a consensus on the likely mechanism that led to the East Asian financial crisis and particularly the banking sector failures. Much of the theoretical work done to date on the dynamics of the Asian crisis has not dealt with the impact of domestic financial liberalizations. The majority of the empirical work has focused on the financial flows engendered by

[163] International Monetary Fund. 2005. *Global Financial Stability Report: Market Developments and Issues,* p. 58
[164] For such a pessimistic interpretation of the recent reforms in Korea, see Lee, C.H. 2004. *Post-Crisis Financial Reform in Korea: A Critical Appraisal.* Korea Development Institute Manuscript

international (rather than domestic) financial liberalization and the evident globalization of international capital markets throughout the 1990s.[165]

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[165] For discussion on the increasing volumes of international financial flows, see Aizenman, J. and I. Noy. 2003. "Endogenous Financial Openness: Efficiency and Political Economy Considerations." National Bureau of Economic Research Working Paper No. 10144. For the impact of international capital flow reversals in the Asian crisis, see Hutchison, M. and I. Noy. 2005. "Sudden Stops and the Mexican Wave." *Journal of Development Economics.* Forthcoming

Table 1:On the Banking Crisis in East and South Asia (1980-2002)

Country/economy	Time-frame	Non-Performing Loans (% of total loans)	Fiscal cost of crisis (% of annual GDP)	Forgone output (% of annual GDP)
BANGLADESH	1985-1996	20		
CHINA	1990-	50	47	
INDONESIA	1997-2002	70	55	39
JAPAN	1991-	35	24	48
KOREA	1997-2002	35	28	17
MALAYSIA	1997-2001	30	16	33
NEPAL	1988	29		2.2
PHILIPPINES	1983-1987	19	3	26
PHILIPPINES	1998-	20	13	10
SRI LANKA	1989-1993	35	5	1
TAIWAN	1997-1998	26	12	
THAILAND	1983-1987		1	0
THAILAND	1997-2002	33	35	40
VIETNAM	1997	18		23
Average for Asia (14 episodes)	1980-2002	32	22	22
Average for the rest of the world (97 episodes)	1980-2002	41	15	12

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Non-performing loans are defined as loans for which no scheduled repayments are being made. Fiscal cost is the cost to the government of paying depositors or other debtors for nationalized debt and recapitalization of banks. The output cost is calculated relative to potential output (according to the International Monetary Fund's definition of this term). Blank spaces indicate data unavailable.

Source: Caprio, G. and D. Klingebiel. 1999. *Episodes of Systemic and Borderline Financial Crises*. Manuscript, The World Bank.Update available at: www.econ.worldbank.org

Table 2 Banking Crises and Liberalization Dates in East Asia

Country	Banking Crisis	Decontrol of Interest Rates	Abolishing Direct Credit	Increasing Competition	Allowing Capital Flows	Privatisation	Deregulation
Indonesia	1997-2002	1983	1983	1988		1996	1992
Korea	1997-2002	1991	1982	1981	1996	1983	1988
Malaysia	1997-2001	1991	1976	1985			1989
Philippines	1998-	1983	1983	1993	1995	1995	
Thailand	1997-2002	1992	1980	1992	1992	1993	1993

Source: Abiad, A. and A. Mody. 2005. "Financial Reform: What Shakes it? What Shapes it?" *American Economic Review* 95(1): 66–88. Blank spaces denote sectors either liberalized before 1980 or not yet liberalized.

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3.4 China's Commitment to Financial Liberalization

A study of the liberalization path undertaken by China is important because of the lessons it has drawn from the 1997 East Asian financial crisis and the measures the country will undertake in order to avoid a financial crisis of its own.

The stability and health of the Chinese banking sector is one of the biggest concerns regarding future economic policy in the region. A destabilized banking sector in China will most likely involve a deep recession and is thus a concern for China, its neighbors, and its trade partners. China has the biggest financial sector in developing East Asia, with a higher domestic credit-to-GDP ratio (a typical measure of the importance of an economy's financial sector) than Korea, Japan, or the United States. Domestic currency deposits in deposit-taking institutions amount to 178 percent of GDP. Four state-owned banks, all of them possibly insolvent by international accounting standards, dominate China's banking sector. Accounting for more than 60 percent of total assets, these institutions are the Agricultural Bank of China, Bank of China, China Construction Bank, and Industrial and Commercial Bank of China (ICBC).

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The historical role of the big four was to provide government directed credit to state-owned enterprises (SOEs). Since many of the State Owned Enterprises are now virtually bankrupt, the banks have large portfolios of non-performing loans, which prevent them from allocating additional credit and improving performance. The four banks have already experienced several publicly funded capital infusions—most recently when US$15 billion was handed to the Industrial and Commercial Bank of China in April 2005. Foreign funded banks still account for less than 1.5 percent of total assets in the Chinese banking sector, although a number of large foreign financial institutions have bought substantial shares in the big four during the last couple of years.[166]

The Chinese government has embarked upon a process of liberalization and opening up of the banking sector as part of the commitments undertaken in the World Trade

[166] For a recent detailed and informative International Monetary Fund review of the Chinese banking sector, see Barnett, S. 2004. "Banking Sector Developments," In Prasad, E. (ed.). "China's Growth and Integration into the World Economy: Prospects and Challenges." International Monetary Fund Occasional Paper No. 232. Washington, D.C.: International Monetary Fund Press.

Organization (WTO) accession agreement (under the General Agreement on Trade in Services, or GATS). The government had pledged to fully open up the banking sector to international competition by December 2006. The banking sector went through significant reforms in December 2003 but is still far from liberalized. Most importantly, deposit rates are still set by law, competition on lending rates is still circumscribed, and foreign bank participation is heavily curtailed, and foreign ownership of any domestic bank is limited to a total of not more than 25 percent.

Discussion of the two possible pathways that lead from liberalization to crisis raises a number of issues that are highly relevant to the imminent Chinese liberalization process imposed by the WTO-GATS agreement.

Important questions include: (a) whether the institutional arrangements governing the newly founded regulatory agency are adequately robust to withstand liberalization; (b) whether the regulatory agency has the institutional knowledge and political power to successfully regulate a post-liberalized banking sector; (c) whether the banking sector's profit margins are sufficiently wide and balance sheets healthy enough to withstand increasing competition from more profitable foreign banks. These are especially pertinent questions considering the previous painful and costly experiences in East Asia in 1997–1998.

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The answers to these questions will be of vital importance to the health of the Chinese economy and the region in general in years to come. African countries can draw some useful lessons from China's efforts to cope with liberalization of its financial services industry. This should however be done while taking into consideration the peculiarities of the Chinese market like its huge size.

It is clear that the Chinese banking sector can be successfully liberalized and the danger of a banking crisis averted only if banks' balance sheets are carefully monitored and the monopoly power enjoyed by the leading banks is dismantled slowly. This, of course, implies that the December 2006 deadline to finish the liberalization process was woefully inadequate.

A Lesson for Africa

Extending this to Africa, it would be prudent for African negotiators in the Financial Services Negotiations for Liberalization of the Industry should always negotiate foe adequate time frames to enable their governments to comfortably ensure compliance with the commitments. This is because of the lack of the capacity of most African governments to quickly comply with the commitments. The adequate time frame comes in handy in ensuring proper regulatory and supervisory mechanisms are put in place. It also ensures that the monopoly power of the dominant players in the pre-liberalized era is slowly dismantled. This is vital to ensure that then dominant domestic players facing stiff foreign competition do not control a large part of the financial services industry. Thus any losses they incur will not have an adverse effect on the economy.

3.5 China, Her Financial Services Industry and GATS

It is noteworthy to state that China presents a prudent and graduated approach to the liberalization of the financial industry under the auspices of GATS. It is vital to examine this approach adopted by China as a model for African countries in the liberalization of the financial sector. However, it must be noted that the commitments that have been made by China cannot be taken by African countries wholesomely due to the peculiarities of the Chinese financial market like its size and its phenomenal economic growth.

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China signed the GATS upon its WTO accession at the end of 2001. Although there is a phasing-out period of five years with respect to business scope (local currency vs. foreign exchange banking business), customers (resident vs. nonresident, consumer vs. firms), and geographic location, its overall commitment is relatively liberal compared with countries in East Asia and most of the developing economies. Even before its WTO commitments, foreign banks have already been allowed to operate in certain geographic areas with progressively liberalized scope of banking businesses.

***3.5.1 The impact of foreign banks on China's interest rate liberalization**:* China's interest rate liberalization essentially follows a standard textbook sequencing approach: Short-term rates are liberalized before long-term rates, lending rates before the borrowing

rates, and lending and deposit rates of foreign currency before that of domestic currency. Inter-bank rates and government bond rates are fully determined by markets. On January 1 2004, bank-lending rates were allowed to fluctuate between 10 percent below and 170 percent above the base one year lending rate set by the Central Bank. After October 29th 2004, the limit on the upper bound of lending rate has been abolished. Although deposit rates are not yet fully liberalized, the deposit rates of large deposits can be negotiated between depositors and banks. The rationale of such a sequencing strategy appears to aim at protecting the franchise value of banks so as to avoid excessive competition for deposits among banks.[167] This therefore ensures that there is no drastic fluctuation of interest rates and that banks will offer reasonable rates on deposits that they can afford to pay, thus avoiding profit reduction and eventual loss due to inability to pay interests for deposits.[168]

A Lesson for Africa

Africa can borrow from the interest rate liberalization model; adopted by the Chinese. The graduated and sequenced liberalization of the interest rates ensures that banks do not have excessive competition for deposits and therefore avoid making losses and going bankrupt due to offering high interests for customers deposits or very low interest rates on loans so as to attract borrowers. This in turn averts a financial crisis that is imminent when banks become bankrupt and collapse thus going down with the funds of many depositors.

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Foreign banks, because of their small RMB deposit base, have always been active participants[169] of the inter-bank markets since 1998 and their participation has acted to help unify the national inter-bank market by breaking barriers of regional segmentation. One concrete case was in the early days of foreign entry in the interbank RMB market. Shanghai and Shenzhen are two major inter-bank market centers.

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[167] Li-Gang Liu (2005) The Impact of Financial Services Trade Liberalization on China, RIETI Discussion Paper Series 05-E-024, Research Institute of Economy, Trade and Industry (RIETI)
[168] See 167 above
[169] Foreign banks' net borrowing from the inter-bank market is about 8.2 percent of the inter-bank trading volume at the end of June 2004.

