

THE LIBERALIZATION AND REGULATION OF TRADE IN
FINANCIAL SERVICES:
EXERCISING DOMESTIC REGULATORY AUTHORITY

by

Guy V. T. Gensey

Submitted in partial fulfillment of the requirements
for the degree of Doctor of Philosophy

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Dedicated to my father, Victor Thomas Gensey.

Without his unconditional support,
this dissertation, and so much more
would never have happened.

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Abstract

The Uruguay Round of multilateral trade negotiations was completed at the end of 1993 and established the World Trade Organization (WTO) and the General Agreement on Trade in Services (GATS). Financial services, including banking, insurance, and securities, are now covered under the Financial Services Agreement (FSA) of the GATS, which oversees the exchange of these services between countries. Creating a comprehensive multilateral agreement in financial services proved challenging, reflecting the growing complexity of financial sector issues in more developing and emerging economies.

This dissertation provides an overview of trade in financial services and evaluates the benefits and drawbacks of the process of liberalization under the FSA. The process is examined in Canada, India, and Singapore, and provides three conclusions. First, liberalizing trade in financial services is a separate process from opening up to more capital flows. This tends to remove it from the criticisms that are often directed at pushing financial deregulation too far and too fast. Second, the GATS raises some special concerns because its rules can affect domestic financial regulations, and the control that governments retain over them. It accounts for this by allowing countries to liberalize only where they choose, and providing the necessary economic safeguards to do so. WTO Members thereby retain a high degree of self-determination in their capacity for prudential regulation and their ability to control their pace of liberalization. Finally, the importance of the FSA has thus far been largely political and structural. There has not been major pressure on countries to liberalize, and the process is more likely conditioned by the domestic factors where it is occurring. Its significance therefore lies in making an effective start, and continuing the relatively new process of liberalizing trade in financial services, without adding unnecessary economic risks.

Abbreviations

ACU	Asian Currency Units
ASEAN	Association of Southeast Asian Nations
ATM	Automated Teller Machine
BCCI	Bank of Credit and Commerce International
BIS	Bank for International Settlements
CDIC	Canada Deposit Insurance Corporation
CPF	Central Providence Fund
DBS	Development Bank of Singapore
DFAIT	Department of Foreign Affairs and International Trade
EOI	Export Oriented Industrialization
EU	European Union
FDI	Foreign Direct Investment
FLG	Financial Leader's Group
FSF	Financial Stability Forum
FSA	Financial Services Agreement
FSP	Foreign Service Provider
FTA	Free Trade Agreement (Canada-United States)
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GSP	Generalized System of Preferences

IAIS	International Association of Insurance Supervisors
IASB	International Accounting Standards Board
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
ISI	Import Substitution Industrialization
LDC	Lesser Developed Country
MAS	Monetary Authority of Singapore
MFN	Most Favoured Nation
MNC	Multinational Corporation
MTI	Ministry of Trade and Industry (Singapore)
NAFTA	North American Free Trade Agreement
NGO	Non-Governmental Organization
NT	National Treatment
OECD	Organization for Economic Cooperation and Development
OSFI	Office of the Superintendent of Financial Institutions
PAP	People's Action Party
QR	Quantitative Restriction
RBI	Reserve Bank of India
SAR	Special Administrative Region (Hong Kong)
SEBI	Securities and Exchange Board of India
TPR	Trade Policy Review
WTO	World Trade Organization

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CHAPTER 1

Introduction

“Trade and production ... are driven by the demand and imagination of *individuals* responding to market opportunities and desires. Government’s role is to regulate the resulting flow of goods and services. Trade agreements do little more than reduce the scope for arbitrary and discriminatory regulations and for unproductive interference in market-based decisions. Concern about the impact of such agreements on sovereignty is perhaps overwrought and misplaced.”¹

Section I: General Overview

Almost all areas of economic activity today are fundamentally linked to banking, insurance, and other financial services. Financial services thus represent a very large and growing part of the economies in both developed and developing countries. The financial services sector has experienced rapid growth in recent years as a result of the deepening of the international financial markets, largely due to globalization. This includes, for example, technological innovations like rapid electronic data transfer between national networks and the increasing number of participating markets in Europe and Asia. Modern communications capabilities also tend to blur the boundaries between services suppliers and consumers and increase the proximity of these actors. These changes have profound implications for the international trade regime, which oversees the exchange of goods and services across borders, and in certain cases, through direct service in foreign markets.

This dissertation examines the process of the liberalization of trade in financial services through the General Agreement on Trade in Services (GATS), under the auspices

¹ Hart, Michael, (2002), A Trading Nation: Canadian Trade Policy from Colonialism to Globalization, 8.

of the World Trade Organization (WTO). In doing so, it seeks to explore and expand on this new, complex, and developing area of international trade law. At the end of 1993, the Uruguay Round of multilateral trade negotiations was completed and established the WTO and the GATS. The GATS brought trade in services into a multilateral framework of rules and disciplines broadly comparable to that provided for trade in goods by the WTO. The underlying principle of these rules is non-discriminatory treatment between domestic and foreign trade partners, a philosophy carried through from the General Agreement on Trade and Tariffs (GATT), the predecessor to the WTO. In order to achieve a reduction in barriers to the provision of services, the GATS aims to subject both foreign and domestic service providers to similar regulations. The financial services sector was brought into the multilateral trading system with the intention of creating equally competitive opportunities for both foreign and local institutions.² It aims to do this in several ways: by limiting discrimination, guaranteeing market access by binding liberalization, offering a dispute settlement mechanism, and establishing a process through which to negotiate further liberalization. Ten years after the inception of the WTO GATS, negotiations in financial services, although they are still at a relatively early stage, have been progressing along with other services areas. There have been several factors that have complicated this process and they are discussed in turn.

The process of liberalizing trade in financial services raises three important issues for

² The GATS rules apply equally to all WTO Members. Most notable in this regard are the principles of Most-Favoured Nation Treatment (Article II), Market Access (Article XVI), National Treatment (Article XVII), and the dispute settlement provisions (See next chapter).

governments that are considering making commitments in the GATS. First, there are concerns about how GATS rules would affect domestic regulations (i.e., financial regulations), and the control that governments would retain over them. The main reason for this concern is that multilateral rules in services have taken on a character of ‘positive rule-making’, meaning they can affect the very laws and regulations states use to govern their societies. The main concern has been that the liberalization of trade in financial services affects domestic policy-making capabilities by reducing the self-determination that governments have over prudential regulation as binding commitments are made in the WTO. Governments need to consider prudential issues (i.e., safety and soundness), when allowing foreign firms and foreign capital to invest in their markets,³ so a reduction of this discretion would be significant. Maintaining this oversight is the only way a government can be assured that the economy and the welfare of consumers are safeguarded when foreign firms establish.