To prevent excessive competition for businesses of foreign banks, the Bankers Association in Shenzhen reached an agreement that the RMB loan rates to foreign banks should not be below 20 percent of the average standard lending rate. However, the Shanghai inter-bank market center did not have such an anti-competition practice.[170]

Indeed, available data indicate that the inter-bank rates in Shanghai could go down as much as 36 percent in 2001[171]. As a result, foreign banks did most of the borrowing in the Shanghai market. Fearing of losing market shares to Shanghai, the Shenzhen Bankers' Association eventually revoked the practice in 2002.[172]

***3.5.2 Fee-Based Business**:* After China's accession to the WTO by the end of 2001, foreign banks operating in China could immediately conduct foreign exchange business with Chinese depositors. Although foreign banks provide better services, customers would have to pay for such services, which were not entirely expected by Chinese customers. For example, Citibank in 2002 charged depositors $6 or 50 RMB monthly if the monthly average deposit of a customer is less than $5000 dollars.[173]

Other foreign banks such as HSBC and Bank of East Asia also had charges on deposits but of various forms. Domestic banks followed the examples of foreign banks quickly and started charging fees on foreign currency deposits. They then started to charge fees on ATM transactions across banking groups. With respect to the RMB business, domestic banks also innovated by providing differentiated services offered to their large depositors.

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Fee-based business, a vague area in China's commercial bank regulation, caused many legal disputes between consumers and the banking sector.[174] The regulatory authority then had to revise regulations on this issue by issuing a new rule to clarify the scope of the fee-based businesses that commercial banks are able to conduct. It finally recognized

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[170] Li-Gang Liu (2005) The Impact of Financial Services Trade Liberalization on China, RIETI Discussion Paper Series 05-E-024, Research Institute of Economy, Trade and Industry (RIETI)
[171] See 170 above

[172] Liu, Li-Gang, "**The Impact of Financial Services Trade Liberalization on China,"** Research Institute of Economy, Trade and Industry (RIETI) (September 2005), RIETI Discussion Paper Series 05-E-024
[173] See 172 above
[174] Liu, Li-Gang, "**The Impact of Financial Services Trade Liberalization on China,"** Research Institute of Economy, Trade and Industry (RIETI) (September 2005), RIETI Discussion Paper Series 05-E-024

the principle that fee-based business is legal with only limited exceptions. Commercial banks are granted the right to charge fees on their intermediation businesses. Certain prices of the fee-based businesses are regulated by the government, but the majority of them are determined by the market. Because of strong opposition from the consumer groups, a compromised solution was reached on the RMB deposits. Fees charged on foreign currency deposits remain. However, banks are not allowed to charge fees on the RMB deposits.[175]

3.5.3 Impact on the scope of banking business: One important feature of China's financial service trade liberalization agreement is that criteria for authorization to operate in China's financial sector are based on prudential means alone and are not based on economic needs test or quantitative limits on licenses[176]. As a result, corresponding changes in regulation after the accession must be made. From 2002-2003, the bank supervisory authority has removed 26 bank businesses from the list that requires approval. One certain banking business are granted approval, the headquarters of a bank can decide whether its bank branch can conduct such business, without further approval from the regulatory authority. For those new categories of banking businesses that require approval from the regulatory authority, a decision should be made within 10 business days of filing of the application. Indeed, the WTO accession has sped up the converging process of the Chinese regulatory practices to the international standard. Transparency and efficiency have been improving.

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A Lesson for Africa

An adoption of a less bureaucratic financial service industry regulatory framework by African countries will boost business because it will save time and money usually spent in getting approval to set up a financial institution. However, care must be taken to ensure that this less bureaucratic regulation does not have loop holes that will be exploited by the foreign entrants.

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[175] See 174 above

[176] See report of the Working Party on the accession of China, WTO October 2001.

3.5.4 Impact on financial regulation: *The case of the financial holding company:*

China's Commercial Bank Laws, modified in 2003, stipulates that commercial banks operating in China are prohibited from engaging in trust and securities business, investing in real restate business not for self use, and investing non-bank financial institutions and enterprises only with limited exceptions.[177] Indeed, the Bank of China Group is one of such exceptions. It controls 3 commercial banks, 3 investment banks, 1 mutual fund, and 2 insurance companies. However, large foreign banks operating in China are generally within a financial holding group and they are perceived to have unfair advantage over the Chinese banks.[178] As a result, a new law on financial holding group is under discussion. In addition, because of foreign entry and the presence of its own financial holding groups, China has put great emphasis on cross-agency coordination and information sharing in its amended Central Bank and Commercial Bank Law. The newly established financial stability bureau is supposed to be in charge of such coordination.

A Lesson for Africa

African countries should limit the foreign financial service providers' scope of operation like the Chinese government has. This will reduce the dominance of the foreign firms in the African markets. If the foreign firms are allowed to engage in both bank and insurance activities they will dominate the financial services industry and will eventually monopolize the same. African governments should ensure that the foreign firms' scope of operation is clearly demarcated to limit the foreign firms to one sector of the financial industry.

3.5.5 Impact on new entry into the financial sector and privatization of state owned commercial banks: Since 1996, the regulatory authority has authorized 112 city commercial banks and 4 rural commercial banks to be formed. Many of them were merged from city and rural cooperatives. If China can offer national treatment to foreign banks under its WTO obligations, how it should treat the entry of newly formed and

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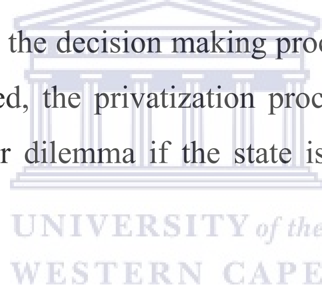
[177] Article 35, section 2 of the Commercial Bank Law of the People's Republic of China, 2003.

[178] For example, foreign holding financial companies are viewed as "supermarket", whereas Chinese commercial banks are viewed as "specialty" shops that lack economies of scale to compete with foreign entities (Huang, 2004).

privately owned banks has raised strong interests in recent years. The banking regulatory commission, instead of issuing more new banking licenses to allow domestic entry, has taken an approach to encouraging private investors to be equity shareholders of existing banks. Even if a privately owned Chinese bank applies for a banking license, the applicant will be required to have a foreign investor as a strategic partner. Based on the experiences of and lessons learned from emerging market and transition economies, private banks mushroomed after financial liberalization have failed in great numbers and eventually the tax payers would have to shoulder the losses. Therefore, the domestic entry should be treated with great care.

In this sense, the current regulation is prudent. However, because of the lack of transparency on financial conditions of city commercial and state owned banks, private investors have been quite hesitant in becoming shareholders. They fear that their investments are going to be used to fill the holes of NPLs but at the same time, they cannot participate effectively in the decision making process because the state remains as the majority shareholder. Indeed, the privatization process of the big four state-owned commercial banks faces similar dilemma if the state is unwilling to yield its majority control on these banks.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4.0 CHAPTER 4

4.1 THE ANTICIPATED IMPACT OF GATS ON THE FINANCIAL SERVICES INDUSTRY IN AFRICA

A number of significant benefits arise from liberalizing trade in financial services. These include among others, strong positive effects on income and growth driven by specialization on the basis of comparative advantage, know how, and new technologies. Because liberalization improves financial intermediation, it enhances efficient sectoral inter-temporal and international allocation of resources. Trade liberalization in financial services has the potential of achieving the following[179]:

- Inducing the government to improve macro-economic management, review policy intervention in credit and financial sector regulation and supervision;[180]
- Provision of better quality and variety of financial services, enhancing competition and improvement of sectoral efficiency thus lowering costs
- Improving financial intermediation and investment opportunities through improved resource allocation across sectors, countries and through better means of managing risks and absorbing shocks[181]
- An efficient and well regulated financial services industry leads to an efficient transformation of savings and investments, ensuring that resources are deployed where they have the higher returns [182]
- Benefits arise from increased product variety and better risk sharing economy

On the other hand, domestic financial services providers will face stiff competition from the well-funded foreign entrants. This will lead to reduced profits of these domestic outfits, which may reduce their operations especially in the less profitable rural areas.

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[179] International Lawyers and Economists against Poverty (ILEAP), " African Financial Services Trade and Negotiations" Workshop Paper, Post- July 2004 African Strategies for Bilateral and MultiLateral Trade Negotiations, November 10-12, 2004, Nairobi, Kenya.
[180] Stichele, M.V., (18 May 2006), Comments and assessment on the Plurilateral GATS request on financial services: Senior Researcher, SOMO
[181] See 180 above
[182] Stichele, M.V., (18 May 2006), Comments and assessment on the Plurilateral GATS request on financial services: Senior Researcher, SOMO

Eventual shutting down of the least profitable domestic financial service providers may be inevitable.

Alternatively, foreign suppliers of financial services, who are driven solely by a profit motive, are highly likely to leave out rural areas or small to medium scale agents with detrimental effects to the economy. The withdrawal of banking services from the rural areas by domestic financial services providers, due to increased competition from the foreign banks will disrupt rural agricultural economies. This will have adverse effects on the African economies, whose economic mainstay is agriculture. The agricultural economy in some African countries like Kenya is already reeling under the effects of the collapse of the co-operative sector, which was previously the most dependable source of credit due to its low interest rates and timely loan facilities. The township traders unable to bank their earnings have become an easy target for criminals.[183]

The role of GATS in the comprehensive development framework of most African countries is not clear i.e. poverty reduction through growth is not very clear neither are financial corporate responsibility initiatives. Increased competition is likely to reinforce and move financial industry towards high profit, concentration and consolidation. In this case, if government wishes to provide support to national policies and maintain its presence, fiscal initiatives rather than outright exclusion of Foreign Service providers could be considered. The abuse side of the market may not always hold given that both domestic and foreign suppliers and the openness of the market to the new entrants could minimize this. Government could also deploy competition policies to ensure fair competition.[184]

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Although the liberalization of financial services has the potential to improve efficiency in the financial industry and economy, the experiences of African countries tend to show that there is a lot more at stake than increased efficiency, choice of products and access to capital. Since GATS has no rules to govern foreign firms' activities, these firms often

[183] Stichele, M.V., (18 May 2006), Comments and assessment on the Plurilateral GATS request on financial services: Senior Researcher, SOMO

[184] SOMO, *Challenges for the South in the WTO Negotiations on Services*, 2www.somo.nl/somo_ned/projecten/Challenges.pdf

dominate the most lucrative services, thus creating a financial vacuum in non-lucrative areas and increasing the potential to crowd out domestic firms. Liberalization of financial services rarely results in the proclaimed improvement of competitiveness and efficiency of domestic financial technologies, especially when Foreign Service providers dominate the lucrative markets dealing with prime borrowers such as multinational companies. In such cases domestic banks are left to meet the credit needs of small to medium sized firms with low technology banking.[185]

Liberalization of the financial services industry could contribute to widening of the existing gaps between the favored and the marginalized segments of population and regions. Foreign firms widen the gap between the rich and poor by targeting the richest clients, the most developed regions and the best human resource in the host country. It has been suggested that in sub Saharan Africa, foreign firms often rapidly take over a large part of the domestic financial industry and since GATS has no restriction on profit repatriation (GATS article XI), more profits are siphoned off from the host country to the parent company with little or no re-investment in the host country.[186] There is a possibility of creating dis-intermediation of up to levels allowed by the foreign exchange rate exposure limit through transformation of local liabilities into foreign assets. In addition, these countries must spend additional and often unavailable resources for regulatory and supervisory measures to handle changes and risks by new financial firms.[187]

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Counter arguments to this include, weakness in the legal system to enforce claims thus making transactions with segments of the industry risky; lack of sufficient bankable economic activity or its potential that create a financial services vacuum in rural areas. The latter also could be addressed through fiscal incentives, rather than excluding Foreign Service providers.

[185] SOMO, *Challenges for the South in the WTO Negotiations on Services*, 200 www.somo.nl/somo_ned/projecten/Challenges.pdf

[186] SOMO, The Risks and Dangers of Liberalization of Services in Africa under EPAs

[187] See 186 above

The liberalization of financial services also poses substantial threats to the financial stability of African countries and these threats arise from:

- New financial services, which may have a destabilizing effect on a developing country's financial system[188].
- GATS Articles in support of cross border capital movements and financial instability by limiting governments' restrictions on profit repatriation and capital flows related to committed financial services. [189]
- Vague financial prudential measures permitted by GATS that leave developing countries' regulations open to challenges by WTO disputes[190], and
- GATS rules permitting restrictions on unstable capital flows and financial services, which are limited by many conditions, prioritize the interests of foreign service providers at the expense of the developing countries' ability to deal with problems in their financial systems.[191]

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Successful opening of financial markets together with liberalization of financial trade requires careful sequencing. Two important actions that underpin any successful liberalization of financial services trade include macroeconomic stability and ability to regulate and supervise the financial system.

On macro-economic stability, it is observed that a number of developing countries that opened up their banking systems in the last one and a half decades experienced problems thereafter. To the extent that there are costs associated with bank failures such as

- Bailing out of failed banks, which impacts heavily on the government budgets
- Worsening employment and thus lowering economic activity

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[188] Abdi Noor Halima " Assessment of EU's interests in Exports of Services into Kenya and ESA in General under EPA's" An analytical paper (May 2005)
[189] See 188 above
[190] Abdi Noor Halima " Assessment of EU's interests in Exports of Services into Kenya and ESA in General under EPA's" An analytical paper (May 2005)
[191] See 190 above

However, the liberalization of financial service trade itself does not cause financial crises, rather it is the inadequate regulation and supervision, macroeconomic policies and inappropriate intervention in financial markets that increases financial problems.

Adequate prudential regulation and supervision in needed for all financial institutions that act as intermediaries and manage risk if the stability of the financial sector is to be strengthened. The interdependence between macroeconomic and financial stability increases in a liberalized environment. Besides, prudent regulation and supervision helps improve governance of the financial institution and the detection of problems at an early stage thereby allowing more time to apply corrective measures. In addition, appropriate regulation and supervision increases the stability of the financial system.[192]

It appears that financial instability, in particular during the turbulent 1997-1999, was larger in more open countries with higher and more liberal financial sector commitments. Using a robust estimation procedure, the econometric evidence weakly supports this view. More liberal commitments on commercial presence than on cross-border supply have systematically increased the likelihood of banking crises, most likely reflecting the short-run negative effect of increased foreign competition on the domestic financial services market. At the same time, commitments biased towards cross-border supply of financial services have increased the risk of a currency crisis, as they are associated with more volatile capital flows. Hence the evidence suggests that a better resource allocation framework created by a more liberal financial system should be safeguarded, in particular in the short-run, against possible negative spillovers and international contagion by means of sound domestic macroeconomic and prudential policies.[193]

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Commitments to core principles in banking for effective supervision puts liberalization on track as these propose the minimum standards for licensing, ownership and liquidation, in addition to rules and requirements for both domestic and cross border

[192] Stichele, M.V., (18 May 2006), Comments and assessment on the Plurilateral GATS request on financial services: Senior Researcher, SOMO

[193] Valckx, Nico, "WTO Financial Services Liberalization: Measurement, choice and Impact on Financial Stability," (October 2002) Research Memorandum WO no 705

activities.[194] The principles carefully consistent with multilateral obligations and commitments, and to date many governments and central banks world over have adopted these standards. Apart from these standards, adequate entry and exit rules, deposit insurance schemes to provide safety nets, know how and technology developments, together with market based and international monitoring help to strengthen the financial sector and prepare it for internationalization of its trade.

However, this financial sector reforms should be gradual and well sequenced given that building capacity and institutions to monitor the financial system is costly and takes time ought to be carefully considered during negotiations and strongly put forth by the African Countries. It should also be kept in mind by the developing countries' negotiators that the developed countries should adhere to articles IV and XIX of the GATS.

It is through GATS principles that developed countries are likely to eliminate the flexibility that African countries can exercise in making decisions on regulations and prudent measures to protect their financial systems, by targeting regulations that are necessary and designed to promote the development of domestic businesses and curb the powers multinationals when operating within the African hosts' borders. African countries should insist on due respect for national policy objectives, individual level of development and full recognition of flexibility that is required by developing countries so as to ensure that the right to regulate the services sector is not undermined at all.[195]

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Kenya has expressed the need for a strong and transparent regulatory regime and efficient supervisory body before further liberalization of financial services is undertaken. Experience has shown that it is vital to strengthen the supporting institutional framework in parallel with liberalization.[196]

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[194] SOMO, *Challenges for the South in the WTO Negotiations on Services*, 200 www.somo.nl/somo_ned/projecten/Challenges.pdf

[195] Ikiara, G., Nyandemo, S.M. & Moses I. Muriira, " Kenya's Service Sector: Emerging National, regional and Global Issues," March 2003

[196] Ikiara, G., Nyandemo, S.M. & Moses I. Muriira, " Kenya's Service Sector: Emerging National, regional and Global Issues," March 2003

4.1.1 The Anticipated Negative Impact of GATS on the Financial Services Industry In Africa

It is often argued that foreign financial service providers increase efficiency and improve the quality of the financial services in developing countries. Also, foreign banks are claimed to improve the allocation of savings, improve access to foreign capital, and provide capital in times of crisis. However, experiences show mixed results to that extend and the most recent research and literature gives a much more nuanced view.

Developing countries opening up to foreign banks are faced with the following challenges because of the profit making strategies of foreign banks who do not really behave like domestic banks:

4.1.1.1 Lack of credit to smaller domestic firms[197]

Foreign financial service providers first focus their, more efficient, services on rich clients and rich regions ('cherry picking'). The most recent research has found that this is especially the case in poorer countries, while in a few more developed emerging market economies, foreign banks also try to make profit through broader lending.[198]

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However, in all countries, small and medium sized domestic companies and farmers have difficulties in obtaining credit from foreign banks. This restrictive lending leads to lack of financial support to vital sectors in many developing countries or even to stifling of a whole economy due to a lack of credit ('credit crunch') to the domestic industry as was the case in Mexico.[199] This has been the result of the introduction of standardised credit evaluation systems by foreign banks, and loss of capacity to assess local enterprises, as well as fears of lending that is considered risky by financial analysts who assess the

[197] Zie MVS report; D. Domanski, Foreign banks in emerging market economies: changing players, changing issues, in BIS Quarterly Review, December 2005, p. 77

[198] E. Detragiache, T. Tressel, P. Gupta, Foreign banks in poor countries: theory and evidence, IMF Working Paper, WP/06/18, January 2006; MVS report p. 191 : In Sub-Saharan Africa, the presence of foreign banks increases loans by both domesticand foreign banks, but the variability of the loan supply decreases.

[199] See for instance: J. C. Moreno-Brid, J. C. Rivas Valdivia, J. Santamaría, Mexico: Economic growth exports and industrial performance after NAFTA, CEPAL - Serie Estudios y perspectivas, N°42, December 2005, p. 30 (seen on 27 March 2006 at: http://www.cepal.org/publicaciones/Mexico/0/LCMEXL700/L700.pdf)

foreign banks' value on the stock market. Such practices stimulate the gap between rich and poor.

4.1.1.1.1 Implications for Africa

The cherry picking by the foreign financial service providers, which dominate the market in Africa, will lead to the predominantly poor population and the local small and medium size enterprises having no access to credit facilities. This means that they will be unable to start off or improve their farming projects and small and medium sized enterprises. This in turn will lead to the increase in the gap between the rich and the poor.

4.1.1.2 The risks of negative impacts on the domestic financial industry

The proponents of foreign financial service liberalization often indicate where competition by foreign banks has proved to be an incentive for local banks to improve their operation.[200] However, actual experience also shows that some local banks have little chance to survive the foreign competition or acquisitions. Because foreign banks attract the richest clients, they leave the poorer clients to the domestic financial services. Although the latter are much better in serving local small companies and poorer clients, not all can make enough profit from such clients. Chinese statistics have shown that 80% of the banks' profits come from the richest 20% of the clients.[201]

In addition, new international standards about capital reserves that banks need to set aside when providing credit (Basle II) are making foreign banks much more competitive because they have their own risk assessment system which local banks often do not have. In order to survive the foreign competition, local banks might take too many risks, which can result in destabilisation of a country's banking system. Also, in order to operate well in new markets, foreign banks attract the best managers from local banks to the foreign banks. The result is that expertise goes from local to foreign banks, contrary to the claims

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[200] G. Bies, **Financial** liberalisation in Latin America, in Developing countries and **GATS**, Ed. C. Jepma & E. Kamphuis, University of Groningen, 2003, p. 64.

[201] MVS report, p. 177

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of transfer of know how. In such cases, how much efficiency gains can be made? The collective request on financial services explicitly asks for the removal of discrimination between domestic and foreign suppliers while foreign suppliers have advantages from their operations abroad and the domestic financial industry might require special, but transparent, support to become competitive or to be able to finance poorer clients.

4.1.1.2.1 Implications for Africa

Domination by the Foreign Service providers will lead to the loss making or even collapse of the local banks. The local banks are the institutions highly likely to give better terms to the locals. They are also more accessible to the locals because they have branches in the rural areas. With their demise, the local traders and farmers in Africa will face lack of credit facilities. The Foreign Service providers that engage in cherry picking will fill the gap left by the local banks. The foreign banks are likely to make more profits because their rich clients are able to pay higher interest rates unlike the poorer clients of the local banks.