The second important issue facing governments is how the results of liberalization came under question against the backdrop of the 1997 Asian financial crisis. Much of the blame for the Asian crisis was focused on the International Monetary Fund (IMF), which is said to have pushed financial liberalization too far and too fast on the developing countries. Another suspected cause of the Asian crisis was that many countries had inadequate domestic financial laws and regulations to deal with the financial conditions of the time. The immediate reaction was that further tinkering with these laws and regulations would only make matters worse. Even though the GATS financial services agreement was designed

³ See Chapter 2 for an explanation of “prudential” measures.

specifically to correct these two issues, it became indirectly, and unjustifiably, the focus of similar criticisms.

The third problem is closely interrelated to the first two. That is, it is possible to misunderstand what exactly is involved in the process of liberalizing trade in financial services, in contrast to either domestic regulatory reform or capital account liberalization. These processes are outlined in greater detail below. The important idea is that the liberalization of trade in financial services, a process dealt with exclusively in this dissertation, involves only the removal of discriminatory measures between domestic and foreign financial services providers (FSP's). It does not seek to 'deregulate' the financial regulations of WTO Members, nor does it aim to thoughtlessly open economies up to international investment flows.

Considering the three main problems above, this dissertation asks whether it is still advisable to recommend GATS-style liberalization in financial services, especially to developing and emerging economies. The argument of this dissertation is that the process of making commitments in the WTO FSA allows countries to retain a high degree of self-determination in their capacity for prudential regulation and their ability to control their pace of liberalization. The GATS was designed with built-in mechanisms to protect the policy-making autonomy of Members that make commitments in services. The countries alone are responsible for deciding which commitments they would like to make. In areas where binding commitments have been made, countries have done so because they have perceived these commitments as being in their own interest. Thus, pressures for trade liberalization that originate at the international level are conditioned individually by the domestic politics

unique to each country. Showing that greater economic instability derives from increased capital mobility, and not from the liberalization of trade in financial services, offers further support for this argument. This argument offers support for WTO initiatives in financial services that began in the early 1990's, and provides overall support for the trade regime. Despite the criticisms, they are useful concepts that should continue to be developed. This argument is explained in greater detail later in the chapter.

Three countries are used as case studies in order to facilitate an understanding of these issues. Chapter 3 examines the case of Canada because it provides a good example of financial policy development and “free trade” in financial services. It gained extensive experience in the area, as a result of the Canada-US Free Trade Agreement (FTA), and the North American Free Trade Agreement (NAFTA). The case of Canada shows how financial governance can match conservative levels of liberalization in the financial sector with adequate concerns for both social and private interests. Chapter 4 examines Singapore as an example of an economy that has become newly developed, based on a history of government-induced patterns of investment and reform. Singapore’s unconventional response to the 1997 Asian financial crisis was greater liberalization, including improved regulation and supervision, transparency, and competition, as opposed to a protective response. The case of Singapore illustrates the benefits of an outward-oriented and gradual program of financial liberalization that has used the WTO as a vehicle to achieve its goals. The final case study in Chapter 5 examines the case of India, which provides a direct contrast to the first two, because it is a large developing country that has had a history of public intervention and ownership in the financial sector. India’s banking sector has been specifically geared for the

purpose of economic and social redistribution. After encompassing economic reform initiatives were launched in 1991, the process had essentially stalled by 1998. This put into focus the necessity for re-evaluating how the government could better combine its public and social obligations, and how the WTO regime in financial services could help India with the transition to greater global financial competition.

Following the case studies, Chapter 6 evaluates the process of liberalizing trade in financial services. Drawing on the case study chapters, the chapter examines some of the concerns with the process, the potential drawbacks, and the economic and regulatory benefits. The chapter raises important lessons about the pacing and sequencing of opening markets in financial services, the progress being made on the issue of domestic regulation, and the concerns about the structure of the GATS agreement itself. The chapter aims to summarize the argument that initiatives in financial services through the WTO have been constructive and should continue to be the focus of refinement, despite the criticisms that have been directed at it and other technical problems.

Financial Services, Domestic, and International Considerations

The issues that arise in the process of liberalizing trade in financial services are centered around concerns for national economic stability. The establishment of a bank in a foreign country, for example, requires direct investment in that country, while banking from one country to another via the Internet often involves capital movements as part of the service provision. This is also one reason why a government would choose to impose restrictions on trade in financial services. While restrictions may be imposed for legitimate prudential reasons, other restrictions, not based on concerns for safety, may deliberately aim

to restrict trade.

Basically regulations can be considered discriminatory when they distinguish between financial service providers based on nationality rather than on their competence.⁴ For example, some countries may restrict transactions in the belief that foreign firms offer services that are of a lower quality than is offered by domestic firms. In regulating banks, governments may require them to lend only to certain sectors or individuals in order to shelter national firms from foreign competition, or to stay consistent with specific development policies. Requirements like these restrict the ability of foreign firms to operate and compete in a given market, and are seen as protectionist barriers to trade in financial services. These concerns are less important now in most developed economies, which have developed relatively liberal policies that allow foreign financial firms nearly unrestricted access to their markets.

As part of their plans to develop and achieve more economic opportunity, policymakers in many developing economies with emerging or underdeveloped financial markets face difficult questions in determining exactly how to open up their financial sectors to foreign competition. They also confront longstanding perceptions that the banking system is an inherent part of their national sovereignty. This can include fears that domestic groups will lose access to financial services, or concerns that the country could lose control over the course of development if the domestic banking system were taken over by global banks. At the same time, new factors have emerged that are driving the participation of foreign banks in developing financial systems and increasing the pressure on them to open up their markets.

⁴ Nicolaides, Phedon, (1989), Liberalizing Trade in Services: Strategies for Success, 45.

These factors derive from current trends in global banking, including a consolidation of the industry on a global basis, increased interconnectedness of economies, and the fact that a very small number of very large banking institutions with global scope are coming to dominate the sector.⁵ Increasingly, then, domestic banks in developing (and some developed) markets do not have either the resources or the desire to build competitive global networks and they must therefore create alliances with the global banks to provide a better variety of financial services to their customers. Many of the developments described above have compelled countries to bring financial services under a set of rules where there could be better guarantees of equal treatment and market access once they were established.

Services, by definition, have traditionally been characterized as being 'intangible' or 'invisibles'. While tangible goods can be observed and counted as they cross national borders, the international flow of services cannot be observed in the same obvious way. It can therefore be difficult to determine when services trade is actually taking place. Because of this intangible nature of services, they can be traded only under certain circumstances. The typical classification for these is found in the WTO's GATS definitions as the four modes of supply:⁶ 1) Cross-border supply - for example, domestic consumers make a bank deposit with a financial firm located abroad. 2) Consumption abroad, whereby a financial transaction is processed while the consumer is visiting a foreign country. 3) Commercial presence, where a financial firm establishes a branch or subsidiary in a foreign country. 4)

⁵ Pomerleano, Michael, Vojta, George, J., (2001), "Foreign Banks in Emerging Markets: An Institutional Study", 61.

⁶ WTO GATS Agreement, Part I, Article I (2), "Scope and Definition".

Movement of natural persons, where people travel to a foreign country and supply a financial service in that country. The details of the GATS are discussed extensively in the next chapter.