4.1.1.3 Profits to be made in the banking sector go abroad

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Foreign ownership of banks does not only lead to other behaviour and less propensity to invest in the domestic economy while linking more with the international financial markets. It also means that a sector with potentially high profits is not developed at the national level and by domestic entrepreneurs. Profits made by the financial industry can be repatriated abroad by foreign financial services providers (Art. XI of GATS requires transfer of all current payments), taxes are paid to home country authorities and dividends paid to foreign shareholders. Profits made off rich clients in poorer countries are siphoned off to the home countries in the North.[202]

[202] SOMO, The Risks and Dangers of Liberalization of Services in Africa under EPAs

4.1.1.3.1 Implications for Africa

The repatriation of profits by the foreign financial service providers to their home countries from African countries will lead to more growth in the developed countries due to the investment of profits from the poorer African countries. On the other hand, the African financial services markets will be characterised by lack of significant growth since the profits of the foreign firms are not being reinvested in the African countries.

4.1.1.4 Withdrawing if not making enough profit

While foreign financial firms are in constant search for new markets and expand their business to many countries, they also withdraw from countries if they do not make enough profit or cannot gain large market shares.[203] This has for instance been the case in different Latin American countries and recently in Brazil and Indonesia where foreign banks and insurance companies resell their business because of unprofitable business. In Brazil, competition with domestic banks has been tough because of the experience and efficiency of domestic banks (who have learned to operate in financial crises and developed in a large domestic market with a Central Bank making sure they can have enough money reserves). When foreign financial firms cannot make enough economies of scale and do not belong to the top 5 in their category, analysts exert pressure to withdraw from a country. This often leads to instability and social unrest at the financial service provider. It can also influence the overall provision of financial services in the host country, especially if foreign ownership is highly concentrated.[204]

4.1.1.4.1 Implications for Africa

The effect of withdrawal of the foreign financial institutions from African countries will be the destabilisation of the financial services sector, especially if there is a high concentration of foreign firms. This instability will stem from the social unrest of the

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[203] SOMO, The Risks and Dangers of Liberalization of Services in Africa under EPAs

[204] D. Domanski, Foreign banks in emerging market economies: changing players, changing issues, in BIS Quarterly Review, December 2005, p. 78

customers with deposits in the withdrawing banks. If the financial institutions are listed in the stock exchange, their sudden withdrawal may also cause unrest in the stock market. Share prices are highly likely to go down with the shareholders dumping what they may view as non-viable shares.

4.1.1.5 Loss of supervision and regulatory control

Subsidiaries of foreign banks are supervised by both the home country and host country supervisors that imply good coordination and information exchange between the two authorities, which is not always the case. Because decision-making at many foreign banks is being centralized at the headquarters and in order to reduce costs, many foreign banks just establish branches in other countries.[205]

This is a practice that is reflected in the GATS plurilateral requests. However, branches are only supervised by the home country authorities and subject to foreign financial standards and capital requirements. Because foreign authorities do not have the same objectives and knowledge about the impact on the local economy domestic supervisors lose grip on foreign banks, which can have serious implications.

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Also, less information about a foreign bank's operation in a country is available for the market, the authorities and the public because acquired or merged banks are now longer listed as individual banks and the information of operations per country are incorporated as general figures in the annual report of the internationally operating mother bank. Therefore, bank supervisors often prefer subsidiaries that are legally organized as a domestically chartered bank – which is seen by the financial industry as a restriction they wish to remove in the GATS negotiations. The proponents of Financial Services Liberalization are not for regulation of the financial services industry, saying that Non-discriminatory domestic regulation can have a distorting effect on trade in financial services. In some countries regulation may not permit specific activities or specific products to be offered.

[205] Ibidem, p. 79.

Regulation that is unnecessarily burdensome or lacking in transparency imposes additional costs on business. These kinds of issues are not addressed directly by the GATS' rules on market access or national treatment. Because foreign banks have global strategies that might be less adapted to the local needs of the host countries in which they operate, host country governments have less leeway in directing the development of domestic industries. They might have less influence in making sure that foreign banks integrate economic objectives of the country, let alone integrate sustainable development practices such as no lending to environmentally destructive projects.

4.1.1.5.1 Implications for Africa

Most of the African economies are fragile and therefore the financial services industry needs to be controlled by a regulatory body. The essence of this is to have the regulatory agency direct the growth of the financial services industry to ensure its relevance and benefit to the growth of the whole economy. Lack of regulation of the financial services industry may lead to its growth that is relevant and beneficial to the foreign firms. This will be more pronounced if there is a high concentration of foreign firms in the financial services industry. The regulatory agency may require that a firm keep in mind and integrate the economic objectives of the country. Its absence translates into the foreign firms tailoring their operations and strategy to the satisfaction of the companies' profit motive and ignoring the overall economic goals of the African host countries.

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4.1.1.6 Additional resources needed for regulatory and supervisory measures

The request to commit mode 3 for all financial services sectors and the requests in mode 1 and 2 do not mention that the authorities should have all the necessary regulations and supervision instruments in place for the diverse financial services involved. Experience and research have found that risks of financial instability can only be avoided when there are enough institutions to monitor the financial system and regulate complex financial conglomerates. This is costly and takes time. Each country has its weaknesses that should not be exploited to its disadvantage by the private financial institutions.

Even in the home countries, supervision of the allfinanz conglomerates is not fully operational and adequate yet. The need for supervising financial conglomerates can be seen from the several scandals in the United States that resulted in fines of more than $ 1.5 billion for many of the top financial conglomerates. Another example is the condemnations of practices by Citigroup over the last years in different countries.[206]

The US Federal Reserve has banned Citigroup from making major acquisitions until it has changed its governance.[207]

Citigroup is the largest bank in the world, which is likely to be a major beneficiary of the collective GATS request and has been part of the financial lobby in the WTO.

Also, the international financial architecture has not been reformed so as to be able to prevent a new financial crisis or to act very decisively against a speculative wave; this leaves a heavy burden on regulation and supervision at the national level.

4.1.1.6.1 Implications for Africa

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Most African countries do not have the resources to aptly monitor the diverse financial services that the foreign firms may bring into the domestic market. The set up costs for institutions to keep track of the new services being offered in the market are highly likely to be unavailable for African governments. This therefore means that the probability of new and complex financial conglomerates destabilising the financial industry due to lack of supervision is highly likely in the African economies.

[206] V. Marsh, Australian watchdog attacks Citigroup, in the **financial** Times, 1-2 April 2006, p. 8.

[207] D. Wighton, V. Marsh, B. White, Legal snag on road to reputational rescue, in the Financial Times, 1-2 April 2006, p. 8.

4.1.1.7 <u>The many financial services mentioned in the collective request require monitoring and regulation because they can be risky for the stability of the financial system</u>

Examples of such services are:

•Financial leasing (vii in collective **GATS** request): for instance the leasing of shares has caused serious debt problems by some customers with serious loss of savings. Governments in the West had to intervene to allow for more warning against the risks of leasing.

•All money transmission services (viii): in times of **financial** crisis, governments might need to have a control mechanism to avoid capital flight.

•Derivative products (x (C) -(D)): The key risk to derivatives trade is volatility, unknown spill over effects in different parts of the financial markets and the resulting financial instability. Derivatives are already unregulated, with limited requirements to set aside capital reserves when the deal goes wrong. Liberalization will make it more difficult to control, especially if the two parties of a deal are in different countries. While derivatives allow for risk mitigation, they can be used to bypass regulations by complying with investment rules but taking bets on prohibited assets.

Investment banking (xi): Investment bankers promote mergers and acquisitions without guarantees that the new company leads to value added, while many jobs are often shed. The underwriting of shares does not screen the social and environmental record of companies that will get additional funds. The combination at banks between investment banking and securities advisory functions has in lead to many scandals. In the US, top global banks had to pay more than $ 1bn of fines during the last 3 years because of such scandals.

•Asset management and pension fund management (xiii): lack of regulation in investment banking and securities' trading has lead to irrational investment and a bubble in the stock market, and its bursting at the end of 2001. In different countries, regulators issued new

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laws for pension fund managers to avoid too many losses due to too risky investment in shares. The plurilateral request argues that there "can be advantages" in additional liberalization of securities services in mode 1 and 2 for institutional investors in shares, such as pension funds. But there might be quite some disadvantages for financial instability if they are not well regulated.

In general, foreign firms provide rich clients in poor countries with more opportunities to channel their money to the North and invest in Western companies. The argument that foreign banks will provide capital to their subsidiaries or branches in a country in a financial crisis has not always proven to be so in practice.

4.1.1.7.1 Implications for Africa

African regulatory and supervisory agencies will need a lot of resources and expertise to regulate the above-mentioned financial products. Lack of monitoring will be risky to the financial system, especially to the fragile African economies.

4.1.1.8 Limitations in government regulation

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For the purpose of market access opening, there are a few government regulations and policies under attack in the collective request on financial services: monopolies, numerical quotas, economic needs tests (whose removal was agreed in Annex C of the Hong Kong declaration) and mandatory sessions. These can be measures that help the development of a domestic financial industry and keep financial stability in times of crisis. Especially the economic needs test can be useful as it depends on the situation in a country whether foreign financial services can lead to improvement of the economy.

The collective requests does not go as far as the many European Unions bilateral requests which has long lists of governmental measures that the European Union (read: its financial industry) wants to be removed in each country.

More specifically, this plurilateral request does not go as far as the GATS model for financial services liberalization, i.e. the "Understanding on Commitments in Financial

Services" which also requires WTO members to permit any new financial service that a foreign financial service provider wants to initiate, and which covers mode 4. However, if bilateral negotiations on financial services continue alongside the plurilateral requests, many governmental measures might still be targeted in a non-transparent way.

The collective request mentions that regulators are enabled to protect stability and integrity of the financial system. However, many GATS rules undermine prudential regulations, or are not clear how much protection can be provided:

•GATS articles promote cross-border capital movements and financial instability by limiting government restrictions on profit repatriation (Art. XI) and controls on capital flows related to committed financial services (see Articles XI.1. en XVI (footnote 8). For instance, Chile has been asked by the European Union to do away with its requirement that approval by the Central Bank is needed before dividends can be transferred abroad. Such a Central Bank intervention is not allowed under GATS Art. XI. Footnote 8 of GATS Article XVI ("Market Access") requires that a country which makes a commitment in a services sector, including financial services, to allow all *in*flows and *out*flows of capital that is considered "essential" for (financial) services in mode 1 (e.g. e-banking) and allow *in*flows "related" to mode 3. Thus, countries can only regulate the *out*flow of capital except for mode 1, if they have not already deregulated capital flows by liberalizing the capital account as many developing countries have done.