At the domestic level there are many aspects of services liberalization that must be considered before a country makes commitments in an international agreement such as the GATS. Generally, there is a desire to gain competitive advantages with respect to the new information-based economy and to build on the domestic infrastructure needed for development. At the same time caution is taken because eliminating barriers to trade in services without regard for domestic objectives can mean that less desirable development policies will be substituted inadvertently. Also, local services providers may object to a change in local regulations due to the often 'essential' perception of what some services are thought to represent regarding their roles in consumer interests, health, and safety. Finally, in many countries, including developed ones, many local provisions such as local or national television or banking are comfortably owned nationally, including private or government monopoly. Subjecting these situations to foreign competition can create strong nationalist sentiments against liberalization.

At the international level, trade in services negotiations requires countries to grapple with a whole new set of economic challenges. In some cases, negotiations in regional trade agreements offers countries the opportunity to gather experience and explore these issues with a single partner or a small set of relatively like-minded partners. On the other hand, these regional negotiations can create preferential arrangements that become vested interests

and can reduce motivations for progress in the GATS at the international level.⁷ Another potential problem is that services industries as a whole do not share common objectives with respect to expansion abroad. Some industries which already have established foreign operations may be reluctant to participate in a broader push to expand into other foreign countries unless specific reciprocal benefits are guaranteed to them. This dissertation will show that countries generally benefit from their regional services negotiations which in turn helps them to successfully participate and benefit from liberalization at the international level.

Section II: Theoretical Aspects

This dissertation is situated in three important ways in the overall study of international relations. Firstly, the aim of this dissertation is to set out the state of knowledge in the area of financial services trade and demonstrate how it is evolving. It will utilize an inductive analysis which infers generalities about the financial services trade regime from many different specific arguments. In this respect, the purpose of the dissertation is to clarify how the liberalization of financial services can fit into a refined consensus about the broad political objectives and purposes of multilateral trade liberalization. This dissertation is highly technical and legalistic by necessity. There are two main reasons why a dissertation on international relations and trade depends so heavily on legalistic analysis.⁸ First, there has been a proliferation of formal institutions, agreements, and organizations for international

⁷ McCulloch, Rachel, (1990), "Services and the Uruguay Round", 344.

⁸ Slaughter, Anne-Marie, Tulumello, Andrew, S., and Wood, Stepan, (1998), "International Law and International Relations Theory: A New Generation of Interdisciplinary Scholarship", 370.

cooperation through which governments can operate, the WTO being one of them. Secondly, there are now greater numbers of non-state actors, increased international economic and political interdependence, and perceived transformations of traditional state sovereignty. With these developments, international 'government' is arguably being replaced by international 'governance' (formal and informal rules, roles and relationships that define and regulate the social practices of state and non-state actors in international affairs).⁹ The benefits of legalization are a better dissemination of information as well as a reduced capacity for some states to behave opportunistically.¹⁰ One of the political effects of legalizing the trade regime is a desire for increased precision about the distributional implications of trade agreements and the mobilization of domestic groups, both protectionists and free traders alike.¹¹

The second way this dissertation is situated in international relations relates to what Robert Cox calls "problem solving theory".¹² This approach takes the world as it is, with the existing institutions and social and power relationships as the general framework. The pattern of institutions and relationships here is not called into question, so that the particular problems that will be discussed can be considered within this specialized area. This is the

⁹ This can be seen, for example, in the availability of highly technical and legalistic NGO position papers readily available through organizations like the International Centre for Trade and Sustainable Development (ICTSD) in preparation for the Fifth WTO Ministerial Conference in Cancun Mexico, September 2003.

¹⁰ Goldstein, Judith, Martin, Lisa, L., (2000), "Legalization, Trade Liberalization, and Domestic Politics: A Cautionary Note", 630.

¹¹ *Ibid.*, 619.

¹² Cox, Robert, (1981), "Social Forces, States and World Orders: Beyond International Relations Theory", 128-29.

opposite of a critical approach, which would challenge the prevailing order and question its origins. I do not attempt to dispute the state of knowledge in this specific area of international trade, but this does not mean that the approach to liberalization pursued by the WTO in financial services is without error or contention. After the 1999 Seattle meeting of the WTO, it was realized that there were growing concerns about the need for further liberalization as well as misunderstandings about the process in general. Third, this dissertation is theoretically situated by drawing on economic writings in both realist and neo-liberal theory. This is articulated in greater detail in the following discussion.

The Importance of State Initiatives in Managing their Place in the Global Market Economy

According to classic liberal trade theory, the concept of comparative advantage from trade was derived from a country's natural resources and manufacturing capabilities. But now advantages that can be acquired through technological changes and policy competitiveness have altered this. In the services sectors, for example, comparative advantage in information and organization are the most critical of the variables that determine economic success.¹³ While I cannot completely agree with Berger & Dore, who have argued that there is no compelling evidence of a convergence of national policies across countries, national governments have and still use considerable latitude in macroeconomic policymaking.¹⁴

Peter Evans has argued that different kinds of state structures create different

¹³ See for example United Nations Conference on Trade and Development, (1994), "Liberalizing International Transactions in Services: A Handbook", 78.

¹⁴ See Frieden, "Invested Interests", and Wade, R., in Berger and Dore (eds., 1996), National Diversity and Global Capitalism, 9.

capacities for state action, and these determine the kinds of roles that the state is capable of playing.¹⁵ It is argued that in a world of value-added products, the international division of labour presents itself as an opportunity for state agency and comparative advantage. For example, in Singapore, which is almost completely dependent on exports, growth remains the prerequisite for delivering social welfare in the long-term and the government sees comparative advantage as the way to achieve this. Keohane and Nye have argued that the preferences of states predisposes them towards certain strategies.¹⁶ Comparative advantage has depended on a complex evolution of competitive and cooperative ties among local firms, on government policies, and on a host of other social and political institutions. In the neo-liberal perspective, the 'autonomy' of states is embedded in a concrete set of social ties that bind the state to society and provide institutionalized channels for the continual negotiation of goals and policies. While state involvement is a given, the question is not so much 'how much', but 'what kind?'.

In developing countries, the state can play a major role in shaping comparative advantage.¹⁷ This can be accomplished through various changes in the production structure, but also by altering the social and political environment. At the international level, the effects of capital and the bargaining power of multinational corporations is moderated when national governments are able to coordinate their regulations and related incentives. This is

¹⁵ Evans, Peter, B., (1995), Embedded Autonomy: States & Industrial Transformation.

¹⁶ Keohane, Robert, O., and Nye, Joseph, S., Jr., (1987), "*Power and Interdependence Revisited*", 745.

¹⁷ See Mattoo, Aaditya, (1998), "Financial Services and the WTO: Liberalization in the Developing and Transition Economies".

accomplished through international membership agreements such as the WTO. In addition, comparative advantage is determined in a variety of ways that the state can effectively manipulate.¹⁸ Therefore, continually seeking out comparative advantage is not a neutral policy, but a conscious domestic policy decision.