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4.1.1.8.1 Implications for Africa

The limitation on government to restrict profit repatriation means that the African governments will not be able to control capital flows in and out of their countries even when the economies are susceptible to financial instability. This means that the African countries that have committed their financial services industry to GATS will have to subject their already fragile economies to financial instability that may be occasioned by outflows of capital.

4.1.1.9 GATS rules permitting restrictions on unstable capital flows and financial services are limited by many conditions in Art. XI.2, Art. XII

These conditions prioritise the interests of foreign-service providers rather than the capacity of a developing country to deal with problems in its financial system. As no Emergency Safeguard Mechanism has yet been agreed, the possibility of governments to immediately intervene before a crisis erupts is very limited.

4.1.1.9.1 Implications for Africa

Even when there is a looming financial crisis, African governments that have made commitments under the Financial Services Agreement under GATS cannot take intervening measures due to the conditions laid out in Article XI2 and Article XII of the GATS agreement.

4.1.1.10 Influence by the financial lobby

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The short collective requests ends with requesting transparency in "development" and application of laws. This is an issue that needs to be discussed in the negotiations about Article VI on domestic regulation and not when negotiating plurilateral of bilateral requests among a few WTO members. This demand for transparency comes from the international financial industry that wants to ensure it can lobby rule making in the host country before it is faced with laws to be implemented. Clearly, the European Union's reason to participate in the request is following the wish of its financial industry that wants to expand in order to avoid the limits to growth it faces in the European Union markets. "For European Union financial services companies, the fast-growing emerging economies will become a major source of activity that will help to offset slower growth in the more mature financial services markets" according to the European Commission.[208]

[208] Website of the EC, summary of collective requests: Collective requests in which the EU is participating under the DDA Trade in Services negotiations. Annex. Brussels, 28 February 2006http://europa.eu.int/comm/trade/issues/sectoral/services/pr280206b_en.htm (viewed on 27 March 2005)

This is hardly a perspective in the interest of development and the constituency in developing countries. Even in Europe, the benefits of an ever more concentrating, expanding and share value driven financial industry are not clear. In some countries like the Netherlands, the services provided by the Dutch global financial conglomerates are declining and many jobs are lost (e.g. 10,000 between 2000 and 2004 at ABN Amro). After acquisitions or mergers abroad, they also shed jobs in the host countries.

4.1.1.10.1 Implications for Africa

The influence of the financial lobby in the financial services trade liberalization negotiations will lead to the agreements reached in negotiations being skewed towards favoring the Multinational financial services providers. In order to achieve growth and domination of the African governments, these Multinationals may favor mergers and alliances. As mentioned above this may lead to lose of jobs in the host (African) countries. This is because the Multinationals will be seeking to reduce costs and increase profits.

4.1.1.11 GATS articles promote cross-border capital flows and capital account liberalisation[209]

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Some articles of the GATS agreement play a role in increasing the risks of destabilising financial flows related to foreign financial service providers.

GATS Art. XI.1[210] does not allow countries to restrict international transfers and payments for current financial transactions that are related to services in sectors that were liberalised under the Agreement.

That means, first of all, that a country cannot prevent profit repatriation by Foreign Service providers in sectors in which a country has made GATS commitments. For instance, the EU requests from Chile in the current financial services negotiations that

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[209] Source: M. Vander Stichele, Critical issues in the **financial industry**, SOMO **Financial** sector report, Amsterdam, 2005, p.

[210] Art. XI.1.: " Except under the circumstances envisaged in Article XII, a Member shall not apply restrictions on international transfers and payments for current transactions relating to its specific **commitments**."

Chile eliminates the "restriction" that prior authorization by the Central Bank is required before transferring dividends from Chile abroad because this is in breach of Article XI. Thus, if a country has liberalised the financial sectors, foreign banks and insurance companies can transfer their profits abroad without reinvesting them in the country. In countries that have small economies and/or large foreign investors in all sectors, profit transfers affect negatively the balance of payments and exchange rate.[211]

Moreover, Art. XI.1 has a special effect in relation to financial services provided by foreign banks, insurers, investment bankers and asset managers which have established themselves in countries that made GATS commitments in these services (Mode 3). These financial service providers might view cross-border financial flows as "related to" or essential to their services in cases such as:

•Lending in foreign currency;

•Buying securities abroad to balance the risks in pension fund management or to increase the rate of return of asset management services (e.g. mutual funds) for local clients or insurance companies;

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• Providing investment bank services related to foreign stock exchanges (underwriting shares of domestic firms listed abroad) or related to foreign companies (acquisitions abroad);

• Offering international derivatives; and

• Using international credit risk mitigation mechanisms.

Such cross-border capital flows can go beyond current account transfers and undermine management of the capital account aimed at avoiding financial instability and crises. If certain capital account restrictions frustrate the transactions of committed services sectors, they could be challenged under GATS XI. In countries that have already liberalised their capital account, GATS commitments in certain financial sub-sector will

[211] SOMO, *Challenges for the South in the WTO Negotiations on Services*, 200 www.somo.nl/somo_ned/projecten/Challenges.pdf

increase instable capital flows. They might also discourage reversing capital account liberalisation where considered necessary to avoid financial crises. Developing countries that keep a high level of capital control are not likely to attract foreign financial firms as the latter avoid unpredictable local currency convertibility and capital withdrawals.[212]

4.1.1.12 Market opening in financial services and its impact on international capital movements and financial stability

Article XI of the GATS is intended to guarantee the primacy of IMF rules in the area of international capital movements. Obligations as to the liberalisation of cross-border transactions in the WTO are linked to the commitments to market access included in a country's schedule and are designed to prevent their frustration in practice through restrictions on the capital transactions necessary for their fulfilment. However, the decoupling in the GATS of market opening for financial services from liberalisation of capital-account transactions generally none the less leaves substantial scope for connections in practice. This is most easily seen for the hypothetical example of a country, which enters into commitments to no limitations regarding Modes 1, 2 and 3 for all the activities mentioned in the Annex on Financial Services. To ensure effective implementation of such commitments the country would be obliged to undertake comprehensive liberalisation of capital-account transactions. Moreover a country whose commitments were made through the Understanding on Commitments in Financial Services would also be making an open-ended commitment to the liberalisation of such transactions required by its obligation to "permit financial service suppliers of any other Member established in its territory to offer in its territory any new financial service".[213] Although commitments as to market opening for financial services often carry associated obligations as to the liberalisation of capital transaction, the country making them will have to depend on guesswork for the estimation of the size of the capital movements

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[212] Yun-Hwan Kim, **Financial** opening under the WTO Agreement in selected Asian countries: progress and issues, Asian Development Bank, Economic and Research Department, Working Paper No.24, September 2002

[213] Stichele, M.V., (18 May 2006), Comments and assessment on the Plurilateral GATS request on financial services: Senior Researcher, SOMO

which are likely to ensue.[214] This means that the financial crises that are sparked off by capital movements cannot be anticipated. This is especially true for African countries, which undertake GATS commitments without establishment of strong regulatory bodies. They will be unable to estimate the capital movements that will be triggered by the foreign financial services providers. They will therefore find it difficult to anticipate and prevent financial crises.

The difficulty of reaching estimates here is increased by the pace of change in the financial sector, which is adding to the range of possible transactions under the different modes of delivery of the GATS.[215]

GATS Article XVI ("Market Access") commits a country to allow a number of cross-border flows when it has opened up its market for particular (financial) services: the country must allow *in*flows and *out*flows of capital that are considered "essential" for (financial) services in mode 1 (e.g. e-banking) and allow *in*flows "related" to mode 3 (i.e. foreign services provided by firms established in the country). Thus, countries can only regulate the *out*flow of capital except for mode 1, if they have not already deregulated capital flows by liberalizing the capital account as many developing countries have done.[216]

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So far, the interpretation and impacts of Art. XI.1 and footnote 8 of Art. XVI in relation to financial services are a little discussed area about which experts do not always have a clear answer. This is reflected in discussions that have taken place[217] in the WTO about opening up financial services that do not have a presence in the country but rather provide their services from abroad (mode 1).

[214] On the basis of his personal assessment for the activities in the Annex on **Financial** Services an IMF observer attributes "major importance " to "capital flows for virtually all **financial** services delivered through mode 3 (commercial presence), as such presence by its nature implies some form of cross-border investment". Indeed, the only activities under the heading of banking and **financial** services (excluding insurance) to which he does not attribute such importance are **financial** leasing, provision and transfer of **financial** information, and advisory, intermediation and other auxiliary services. See A.Kireyev, Liberalization of trade in **financial** services and **financial** sector (analytical approach), IMF Working Paper WP/02/138, August 2002, pp. 10-14.

[215] See 214 above

[216] Stichele, M.V., (18 May 2006), Comments and assessment on the Plurilateral GATS request on financial services: Senior Researcher, SOMO

[217] See WTO - Committee on Trade in **Financial** Services, Report of the meeting held on 2 December 2002; IDEM, Report of the meeting held on 26 February 2003.

Financial "products" such as lending of all types and asset management provided by financial firms abroad can have a destabilizing effect because they involve cross-border financial flows in foreign currency. Such cross-border capital transfers could affect the balance of payments and the whole financial stability of a country.

4.1.1.13 GATS articles undermine measures to deal with destabilizing capital flows

Financial authorities need to have the capacity to carefully monitor changes in cross border capital flows that result from financial services liberalisation. They may want to take measures to prevent too much financial instability, especially in small countries where swift flows can have a major impact. But GATS rules do not only influence what cross-border capital flows are permitted; they also influence how restrictions on those flows are managed.

Formally, GATS does not prevent any country from taking prudential measures to protect depositors, investors or to ensure the integrity and stability of the financial system.

Art. XI.2. States *"nothing in the GATS agreement shall affect the rights and obligations of the members of the international Monetary Fund under the Articles of Agreement of the Fund"*. This legitimises controls over capital transactions since the IMF's articles continue to permit policy autonomy regarding such controls.[218]

These rights and obligations, however, are subject to the condition that "*a member shall not impose restrictions on any capital transactions inconsistently with its specific commitments regarding such transactions"*. In other words, IMF rights cannot undermine GATS commitments.[219]

WTO members are allowed to not apply Art. XI.1-2. In case of serious balance of payment problems,

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[218] SOMO, *Challenges for the South in the WTO Negotiations on Services*, 200 www.somo.nl/somo_ned/projecten/Challenges.pdf

[219] See 189 above

Art. XII allows countries to restrict their market opening in (financial) services sectors (financial or other services sectors) for which they made liberalisation commitments, and to restrict cross-border money transactions related to committed sectors. However, a country that invokes these restrictions is bound to fulfil a number of conditions, including:

• Use criteria of non-discrimination and least-harmful effects on foreign service providers;

• Be consistent with the Articles of the IMF;

• Limit the period the measures are in place;

• Undertake consultations with WTO members.