In the present era, the above process is driven by 'competitive liberalization'.¹⁹ Economic success requires states to compete aggressively for the important international investment that determines who produces what, where the jobs are located, and the resulting development that can be achieved. Orientation toward open trade and investment is critical for this to happen. While most successful development strategies depend on outward orientation, this would not be possible in the absence of relatively open markets around the world. This does not suggest that the state's capabilities are somehow more powerful if the government can simply liberalize in order to attract foreign capital. What I suggest is that the open, liberalized economies are simply the rules of the contemporary economic game. If countries choose not to operate within these sets of rules, their chances of success are reduced. With liberalization, as in any of life's other decisions, we become bound by certain constraints whether we are aware of them or not. Within this set of rules, states still have considerable policy options open to them, even if different states have different options. Economic freedom depends on private property rules, including the right to own, the right to contract, and the right to be compensated for damage resulting from the conduct of others.

¹⁸ See Hindley, Brian, Smith, Alasdair, (1984), "Comparative Advantage and Trade in Services", 377.

¹⁹ See Bergsten, C. Fred, (1999), "The Global Trading System and the Developing Countries in 2000", 3.

Markets are simply a means of exchanging property rights, and without a well-defined system of private property rights and a means to enforce these rights, markets will not function. Government's responsibility is to establish a system to protect property rights and resolve related disputes, and this is why governments in part see value in WTO rules.

It is also important to distinguish between the effects of increased trade on the one hand and of financial integration on the other. With increased financial integration, government options for pursuing autonomous macroeconomic policies are reduced, and this is arguably reflected in the general convergence of interest rates. By contrast, greater trade integration leaves far more space for national policy to make a difference.²⁰ There are options for improving the competitiveness of domestic producers, which may mean more or less government intervention. For example, different ideologies and/or partisan and social alignments can change depending on the national context. In the Canada-US FTA negotiations, the Americans made an attempt to link the liberalization of financial services to the movement of interest rates and fiscal policy between the two countries.²¹ The Canadian negotiating team would not accept an agreement which tied this trade issue (non-discrimination between financial institutions) to purely financial ones (i.e., interest rates), and the Americans immediately backed down. Therefore, the fact that the Department of Finance directs Canada's position in financial services negotiations in free trade does not necessarily signal an intention to relate financial services directly to other areas overseen by Finance.

²⁰ Garrett, Geoffrey, Lange, Peter, (1995), "Internationalization, Institutions, and Political Change", 627-655.

²¹ Personal interview, October 2002.

That Finance leads policy formation in financial services, with the Department of Foreign Affairs and International Trade in tow, may simply be a reflection of its expertise and knowledge about the industry. In other countries, financial services issues are handled by the *de facto* finance department, but the bureaucrats working on those files are usually a mixture of public policy specialists, economists, and legally-trained officials.

In his book entitled *The Political Economy of International Relations*, Robert Gilpin provides a model of intensified mercantilistic competition. He suggests that, in international economic relations, states use both politics and economics as leverage to increase their relative gains.²² He argues further that any clashes between economic interdependence on the one hand and domestic autonomy on the other, are more frequently resolved in favour of autonomy over interdependence because states want to use the international economy for their own political and social goals. Though states want the benefits of interdependence without sacrificing national autonomy, they still want the ‘collective goods’ of liberalized trade and a stable monetary system without sacrificing the ability to manage their own economies.²³ The result is greater competition among states as each tries to maximize its own benefits. As a result, trade theory becomes essentially tied to bargaining theory and the trade policy that emerges comes out of national (domestic) industrial strategy and bargaining

²² Gilpin, Robert, (1987), *The Political Economy of International Relations*, 395.

²³ An attempt to address this problem was initiated in the Bretton Woods regime which according to John Ruggie sought “to devise a form of multilateralism that is compatible with the requirements of domestic stability.” Ruggie argued that Bretton Woods attempted to do this by avoiding (1) the subordination of domestic economic activities to the stability of the exchange rate embodied in the classical gold standard, and (2) the sacrifice of international stability to stronger domestic policy autonomy.

tactics.

The argument of this dissertation also draws on the idea of the primacy of the state in domestic and foreign policy. Essentially states are cohesive collectives in pursuit of rational political strategies which create economic opportunities. The international economic structure and the position of nation states within it create constraints and opportunities that shape the trade strategies of countries in important and predictable ways.²⁴ At the domestic decision-making level, countries follow the incentives of the international system. The foreign policy executive is particularly sensitive to the constraints and opportunities of the international economic structure and acts as one of the main channels through which these systemic incentives pass into the sphere of domestic politics. Fully considering politics, parties, social classes, interest groups, and public opinion (in addition to state officials and institutional arrangements) offers a fuller account of how domestic factors influence foreign policy and international relations.²⁵ Katzenstein has showed the importance of domestic factors by arguing that the main purpose of foreign economic policy is to make domestic and international policies compatible with one another.²⁶

According to realism, the argument that the state is being undermined by globalization is thus incorrect on two accounts. First, it lacks historical perspective in assuming that states had been able to control activities across their borders at some time in

²⁴ Lake, David, A., (1988), Power, Protection, and Free Trade: International Sources of U.S. Commercial Strategy, 1887-1939, 66.

²⁵ Putnam, Robert, D., (1988), "Diplomacy and Domestic Politics: The Logic of Two-Level Games", 431.

²⁶ Katzenstein, Peter, J., (ed., 1978), Between Power and Plenty: Foreign Economic Policies of Advanced Industrial States.

the past. Second, it ignores the consolidation of sovereignty which states have advocated by offering property rights to other states, and the fact that states themselves maintain the capitalist economic system by allowing increased volumes of some transactions. Essentially, since the structure of the international system provides opportunities and constraints, knowledge about state preferences as well as the system's structure help to account for state action.

Thompson and Krasner suggest that the consolidation of sovereignty (the establishment of different sets of institutions exercising final authority over a defined territory) was a necessary condition for more international economic transactions.²⁷ Thus, the notion that there is a conflict between sovereignty and economic transactions when such institutions are being formed may be incorrect. After they are initiated, however, conflict can arise for many different reasons and one response by states to this loss of control is to enter into international agreements. Globalization has actually strengthened the importance of international law which obligates states and mutually constrains their behaviour. This process facilitates international regulation on the basis of the principles of non-discrimination and makes unilateral (protective) policies ineffective. Thus, weakening domestic control actually strengthens state authority through international cooperation which depends on the validation of sovereignty through international recognition.²⁸ Countries thus find it in their interest to negotiate and enter into international agreements. Their decision, which has been

²⁷ Krasner, Stephen, Thomson, Janice, E., (1989), "Global Transactions and the Consolidation of Sovereignty", 198.

²⁸ Krasner, Stephen, D., (1997), "Globalization and Sovereignty", 23.

called an exercise in “new sovereignty”, is based on the fact that domestic actions must be linked to international agreements in which the country voluntarily takes part.²⁹

Section III: The Meaning of the Liberalization of Trade in Financial Services

This dissertation deals with three highly interdependent but distinct processes which occur at the domestic and international levels: domestic regulatory reform, capital account liberalization, and the liberalization of trade in financial services. Many aspects of these processes involve state initiatives, such as ensuring the economy is open to trade and investment and having the respective domestic regulations in place to manage the transactions.

Domestic Regulatory Reform

Domestic regulatory reform is a process that is currently ongoing in most countries in an attempt to make their regulations more efficient and effective. It is characterized generally by deregulation - the reduction or elimination of government intervention in particular industries. In late 1999, for example, the United States repealed the Glass-Steagall Act of 1933 which was created to ensure economic stability after the Great Depression by separating the businesses of banking and securities dealing. While the Act had been amended periodically over the decades, the 1999 repeal seen to be a major step in catching up to a marketplace marked by consolidation and financial conglomerates.³⁰ Domestic reform can also include the reduction of interest rate ceilings or the removal of inappropriate

²⁹ Woodrow, R. Brian, (2001), “Domestic/International Regulation and Trade in Insurance Services: Implications for the Services 2000 Negotiations”, 370.

³⁰ New York Times, “Accord Reached on Lifting of Depression-Era Barriers Among Financial Industries”, by Labaton, Stephen, October 23, 1999, A1, B4.

government intervention in credit allocation decisions. For example, in India, the government has recognized the need to make their publicly-owned national banks more competitive by reducing the proportion of deposits that have to be invested in government securities. Domestic reform is also characterized by a process of re-regulation whereby the government re-works existing regulations or designs new ones in order to be more effective and efficient. One example of re-regulation is the move in most countries to bring the capital adequacy standards of their banks in line with the Basel Capital Accord.³¹ Another example is the introduction of rules to improve corporate governance. In Singapore, for example, after the 1997 Asian financial crises and the recent concerns about the safety and soundness of foreign banks in the country, the government has been improving standards to ensure corporate transparency, accountability, and the competence of senior bank personnel and the nomination process of these personnel. Additionally, efforts are made to attract only the top foreign talent to work in Singapore. Liberalization, therefore, does not mean the complete removal of financial regulations because financial services markets still require that certain basic regulatory principles be in place in order to protect consumers and the overall stability of the financial system.

Capital Account Liberalization

The second process that needs to be explained is capital account liberalization, i.e., measures designed to free the flow of capital in and out of countries. The capital account is the part of the balance of payments account (the record of a country's total income and

³¹ The Capital Adequacy Ratio is a measure of a bank's capital. It is expressed as a percentage of a bank's risk weighted credit exposures. This ratio is used to protect depositors and promote the stability and efficiency of financial systems around the world.

expenditures) that specifically measures the flows of capital (i.e., investments) in and out of the country. Capital market liberalization specifically involves deregulation, i.e., the reduction or elimination of regulations intended to control the flow of hot money in and out of the country (e.g., short-term loans and contracts which benefit from exchange rate fluctuations). Financial repression has the exact opposite effect, usually by tightening regulations and instituting measures to control and direct the flow of capital. The decision to introduce or discourage controls on capital is based on the need to either insulate the economy from the potentially destabilizing effects of unrestricted capital flow, or a contrasting desire to capitalize on market developments which can enhance growth.³² For example, in the early 1970's when an increase in speculative capital flows endangered the stability of the international exchange rate system, Japan and Western Europe argued for the introduction of controls on capital movements as a way of protecting the regime.³³ There are numerous specific mechanisms countries can use to regulate the flow of capital inwards and outwards across their borders. These controls can come directly in the form of quotas or in the form of a tax on the outward movement of capital. For example, from 1992 through 1998, Chile required 30 per cent of capital inflows to be deposited at no interest at the Chilean central bank for a period of one year.³⁴ Such reserve requirements, which are not remunerated, represent a tax on short-term capital inflows. Capital flow can also be managed

³² Helleiner, Eric, (1994a), States and the Re-Emergence of Global Finance: From Bretton Woods to the 1990s, 4-6.

³³ *Ibid.*, 9-10.

³⁴ Tirole, Jean, (2002), Financial Crises, Liquidity, and the International Monetary System, 33.

by more indirect measures. Countries can impose credit allocation requirements which require institutions to direct a certain portion of their loans to priority sector projects. In India by 1990, about 80 per cent of bank credit was subject to directed credit allocations, including the agricultural and other “weaker” sectors of the economy.³⁵ This type of lending is a disincentive for private and foreign investors because directed credit loans are notoriously non-performing. Another method of controlling the flow of capital includes controlled offshore borrowing and lending policies. In the Foreign Exchange Regulation Act of 1973, India closed the capital account by making it illegal for Indian residents to hold foreign currency, or to engage in foreign currency transactions.³⁶ Finally, countries can regulate their domestic interest rates in order to make their market more attractive to investors. Among many considerations for changing the interest rate, one is based on the idea that foreign investors will seek an appreciated currency in a foreign country so that their assets remain more valuable there.³⁷

The reasoning behind liberalization policies is that the sources of comparative advantage for countries is no longer exclusively dependent on endowments of land, labour, and capital, or locational advantage, but their ability to attract capital investment. Many argue that capital flows between countries have become so significant that the costs of

³⁵ Hanson, James, A., (2001), “Indonesia and India: Approaches to Repression and Liberalization”, 246.

³⁶ Ibid, 245.

³⁷ Tirole, Jean, (2002), Financial Crises, Liquidity, and the International Monetary System, 107.

ignoring them can be significant.³⁸ Until the East Asian crisis of 1997, the International Monetary Fund (IMF) argued strongly that without capital market liberalization, countries would not be able to attract foreign capital, and especially foreign direct investment.³⁹ Essentially this assumes that the international supply of capital will then be sensitive to the economic prospects and regulatory structures of recipient countries.⁴⁰ While all countries regulate their financial markets to different degrees, deregulating too much has brought major problems, especially for the developing countries. Financial institutions will be undermined if inadequate financial sector regulation and corporate governance problems exist, as they did recently in Asia and Latin America. In developing countries, these elements can be highly destabilizing because their financial markets are relatively shallow to begin with.⁴¹ Therefore, countries must have a strong infrastructure (wholesale payments system, securities settlement, and clearance systems) and resilient intermediaries, such as banks, that can cope with these flows. In fact, countries that have well-developed regulatory infrastructures in place are aware of the competitive advantage it gives them for attracting quality foreign investment.⁴²

³⁸ See Gill, Stephen, R., Law, David, (1989), “Global Hegemony and the Structural Power of Capital, 481.

³⁹ Stiglitz, Joseph, E., (2002), Globalization and Its Discontents, 66.

⁴⁰ IMF Occasional Paper # 122, (1995), Capital Flows in the APEC region”, 32.

⁴¹ Das, Dilip, K., (1998), “Trade in Financial Services and the Role of the GATS: Against the Backdrop of the Asian Financial Crises”, 91.

⁴² The infrastructure includes improved bank governance rules, risk management, disclosure and accounting standards, and effective regulation and supervision by the de facto financial authorities. See Speech by Mr. Ravi Menon, Executive Director, Supervisory Policy Department, MAS, “Sound Regulation as a Source of Competitive Advantage”, 21 March, 2001.