Ultimately, the assessment of the IMF of the financial situation of the country determines whether the restriction measures are to be allowed (Art. XII.5.(e)).[220]

4.1.1.14 GATS articles undermine prudential measures and regulations

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The vagueness of financial prudential measures permitted by GATS, e.g. in the prudential carve out integrated in the GATS Annex on Financial services, leaves many developing countries' regulations open to challenges by WTO disputes. This uncertainty about the interpretation of some GATS rules could result in countries refraining from introducing national legislation for fear of future WTO disputes. The major problem is how, during the (bilateral) negotiations on financial services, some governmental measures will be identified as trade restrictive and be removed in the commitments or some rules will be allowed and considered as being prudential. The European Union bilateral requests are targeting many governmental measures whose interpretation is left to the power games and bargaining of the negotiations. These issues are very much ignored in the collective requests

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[220] SOMO, *Challenges for the South in the WTO Negotiations on Services*, 200 www.somo.nl/somo_ned/projecten/Challenges.pdf

Art. 2 of the GATS Annex on Financial Services permits domestic regulations and prudential measures that protect a country against financial instability and foreign exchange exposure.

This article does not define prudential measures but stipulates that such measures are authorised to contravene other GATS provisions ("prudential carve-out"). However, the article states that prudential measures should not be used to avoid market openings or obligations under the GATS agreement.

These conditions attached to the prudential carve-out measures may prevent countries from taking measures, which, while contravening GATS commitments, are nevertheless the most effective for dealing with financial instability.

The vagueness of what a prudential regulation may entail allows a WTO member to challenge a measure of another WTO member as being not a prudential measure, but rather a way to avoid GATS commitments or obligations. For instance, Western countries robustly challenge prudential measures by China during current negotiations and WTO reviews with the argument that they undermine financial services commitments.[221]

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In case of disputes brought before the WTO, a panel must in such case decide what prudential measure is permitted or trade restrictive to the foreign financial industry**.**

Although the GATS Annex on Financial Services (Art. 4.) specifies that a panel must have the financial expertise necessary for the dispute, still, central banks and other regulators lose their full freedom to impose the prudential regulations they see as essential.[222]

[221] SOMO, *Challenges for the South in the WTO Negotiations on Services*, 200 www.somo.nl/somo_ned/projecten/Challenges.pdf

[222] Stichele, M.V., (18 May 2006), Comments and assessment on the Plurilateral GATS request on financial services: Senior Researcher, SOMO

4.1.1.14.1 Implications for Africa

African countries will avoid disputes in the WTO due to the cost of the dispute settlement exercise and their lack of expertise in handling dispute settlement. African countries also want to avoid retaliatory measures taken by their more developed and powerful trade partners if they (African countries) violate any GATS provisions. Therefore they will be hesitant to implement the unclear financial prudential measure lest they violate the other GATS provisions and end up in dispute settlement at the WTO. .

4.1.1.15 CONCLUSION

The concrete experiences of liberalisation of financial services and the lessons learned from their role in financial crisis need to be at the basis of the decisions by WTO member states about financial services liberalisation, not the interests of the global financial industry**.** Liberalisation of financial services of developing countries needs to be gradual and well sequenced. The plan for instance of Malaysia to do so over a period of 10 years needs to be respected, and not be challenged by a collective or bilateral GATS request. There needs to be coordination between the trade negotiators and the institutions responsible for the stability of the national and international financial system, which is now lacking for instance in some European countries.

The limitation of policy space due to GATS rules needs to be taken into account in the negotiations. In countries where the domestic financial sector needs improvement or is not yet capable of competing with foreign competitors, GATS articles XVI, XVII and VI limit the government's ability to make this a priority. Governments can set out exemptions to GATS articles that would allow regulators and central banks to maintain their policy space. However, the negotiations on the plurilateral and bilateral requests on financial services will put pressure to limit these exemptions as much as possible.

Last, but not least, there is little proof in the literature that binding liberalisation of services in trade agreements leads to additional investment in the committed sectors

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5.0 CHAPTER 5

5.1 Africa's path in the GATS negotiations

African countries should make informed decisions when liberalizing services under GATS. They should make wise decisions on which sectors to liberalize or bind and push for reciprocal actions from WTO members. This would be the service industries that enjoy little or no protection. This therefore means that the African countries that have little or no protection of their financial services industry should take this first step.

Some of the specific issues that African governments could pursue in order to maximize its interests in International trade in services include making commitments on those sectors where the country itself stands to gain from transfer of technology for the benefit of producers and consumers, through lowering of the costs of supplying the services.

In the medium term, there are, however, service areas that will require some restrictions on foreign suppliers and investors so as to allow domestic firms to restructure and prepare themselves to face global competition. This is the case especially in those sectors where there are a considerable number of domestic players already involved in the supply of the concerned services. Some of the sectors in Africa that are likely to benefit from such restricted access include financial, insurance and transport services. Some of the conditions could be in terms of the cadres of the labor force that should be confined to nationals, proportional shares that can be held by foreign investors in joint ventures for a given period of time, and setting aside parts of the country for the exclusive operation of local suppliers. A good example of the latter would be restricting provincial and district air transport market to local firms that is already being implemented in the country. [223]

African countries' long term plans to liberalize service provision should be characterized by the following underlying objectives in certain sectors and sub sectors

- Attraction of foreign investment (employment)
- Foster competition (efficiency)

[223] Njikeu, D., "Options for Africa's Priorities in WTO and EPA Services Negotiations, Negotiating Brief No. 7, April 2005.

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- Broaden product choice and improve quality (consumer welfare) [224]

On the other hand, the other underlying objectives in undertaking limited liberalization or total exclusion of certain sectors or sub sectors to:

- Prevent market congestion
- Promote transfer of technology (joint venture requirements)
- Prevent market disruption (phase in commitments); this would be especially important in the distribution services

It is necessary for African countries to commit some service sectors but to retain some of the flexibility and restrictions allowed under GATS, to enable the countries to take advantage of the prevailing opportunities. Some of the restrictions could include transfer of technology and training conditions. GATS also allows developing countries to liberalize in a seek Special and Differential Treatment (SDT) with other partners.[225]

It should be borne in mind by African countries that Articles IV and XIX of GATS contain special provisions reflecting the interests of the developing countries. In considering progressive liberalization, GATS provides that there shall be appropriate flexibility for developing countries (especially Least Developing Countries-LDCs) for opening fewer sectors, liberalizing fewer types of transactions, progressively extending market access in line with their development situation and, when allowing access to their markets to foreign service providers, attaching conditions aimed at:

- Strengthening their domestic services capacity and its efficiency and competitiveness, including access to technology on a commercial basis;
- Improving their access to distribution channels and information networks; and
- Liberalizing market access in sectors and modes of supply of export interest to them.

[224] Njikeu, D., "Options for Africa's Priorities in WTO and EPA Services Negotiations, Negotiating Brief No. 7, April 2005.

[225] See 224 above

5.2 Technical support

An aspect of an offensive strategy that African countries can pursue aggressively is getting firm commitments for technical support. It is apparent that regulatory capacity is limited. Given that a lack of regulatory capacity is commonly seen to impede the benefits of liberalization and is one reason of a gradualist approach, getting a commitment to support regulatory capacity should be easy enough to justify. It may also be strategic to specifically link any pre-commitment to reform to targets in capacity building by the more developed countries. This will ensure that any failure on the part of the developed countries to deliver on the commitments to build African countries' capacity as provided for in GATS Article IV will be met by failure to stick to liberalization process.[226]

In the area of capacity building in Africa, market access requirements may include transfer of technology and managerial know how through partnerships between local environment firms and foreign firms, training of personnel, minimum local content requirement. In addition there should be

- Ongoing support for core functions: There are certain functions that are core to regulatory oversight exercise that occur on a repetitive basis. These would include setting price controls, monitoring adherence to legislation, assessing anti-competitive behavior and resolving disputes. These types of functions need to be conducted by regulatory staff and require building of in-house capacity. By implication, the type of technical support would include training and some in-house support to ensure that staff is able to support the application of the theory to the practical case of Kenya. This type of support must be on-going because of the turnover of staff experienced.[227]
- Once-off technical support: there are also a number of regulatory functions that are only performed sporadically and do not necessarily require specific in house regulatory capacity.[228]

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[226] Abdi N.H. (LL.D), "Assessment of EU's interests in Exports of Services into Kenya and ESA in General under EPAs (May 2005), Analytical Paper on Services
[227] See 226 above
[228] Abdi N.H. (LL.D), "Assessment of EU's interests in Exports of Services into Kenya and ESA in General under EPAs (May 2005), Analytical Paper on Services

- Development oriented technical assistance: this could focus on infrastructure development, i.e. in the telecommunication sector

At the political level, African countries should jointly give a call for a "standstill" for any new commitments from their side are concerned. Such a call will be fully justified because African countries will need complete data to make informed assessment of the concessions to be made or received in the negotiations. There are other equally strong grounds reinforcing the assertion. The mandatory review of the trade review of the trade in Article XIX: 3 of GATS that has to take place prior to the negotiations have not yet taken place. A prior meaningful review is crucial to African countries as it expected to assess the extent to which the operation of GATS has fulfilled the development objectives and realized preferential and special treatment in favor of developing countries specified in various articles of GATS. Such an assessment will not be meaningful unless adequate and direct statistical data on trade in services are available.[229]

An aspect of an offensive strategy for Kenya is to insist on the issue of creation of adequate safeguard measures to ensure that development goals are not destroyed by liberalization. More importantly, safeguard provisions such as those in Articles X, XV and XII of WTO, which are crucial to developing countries, cannot be effectively operational in the absence of statistical data. Negotiations on the rules and procedures to be made under safeguard provisions are not yet over. In such a situation, fresh commitments would expose African countries to avoidable dangers and even irreparable damage.[230]

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5.3 Proposals For Special Safeguard Measures

5.3.1 Overview

A safeguard has been described as a mechanism that can be invoked by governments, under specific conditions, to impose or increase protection in order to relieve, on a temporary basis, difficulties or pressures that have risen as a result of liberalization

[229] Raghavan C., " Comment On The New Round Of Services Negotiations," Paper presented at a Seminar for Developing Countries Organised by Third World Network, March 2001.
[230] See footnote 229 above

commitments and obligations undertaken in trade agreements. The main features of a temporary safeguard are that it targets a specific product or industry, is applied on an MFN basis, is of limited duration, and is sometimes progressively liberalized over the period of its application, and in some cases is subjected to demands for compensation from other members affected by the measure. Another key element of this type of measure is that increased imports resulting from the liberalization must be causing or threatening to cause "injury" to domestic producers of a like or directly competitive product.[231] Examples of this safeguard can be found in GATT Article XIX, in the Agreement on Safeguards, in Article 5 of the Agreement on Agriculture and in Article 6 of the Agreement of Textiles and Clothing.