In countries with undeveloped financial systems including weak regulation, supervision, and transparency requirements, capital movements can spark far worse situations when the behaviour of international investors leads to recurrent overshooting and cycles of euphoria and pessimism. For example, until the summer of 1997 investors poured money into Asia to get a slice of the 'Asian Miracle', only to undo these investments a few months later. Over-investment or under-investment in a country and inflows or withdrawals which happen too quickly are problems that can dominate any potential gains from trade.⁴³ The issues of financial liberalization, its proper sequencing and pacing, and foreign investment will be considered in more detail in the discussion of the 'process of liberalization' covered in chapter six.

The Liberalization of Trade in Financial Services

The third process, the liberalization of trade in financial services, is the central focus of this dissertation. As a part of the GATS, the liberalization of trade in financial services focuses exclusively on improving the terms and conditions of market access and non-discriminatory treatment for foreign suppliers of financial services. It is a separate and distinct process from the liberalization of the capital account discussed above. However, there is a strong interdependence between these processes because the liberalization of trade in financial services does have the potential to fuel problems if it happens in the presence of inadequate macroeconomic and regulatory policies, and inappropriate government

⁴³ Steinherr, Alfred, Peree, Eric, "How Strong is the Case for Free Trade in Financial Services? Walking the Tightrope between Domestic Stability and International Shocks", 1229.

interventions.⁴⁴ Some also argue that the liberalization of trade in financial services has been one of the contributing causes of financial crises in many countries.⁴⁵ One way this can happen is through the GATS requirement that countries must allow international transfers of capital for transactions relating to their commitments in the GATS. It requires that “...if the cross-border movement of capital is an essential part of the service itself, that Member is thereby committed to allow such movement of capital.”⁴⁶ This has been a rather contentious clause in the GATS because it can arguably force countries to accept inward capital flows even if they would otherwise choose not to allow them, for whatever reason. However the GATS offers two essential safeguards relating to this specific concern and more generally to allow Members to maintain autonomous control over their economies. First, the GATS allows Members to maintain temporary restrictions in the case of serious balance-of-payments crises or external financial difficulties, especially for countries undergoing economic development or transition.⁴⁷ Second, the GATS Annex on Financial Services allows Members to impose measures for prudential reasons to ensure the integrity and stability of the financial system.⁴⁸ Prudential measures may be taken contrary to a Member’s scheduled commitments to ensure the protection of investors, depositors, policy holders, or

⁴⁴ Kono, Masamichi, et. al., (1997), “Opening Markets in Financial Services and the Role of the GATS”, 23.

⁴⁵ See for example Arestis, Philip, and Demetriades, Panicos, (1999), “Financial Liberalization: The Experience of the Developing Countries” or Armijo, Leslie, E., (ed., 1999), Financial Globalization and Democracy in Emerging Markets, both of which argue that liberalization is destabilizing.

⁴⁶ GATS, Part III, Article XVI, footnote #8.

⁴⁷ GATS Article XII (1-6).

⁴⁸ GATS Annex on Financial Services, Paragraph 2 (Domestic Regulation).

to ensure the integrity of the financial system. Since the whole purpose of the GATS is to ensure non-discriminatory trade relations between Members, each of these safeguards must not discriminate between Members or be initiated to avoid a Member's commitments in the GATS (i.e., they must not be used for protectionism). Each of these are discussed in greater detail in Chapter 2.

In addition to other international initiatives which aim to improve financial regulation, the liberalization of trade in financial services through the GATS is another way countries can improve the quality of capital flows across their borders.⁴⁹ This strengthens the case for sound macroeconomic policies mainly because capital movements respond to, rather than cause imbalances.⁵⁰ Though some increased capital movement is a natural consequence of the process of liberalizing financial services, it does not necessarily lead to capital account liberalization, i.e., the free and unrestricted flow of capital in and out of countries. Nor does it directly affect the macroeconomic freedom of WTO Members.⁵¹ This is because different types of financial transactions have differing impacts on the type of capital that flows into a country.⁵² For example, transactions which occur by cross-border trade potentially involve the movement of more footloose capital while the establishment of

⁴⁹ Sauve, Pierre, (1998), "The Benefits of Trade and Investment Liberalization: Financial Services", 6.

⁵⁰ Kono, Masamichi, et.al., (1997), "Opening Markets in Financial Services and the Role of the GATS", 23.

⁵¹ Macroeconomic policies may include fiscal balance (government spending and taxation), the level of employment, economic growth, the balance of payments (incomes & expenditures), and current accounts (trade in goods and services).

⁵² Kono, Masamichi, and Schuknecht, Ludger, (2000), "How Does Financial Services Trade Affect Capital Flows and Financial Stability?", in Claessens, Stijn, and Jansen, Marion, (eds., 2000), The Internationalization of Financial Services, 139.

a commercial presence involves significantly less because it entails direct investment.⁵³ Reflecting this potential danger, all countries have made far fewer attempts to liberalize trade that can occur directly across borders, reflecting the concerns countries have had for prudential regulation and protecting themselves against excessive risk. Countries have been far more willing to liberalize trade that occurs when foreign services providers are required to physically establish their business in the affected market because of the regulatory and legal assurances this offers in comparison to trade across borders.

Section IV: The Argument of this Thesis

Challenges to Liberalization and the International Trade and Financial Institutions

The purpose of this dissertation is to provide an overview of the knowledge of trade in financial services up to the present and specifically to examine the *process* of financial services liberalization in different countries. The dissertation compares the cases of Canada, Singapore, and India, as they have initiated domestic regulatory reform and consequently liberalized their trade commitments in financial services. Well-known critics of liberalization, including Philip Cerny, Geoffrey Underhill and others, suggest that international politics has built-in features that constrain state behaviour by rewarding some actions and punishing others.⁵⁴ Trade and financial liberalization, along with greater

⁵³ Part I, Article I(2)(a) of the GATS defines the cross-border supply of services as transactions from the territory of one Member into the territory of any other Member. Article I(2)(c) defines commercial presence as the supply of a service by a service supplier of one Member, through commercial presence in the territory of any other Member.

⁵⁴ See Underhill, Geoffrey, (1997), The New World Order in International Finance. Cerny, Philip, G., (1994), "The Dynamics of Financial Globalization: Technology, Market Structure, and Policy Response". Gill, Stephen, R., Law, David, (1989), "Global

technological innovation, it is argued, results in higher capital mobility and is thought to undermine the state's governance capacity and its ability to produce public goods.⁵⁵ Essentially, the effects of liberalization cause countries to lose control of their economies. The mechanisms of action are argued to be 'regulatory arbitrage' and 'competitive deregulation', processes whereby governments promote the attractiveness of their domestic markets in order to attract more foreign capital. Regulatory arbitrage suggests that investors will seek out economies with the most favourable regulations for their assets. An example of this is transnational corporations using political risk management to evaluate a country's political and legal stability, production costs, labor relations, and financial incentives, before deciding to invest there. Competitive deregulation occurs when countries seek ways to 'level the playing field' and offer domestic firms better opportunities to compete with foreign firms. This would involve a number of domestic regulatory changes designed to make the investment climate more favourable for investors.⁵⁶ Faced with the dilemma, countries can make a choice to isolate themselves from the changes or respond differently, but they will pay an economic price because investors will seek out other more favourable places to invest.

Three processes were outlined earlier that attempted to clarify the focus of this dissertation: domestic regulatory reform, capital account liberalization, and the liberalization of trade in financial services. While capital account liberalization is interdependently related

Hegemony and the Structural Power of Capital". Andrews, David, M., (1994), "Capital Mobility and State Autonomy: Toward a Structural Theory of International Monetary Relations".

⁵⁵ Cerny, Philip, G., (1994), "The Dynamics of Financial Globalization: Technology, Market Structure, and Policy Response", 319.

⁵⁶ See Helleiner, Eric, (1994a), States and the Re-Emergence of Global Finance, 12.

to these two processes, the focus of the dissertation is on the process of improving market access and non-discriminatory treatment between domestic and foreign services suppliers. It has been explained earlier that while the GATS requires WTO Members to allow a certain amount of capital to move irrespective of their services commitments, it also provides for prudential and extraordinary safeguards in this respect. This ensures that the state maintains important policy-making capacities, such as having the adequate regulations in place. The danger of undermining governmental autonomy that is associated with financial liberalization should come largely from increased capital mobility, and not from trade liberalization per se. However, there is evidence which suggests that domestic deregulation and financial services liberalization can uncover or even fuel problems when regulatory and macroeconomic weaknesses are present.⁵⁷ This controversial relationship between the globalization of financial services and state autonomy remains largely unresolved. The main question of this dissertation, then, is whether states under the WTO's financial services regime have exercised sufficient autonomy in making their choices about liberalization.

In seeking an answer to this question, the dissertation seeks to determine if a shift of focus might be necessary, i.e., a shift away from how financial liberalization affects domestic politics to how domestic politics can in fact condition the liberalization of finance in each country. Coleman has made this argument by showing that distinct national processes including local politics, institutions, and regulations, have a large influence on how financial

⁵⁷ Dobson, Wendy, Jacquet, Pierre, (1998), Financial Services Liberalization in the WTO, 32.

liberalization is carried out.⁵⁸ Essentially, government involvement in the politics of liberalization and economic reform changes largely depending on the issues facing it at the domestic level.⁵⁹ Singapore, for example, is an example of a competitive state that has responded to economic challenges based on its particular history and endowments, rather than on the adoption of a standard set of development initiatives. This is one example of how domestic political institutions can in fact impede and deflect the effects of internationalization.⁶⁰ While the GATS provides the basic structure for liberalization in financial services, how this process is filtered through the type of political system, geographic region, level of development, and the cultural and historical background of the country is essential for understanding its effect on domestic politics. Effectively demonstrating the importance of these factors should discredit anti-liberalization views which argue that the combined pressures from the developed countries, the international financial organizations, and corporations have been responsible for essentially forcing countries to open their financial markets, change their regulations against their wishes and beyond their capacities, and lose control of their economies.

A second related purpose of this dissertation is to make an attempt to assess the current trade regime in financial services. In the face of mounting challenges, the dissertation hopes to clarify how liberalization in financial services affects national policies.

⁵⁸ Coleman, W., (1996), Financial Services, Globalization, and Domestic Policy Change.

⁵⁹ Holt Dwyer, Jennifer, (1997), "The Dynamics of Financial Market Reform in Japan, 1975-95", 206.

⁶⁰ Keohane, Robert, O., Milner, Helen, V., (1996), Internationalization and Domestic Politics, 5.

Critics suggest that developing countries have been pressured into liberalizing beyond their capacities based on the equal opportunities promised by liberalization.⁶¹ As a result, they argue, governments become increasingly constrained by the economic and trade policies of other states as well as the ebb and flow of investment capital. One of the major problems in this respect has been the speed and depth by which the WTO and the IMF have pushed the liberalization agenda on developing countries (i.e., the removal of government interference and barriers to trade), arguably without much concern for stability or for maintaining growth or jobs.⁶² The IMF is said to be guilty in this regard mainly because it has historically insisted on an accelerated pace of liberalization in exchange for its financial assistance - policies of “conditionality” that it pushed too far and too fast. Another criticism, which is specific to the trade regime, has pointed to the hypocrisy of those who push for trade liberalization. It is argued, for example, that the Western countries pushed liberalization for the products they exported, and at the same time continued to protect sectors in which developing countries have a comparative advantage.⁶³ This agenda has led to fundamental inequalities for the developing countries, who face highly protectionist foreign markets for their exports of agricultural products, textiles, and labour services. In the end, this has meant an unequal distribution of the benefits between the developed and developing countries that the trade regime promises to bring. Because of the possible importance of these concerns, this dissertation will ask whether the WTO financial services regime been successful in

⁶¹ Dubey, Muchkund, (1996), An Unequal Treaty: World Trading Order After GATT, 47, 53.

⁶² Stiglitz, Joseph, E., (2002), Globalization and Its Discontents, 54, 59.

⁶³ *Ibid.*, 60.

starting the process of liberalization in financial services trade without creating conditions for dangerous economic instability. If this is found to be so, then arguably, states must retain considerable economic and political autonomy as a result of the process of liberalization in financial services. Thus, WTO Members that are considering making further commitments in the FSA, or countries acceding to the WTO, would be assured that they do not have to give up their ability to exercise choice in making economic decisions.

Critics of the international financial and trade institutions also argue the IMF, World Bank, and WTO suffer from an overall lack of transparency (e.g., dissemination of information).⁶⁴ It is argued that the leaders of these public institutions have not been directly elected, so there is no direct accountability to the public. In the financial community, secrecy is a normal practice because it tends to give government officials more discretion in decision making and removes their decisions from public accountability.⁶⁵ In the IMF, this practice has been endemic; it is argued to be especially problematic because the IMF is a public institution, not a private bank.⁶⁶ In the WTO, critics argue, the negotiation process that leads to agreements as well as actual dispute settlement all takes place behind closed doors away from public and democratic accountability.⁶⁷ Allowing citizens who are affected by the policies of these public institutions to have a greater say in their formulation, they argue, is essential. A related argument emanating at the domestic level suggests that the financial

⁶⁴ Stiglitz, Joseph, E., (2002), Globalization and Its Discontents, xii.

⁶⁵ Personal interview, November 2001.

⁶⁶ Stiglitz, Joseph, E., (2002), Globalization and Its Discontents, 228.

⁶⁷ Sinclair, Scott, (2000), GATS: How the World Trade Organization's new "services" negotiations threaten democracy, 80.

sector is either “special” or “strategic” and should remain under domestic control and regulation. The financial sector can be seen to be special because of its public trust (fiduciary) responsibility to deposit holders and as an intermediary through which all economic transactions take place.⁶⁸ Banks also play an important role in monetary policy, providing credit to companies, and in many developing countries, can play a key role in development priorities. Thus, the costs of liberalization are highly visible and concentrated among those who stand to lose from increased competition - domestic industry and potentially the government.⁶⁹ Countries which have been comparatively disadvantaged in financial services, typically the developing countries, have erected discriminatory barriers against foreign firms in order to protect the domestic industry for the reasons mentioned above. However, as countries develop, it is expected that this view changes in favour of a more liberalized financial services regime.⁷⁰ Analysis of these concerns seeks to determine to what extent secrecy and protectionism still exist in financial services, under what conditions protectionism might be practical, and how the process of liberalization in the WTO FSA has conditioned these policies.