Historically, the existence of emergency safeguard measures in trade agreements was viewed as a mechanism to help persuade domestic constituencies to accept greater liberalization. It also provides some insurance for domestic industries fearing difficulties in adjusting to new competitive realities following liberalization. The main role of safeguard clauses is to allow officials to address opposition to liberalization by pointing to the availability of a mechanism to suggest that " defensive" interests have been taken into account. [232]

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Developing countries have emphasized the need for the disciplines on EMS in the context of the mandated negotiations under GATS Article X. owing to its temporary nature, imposing a window of time for implementing necessary adjustment by local suppliers of services and to address employment concerns. ESM becomes a means to deflate opposition to liberalization while possibly allowing an opportunity for affected industries to restructure. The importance of ESM is based on the understanding that liberalization involves adjustments costs and recognizes that imperfection in factor mobility may negatively affect resource allocation. ESM would apply in cases where surges of imports, as measured by value or volume, threaten to cause injury to a domestic sector or provider. They would address the supply of new service or service suppliers or for expanding

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[231] Pierre Sauve, " Completing the GATS Framework, Safeguards, Subsidies and Government Procurement," in Hoekman Bernard, Matoo Aatiya and English Philip, Development, Trade and the WTO, a Handbook, The World Bank 2002, pp 326-335.

[232] Raghavan C.,"A comment on the New Round of Services Negotiations," Paper presented at a Seminar for Developing Countries Organized by Third World Network, March 2001

supply (new branch or contract) for those already present in the country applying ESM.[233]

5.3.2 Proposed Special Safeguards for Africa

It is paramount for African countries to make sure that in the GATS negotiations ESM is an integral part. In the services context, the initial problem is the definition of imports, given that there are four modes of service delivery. Mode 1, cross-border trade, does not pose particular conceptual difficulties because there is an "import" in the traditional sense and the limitation on trade can take the form of constraining the sales of foreign services suppliers in the foreign country. For mode 2, the "import" transaction takes place in the exporter's market, and it is the customer that crosses the border to consume services abroad. In mode 3, the situation is even more complex since the transaction involves the establishment of the service supplier in the importing country. There is a dual dimension to the "importation" issue: the establishment of a commercial presence in a host country and the sales or domestic operations of the established foreign supplier. The former may be dealt with via a limitation on foreign investment, but the latter cannot be conceptually considered as an "import". As regards mode 4, the application of the concept of "import" to movement of persons appears rather incongruous. It has been suggested that the use of an economic needs test represents a form of a safeguard measure, since it relates directly to the capacity of the host country to absorb the additional entry of foreign personnel.[234]

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Since the traditional purpose of an ESM is to provide short-term import relief to the domestic industry, the right to bring a complaint should be that of the "domestic industry." In the services context, the domestic industry could be composed of domestic service suppliers that have established a commercial presence or both. In this case, the question arises as to whether the term "domestic industry" should include all services suppliers within the territorial limits of a country or whether the locally established

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[233] Abdi N.H. (LL.D), "Assessment of EU's interests in Exports of Services into Kenya and ESA in General under EPAs (May 2005), Analytical Paper on Services

[234] Abdi N.H. (LL.D), "Assessment of EU's interests in Exports of Services into Kenya and ESA in General under EPAs (May 2005), Analytical Paper on Services

services suppliers of foreign companies should be excluded. If locally established Foreign Service suppliers are excluded, negotiators must then consider the ramifications of classifying their services as "imports" and thereby making them subject to whatever safeguard measure that is imposed. In addition, the exclusion of foreign suppliers established in the domestic market raises the obvious problem of national treatment.[235]

If an ESM is to be negotiated, a new approach would be needed that would better reflect the intricacies of GATS, in particular those arising from the multiplicity of modes of supply; that would more appropriately relate to conditions of competition in services trade; and that would better balance the various interests at play. [236]

Countries that have shown skepticism about the needs for a GATS ESM have repeatedly argued that data for services industries, particularly in developing countries, are too incomplete and unreliable to establish either injury or causation. As a result, any safeguard could be prone to abuse and could result in repeated WTO challenges.

The data problem has implications in more than one respect, in relation to the implementation of the provision of GATS as well as for the periodic rounds of negotiations for services liberalization: for implementing emergency safeguard measures under Article X of GATS and presumably one criteria to justify a safeguard action would be an objective one based on data about the need for a safeguard, for judging injury to the domestic service suppliers as a result of subsidies.[237]

The data issue is an important not merely for liberalization process but also in terms of the issue of safeguards. A country seeking to apply safeguards may find itself forced to justify its actions by demonstrating that increased imports are responsible for causing injury to its domestic industry. This cannot be done without proper data. Therefore, before African countries undertake any more commitments, the issue of data also needs to be addressed, and agreement reached for collection at national levels and international levels and collation of service data in all four modes of supply. In the meanwhile, African

[235] See 234 above

[236] Abdi N.H. (LL.D), "Assessment of EU's interests in Exports of Services into Kenya and ESA in General under EPAs (May 2005), Analytical Paper on Services

[237] See 235 above

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countries, central banks and other regulatory authorities need to undertake some studies of their own for national data estimations [238]

Without adequate expert studies, an emergency safeguard agreement could easily create further imbalances; it is easy to apply such safeguards in respect of the fourth mode of supply (movement of natural persons), but a host of problems may arise in respect of the third mode (commercial presence).

The foregoing discussions suggest that an ESM would be difficult to transpose to a services context. A safety valve could well support liberalization commitments by addressing the concerns of service providers' with regard to opening their fledging service markets to outside competition. The challenge is to ensure that any ESM makes economic sense. One way to do this would be to require public interest criteria and to ensure that all stakeholders are given a voice.

It is worth mentioning that the developed countries are against the creation of ESM in the services industry; therefore African countries' fallback position would be to negotiate for longer timeframes for liberalization of services or invoke GATS articles that are pro development and flexible thus giving policy space to the African countries.

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Phased opening up, possibly complemented with measures that could smooth the transition to a more open environment, can allow the domestic industry to adjust to the new environment. It can also accommodate some issues of political economy. Mexico committed to a phased opening up, which included progressive market capitalization arrangements that could modulate the growth of foreign participation in the sector in the event of overly rapid foreign penetration. Mexico was permitted, under agreed conditions, to temporarily halt the entry of new foreign participation. In practice, the market caps were never reached and Mexico has subsequently liberalized its foreign entry fully.[239]

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[238] Raghavan C.,"A comment on the New Round of Services Negotiations," Paper presented at a Seminar for Developing Countries Organized by Third World Network, March 2001.

[239] Stijn Claessens, (World Bank) and Marion Jansen, (World Trade Organization), "The Internationalization of Financial Services: Issues and Lessons for Developing Countries,"(2000)

In general, it has been recognized that a phased approach, possibly with market capitalization arrangements and safeguards over agreed time periods in the event of pronounced economic balances, may be a useful part of the GATS.[240] Safeguards were included, for example, in NAFTA for Mexico. If adverse effects were to arise when the share of all commercial bank assets held by foreign-owned banks exceeded a certain threshold, Mexico could request consultations to limit entry. Adverse effects included those associated with a threat to the control of domestic payments, and to the independence of Mexican monetary and exchange rate policy.[241] In the case of Bulgaria's WTO accession agreement, in return for strong commitments to market access and national treatment, commitments were safeguarded in order to address specific adjustment concerns.[242] In the end, none of these provisions have been used. But there can be specific country experiences where it would be useful to commit through international agreements to a phased program of opening up over some agreed time frame [243]

The aforementioned discussions would be apt as a position that African countries should adopt in the FSTLN. Specifically, the following should guide the concerned when negotiating the liberalization of the financial services industry:

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- The unique situation in each country needs to dictate the pace and the path of liberalization most suitable to the circumstances.
- Benefits from privatization and liberalization are not automatic; the appropriate preconditions need to be established through appropriate regulations, entrepreneurial and technological capacity building and complementary policies.

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240 See 239 above

241 Stijn Claessens, (World Bank) and Marion Jansen, (World Trade Organization), "The Internationalization of Financial Services: Issues and Lessons for Developing Countries,"(2000)

242 see 241 above

243 Raghavan C.,"A comment on the New Round of Services Negotiations," Paper presented at a Seminar for Developing Countries Organized by Third World Network, March 2001

- Governments should have flexibility to introduce measures and regulations to redress any unexpected problems that may occur when undertaking liberalization commitments.
- Adjustment costs to liberalization need to be taken into account.

5.3.3 The Path that African Countries should take in Financial Services Liberalization under GATS

It is useful to distinguish three types of financial liberalization, and to delineate the scope of each.

- *Domestic financial deregulation* allows market forces to work by eliminating controls on lending and deposit rates and on credit allocation and, more generally, by reducing the role of the state in the domestic financial system.
- *Capital account liberalization* removes capital controls and restrictions on the convertibility of currency.
- *Internationalization of financial services* eliminates discrimination in treatment between foreign and domestic financial services providers, and removes barriers to the cross border provision of financial services.[244]

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Internationalization can help countries build more robust and efficient financial systems by introducing international practices and standards; by improving the quality, efficiency and breadth of financial services; and by allowing more stable sources of funds. Given the state of institutional development of many countries' financial systems, these benefits could be substantial.

The extent of these benefits, and the costs of internationalization depend, to a great extent, on how it is phased in with other types of financial reform, particularly domestic financial deregulation and capital account liberalization. Many countries which had successful experiences (Argentina, Spain, Ireland, Portugal and others) opened up to foreign financial firms while also engaging in a process of rapid domestic deregulation

[244] Stijn Claessens, (World Bank) and Marion Jansen, (World Trade Organization), "The Internationalization of Financial Services: Issues and Lessons for Developing Countries,"(2000)

and, consequently, reaped substantial gains[245]. The experience of the EU, in particular, suggests that internationalization and domestic deregulation can be mutually reinforcing. Increased foreign entry bolsters the financial sector framework creating: a constituency for improved regulation and supervision; better disclosure rules; and improvements in the legal and regulatory framework for the provision of financial services. It also adds to the credibility of rules.[246] These benefits of opening up to foreign entry follow from top-down actions on the part of government, as well as from bottom-up pressures from the market as best international practices and experiences are introduced.

The two reform processes (internationalization and domestic financial deregulation) are mutually reinforcing, but they are not sufficient in themselves. More than in other sectors, the gains and costs of internationalization depend on the regulatory and supervisory framework, which often needs to be adapted.[247] Experience shows that it is vital to strengthen the supporting institutional framework in parallel with domestic deregulation and internationalization; this is particularly true of the regulatory and supervisory functions of the state but it also applies to the use of the market in disciplining financial institutions[248] (especially through better information and greater disclosure, and improved standards for the governance of financial institutions).

The need to strengthen the supporting institutional framework is even more obvious when it comes to capital account liberalization. Experiences in recent years have shown that achieving the potential gains, and avoiding the risks, of capital account liberalization depend to a great extent on the domestic incentive framework being in place for financial institutions and the strength with which regulations are enforced. The experiences in this volume underline the potential benefits of foreign financial institutions in stabilizing capital flows. Therefore, African countries should by all means ensure that strong supervisory and regulatory institutions in the financial services industry to ensure stability of the said sector. The importance of an adequate legal and incentive framework, including prudential regulation and supervision cannot be over emphasized.

[245] Levine, Ross (1997), "Financial Development and Economic Growth: Views and Agenda." Journal of Economic Literature, 35:688-726, June.
[246] See 245 above
[247] Key, Sydney (2000), "GATS 2000: Issues for the Financial Services Negotiations",forthcoming in American Enterprise Institute Series of Sectoral Studies on Trade in Services, Washington, D.
[248] see 247 above

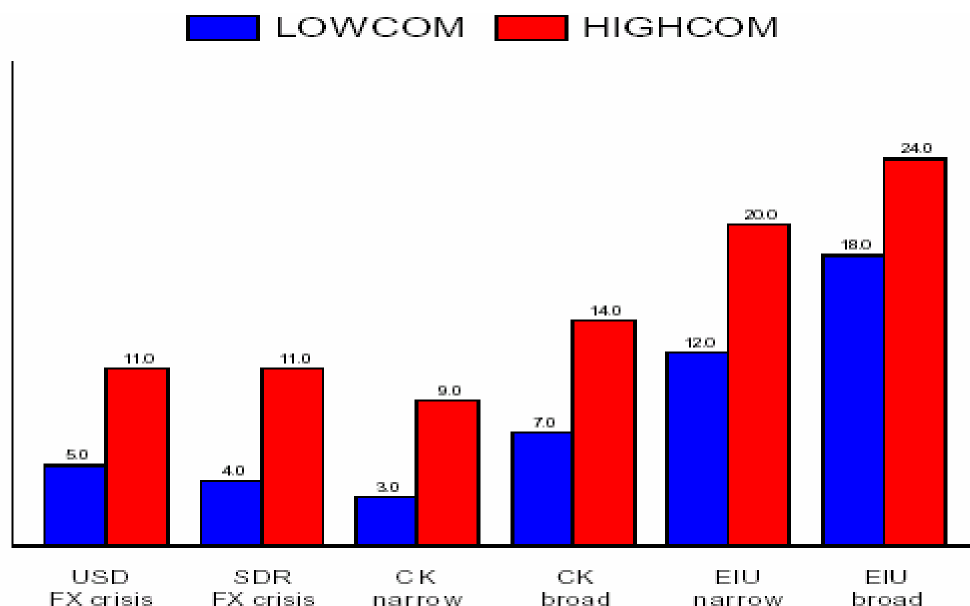
Several countries with significant foreign presence benefited from the access of these institutions to foreign capital during periods of economic presence. More generally, the studies show that foreign presence can lead to a stronger regulatory and supervisory framework, thus making the processes of capital account liberalization and internationalization mutual reinforcing.[249]GATS does not limit, in any way, the prudential measures authorities may wish to use "for the protection of investors, depositors, policy holders or persons whom a fiduciary duty is owed" or "to ensure the integrity and stability of the financial system" regardless of any other provision of GATS. (see further Key, 2000). Further, the GATS explicitly includes a balance of payments safeguard that allows the member to impose temporary restrictions that suspend its of commitments - on a nondiscriminatory basis - in the event of "serious balance-of-payments and external financial difficulties or the threat thereof."

Nevertheless, as a consequence of incomplete legal frameworks, a lack of the skills needed for financial system supervision, and poor market discipline, developing country authorities, and other domestic agents, may find it difficult to monitor the more complex financial system resulting from opening up. In these cases, which likely call for improved domestic measures anyhow, it can be important to improve monitoring effectiveness by taking additional measures. It is therefore vital for African countries to improve their skills base to be able to monitor the financial system and to also develop legal frameworks that can fully address the financial services industry and its likely changes due to liberalization. Adequate financial sector regulation is necessary to deal with the potential problem of bank failure and systemic distress.

5.3.4 Low versus High GATS Commitments

The Figure below shows the number of crises for low- versus high-commitments countries.

[249] Key, Sydney (2000), "GATS 2000: Issues for the Financial Services Negotiations",forthcoming in American Enterprise Institute Series of Sectoral Studies on Trade in Services, Washington, D.



As can be seen, when commitments are high, there appear to be twice as many crises compared to the situation when commitments are low, a conclusion that seems robust with respect to the definition of the crises (except for the EIU-broad definition of banking crisis, the difference is less pronounced: 24 versus 18). This seems to indicate that, if there is any impact of the WTO commitments on financial stability, it will be negative: higher commitments will be associated with a larger probability of crisis. To see whether this result holds, the issue will be investigated econometrically, using a variant of the extreme bound tests typically found in the economic growth literature.[250]

Cross border trade is highly likely to lead to more volatility and a higher likelihood of a financial crisis than commercial presence. This is due to the frequent movement of capital across borders in the former as compared to the latter.[251]

The OECD and countries in East Asia and Eastern Europe are found to have more liberal commitments, whereas Latin American and South Asian countries have lower average commitments. Subsequently, it was investigated whether there were any variables that explained a country's choice of commitments levels.

[250] Sala-i-Martin, Xavier (1997), *I Just Ran Four Million Regressions*, NBER Working Paper no. 6252, November, 21 page

[251] Aizenman, Joshua (2002), *Financial Opening*: *Evidence and Policy Options*, NBER Working Paper no. 8900, April, 27 pages

Several macroeconomic variables, such as economic growth, inflation and openness, banking performance, size and institutional variables were found to have some explanatory power.

Countries with a higher economic growth, a negative growth in the banking sector and with restrictive actual policies were found to have lower liberalization commitments, sustaining an argument of protectionism and a signaling effect of actual policies. There are also clear peer group effects, in the sense that countries from the same region or income group opt for a similar level of commitments. Finally, the contribution of these commitments to the occurrence of financial instability was examined. Casual evidence indicated that a larger number of crises occurred in high-commitments countries. This claim was checked by using a variant of extreme bounds tests.[252] Econometric evidence indicates that the commitments indicators did not have a strong statistical impact on financial crises, although there were signs that the more liberal the commitments, the more likely financial stability was threatened, in line with earlier evidence on the effects of financial liberalization on financial fragility.[253] If the commitments favored commercial presence (mode 3) over cross-border supply (mode 1) of financial services, this would tend to increase the likelihood of banking problems, but reduce the risk of a currency crisis. The former was explained by the negative and possibly short run effects of greater international competition on domestic financial institutions and the latter was motivated by the need for more comprehensive liberalization of capital flows under mode 1, which could give rise to an increased risk of volatile and destabilizing capital outflows. Finally, the evidence suggested that countries have been successful in preventing banking crises if they had more restrictive banking services commitments.[254] This would suggest that African countries that have not made deep commitments should not do so; they should be conservative in their liberalization approach.

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[252] Nguyen, H. and Hodler, R., Trade Liberalization and Financial Stability, A Literature Survey, World Trade Institute, Bern,May 2006

[253] Demirgüc-Kunt, Asli, Enrica Detragiache (1998), *Financial Liberalization and Financial Fragility*, IMF Working Paper 98/83, June, 36 page

[254] See 253 above

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5.3.5 A Graduated, Sequenced Approach to Financial Services Industry Liberalization

In his study, Honohan analyses the effects of financial sector liberalization in Greece and Portugal, countries that had highly regulated financial sectors prior to the introduction of the EU Single Market. He stresses that these experiences are of interest to developing countries as these two countries were the least prosperous members of the European Union, and had banking systems that had much in common with those in developing countries. In the mid-eighties, the banking systems of both countries operated under a regime of high reserve requirements and binding quantitative credit controls.[255] Most of the banks were government owned or controlled, and a large volume of doubtful and non-performing assets had accumulated for several of them. Interest rates were also subject to administrative control, contributing to the net effect that banking, as a whole, was unprofitable and weak in its capital structure. Both countries' financial systems operated behind exchange controls.[256]

In Greece, the structural changes started in the mid-eighties and included the lowering of reserve requirements and the freeing of interest rates. These changes led to significant entry of new banks, though only few of them were foreign. The sector continued to be dominated by a few state-controlled banks, with many non-performing loans and overvalued equity holdings.[257] It was not until the 1990s that the authorities decided to re-capitalize these banks, but the large banks remained under state control, and only a few small state owned banks were privatized. For these and other reasons, Greece is a case of incomplete liberalization that has also led to difficulties of monetary control.[258] Nevertheless, liberalization allowed the Greek financial sector to expand and modernize to some degree.[259]

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[255] Honohan, "Consequences for Greece and Portugal of the Opening-Up of the European Banking Market"

[256] Honohan, "Consequences for Greece and Portugal of the Opening-Up of the European Banking Market"

[257] Honohan, "Consequences for Greece and Portugal of the Opening-Up of the EuropeanBanking Market"

[258] See 257 above

[259] Honohan, "Consequences for Greece and Portugal of the Opening-Up of the European Banking Market"

The reforms introduced in Portugal were more drastic and successful. Changes were brought about progressively over a period of ten years, starting with the admission of new banks (foreign and domestic) in 1983. The removal of interest rate controls, credit ceilings and other controls (on branching, for instance) began in 1988, while privatization of nationalized banks started in 1989. These processes were accompanied by a strengthening of the legislative framework. Exchange rate controls were not abolished until 1993. The reforms led to significant entry into the banking sector. The role of foreign banks remained minor however, partly because they could not participate in the privatization of the large banks. Initially, net interest margins increased, but then dropped rather sharply. Another positive effect of the entry was increased product innovation, which lowered borrowing costs, especially for certain low-risk consumers, and led to a better-developed mortgage market.[260]

African countries can borrow from the Portuguese and Greek experiences of a well-sequenced liberalization process leading to a beneficial liberalization process for the country. This is especially true of the Portugal scenario. It is vital that African countries do not take on liberalization commitments that are too deep in too short a time. The commitments should be few and manageable to enable monitoring and evaluation of their impact and to come up with measures to counter any negative effects.

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[260] Honohan, "Consequences for Greece and Portugal of the Opening-Up of the European Banking Market"

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