More specific concerns with respect to trade liberalization have been expressed about the effects of the new rules of the WTO embodied in the GATS. These rules are characterized by ‘positive rule-making’ which reaches deep into the regulatory regimes of members and thus conditions public policy, altering the traditional relationship between

⁶⁸ Smith, Roy, C., and Walter, Ingo, (1997), Global Banking, 177.

⁶⁹ *Ibid.*, 31.

⁷⁰ Walter, Ingo, (1988), Global Competition in Financial Services: Market Structure, Protection, and Trade Liberalization, 114.

national economies and the global economy.⁷¹ Critics suggest that the most controversial of the WTO's rules is Article VI on domestic regulation which requires that measures affecting trade in services be applied in a reasonable, objective and impartial manner. The operational language of this article comes in paragraph four which requires that measures affecting trade in services must be based on transparent criteria, must not be more burdensome than necessary, and must not have overly restrictive licensing procedures.⁷² In restricting the policy options that governments are allowed to use, these rules are thought to tie the hands of governments in their ability to exercise their regulatory authority. In addition, since regulations can be potentially be quite easily characterized as 'burdensome', critics interpret this language to mean that the responsibility for judgements about domestic regulations, those which balance the public interest with commercial considerations, pass from elected government representatives to appointed tribunals or WTO panels.⁷³ The relationship between liberalization and domestic regulations is currently one of the most important issues in the WTO services negotiations and working groups. In analyzing the process of liberalization in financial services, this dissertation will examine the state of agreement on domestic regulation and the effects this will have on future negotiations and commitments.

Section V: Methodology

The country case study chapters that follow are intended to demonstrate that states

⁷¹ See Dymond, William, A., Hart, Michael, M., (2000), "Post-Modern Trade Policy - Reflections on the Challenges to Multilateral Trade Negotiations after Seattle", 22.

⁷² GATS Article VI(4).

⁷³ Sinclair, Scott, (2000), GATS: How the World Trade Organization's new "services" negotiations threaten democracy, 77.

have had significant autonomy to make the reforms they have wanted to make at the domestic level and to subsequently negotiate those as liberalizing commitments in the WTO. The commitments which are made in financial services in the context of the WTO tend to be major concessions in the larger context of international services negotiations. Locating the origin of these initiatives is therefore quite important. The linkages between the financial services sector and the economy are complex and the factors which influence exactly how reform is carried out are many. They can include local politics and institutions, existing regulations, the regulatory contacts between policy-makers and regulators, the timing of financial crises or economic downturns, WTO liberalization, and finally, in the case of developing countries, balance of payments supports or IMF assistance programs. Finally, governments can also be influenced by less compelling concerns like becoming socialized to the trade regime and the concerns of foreign interests.⁷⁴ In all, the national trade and economic policies of countries results from navigating through a balance of domestic and international pressures.

This dissertation will attempt to examine these various issues by using a historical and comparative study approach. Thus, understanding trade policy in financial services requires an examination of current economic and political environments as well as the historical development of the policy in each country. Three countries will be examined in detail including one developed economy (Canada), one developing (India), and one newly developed (Singapore). First, Canadian banking and insurance laws will be examined in detail. This will be useful in developing a model to identify the essential pieces of financial

⁷⁴ Personal interview, October 2001.

services legislation that are typical in an advanced economy, including the protectionist measures that are commonly applied. These measures can be seen as legitimate prudential measures, depending on where one stands with respect to financial services liberalization. This model will then be compared and contrasted to the legislation in the other two economies. By this means, a number of issues can be examined. First, the extent of liberalization in financial services can be detailed as well as the prudential measures that are maintained by each country. Second, prudential measures which possibly disguise protectionism in Canada will be identified. A search for similar measures in India and Singapore will be conducted, and will identify unique and special circumstances in those economies that might require more flexibility and time for liberalization in financial services. Hence, the analysis will explore whether developed and developing economies may have different reasons for maintaining restrictive measures in financial services trade. The consistency between liberalization and prudential regulation can be evaluated as well as the benefits and drawbacks of both.

The primary methodology used in the case-study approach will be documentary analysis. This will include determining the levels and governmental attitudes towards liberalization in financial services by examining working papers, published speeches of senior bureaucrats, and third party independent analysis of particular countries. Actual trade agreement texts will be used to evaluate the consistency of particular country commitments in financial services, and what commitments should be liberalized to step in line with international standards. This will include the text of the General Agreement on Trade in Services (GATS) as well as the Fifth Protocol to the GATS, otherwise known as the financial

services agreement (FSA). The WTO publishes the individual schedules of commitments in particular areas of trade, and the schedules in financial services will be used to determine the commitments of the case studies. The WTO also publishes regular and detailed Trade Policy Reviews (TPRs), which are also helpful as additional sources of information on the progress of specific countries and their future goals in specific trade sectors. The relevant parts of the Canada-United States Free Trade Agreement (FTA) and the North American Free Trade Agreement (NAFTA) will indicate the areas of commitments that were agreed upon when it came into effect.

The secondary literature reviewed for this dissertation is abundant, reflecting the growing importance of financial services trade. It includes material produced by the international financial and trade institutions, academic papers, sources from the case-study countries, and other bodies. The international institutional material includes working papers, position papers, and documents and schedules from the WTO, IMF, and World Bank. This material is significant because it represents the center of activity in financial services trade liberalization and also the bulk of the pro-reform literature. It is used in this context in order to establish what has been achieved in financial services trade liberalization up to this point (including the WTO negotiations), as well as to support my theoretical argument by distinguishing between the capital flows literature and the financial services trade literature. Separating these two areas of study is essential because while opening the capital account raises important issues about democratic accountability and sovereignty, the liberalization of trade in financial services through the WTO can itself be an exercise in financial governance. This literature is generally directed at developing financial markets and argues

for macroeconomic reform and prudential supervision followed by more open financial services markets in order to create more resilient domestic financial systems. This includes reducing barriers to trade in financial services through the WTO's principles of non-discrimination and transparency requirements, and coordinating this with the efforts of other international bodies such as the Basel Banking Standards. Other supportive literature comes from the Institute for International Economics, the European Commission, the U.S. Federal Reserve system, the Asian Development Bank, independent academic writings, and most importantly, the governments themselves.

The individual country literature specific to this subject generally concurs with the arguments of the international community on the benefits of financial services trade liberalization. The domestically-focused material from these countries deals more with domestic financial institution reform issues such as corporate governance, mergers and acquisitions (M&A's), deposit insurance, and other issues of a national interest. A knowledge of these aspects of a country's financial system is necessary to determine its position on foreign financial institutions operating within its borders and negotiating position for WTO negotiations. Most countries now publish limited information on their official government Web sites; the material available includes financial documents, laws, officials' speeches, the details of major reform programs, and lists of foreign banks operating in that country.

A significant gap in the literature exists in the obvious absence of critical perspectives directed at financial services trade liberalization. While significant theoretical literature is available to criticize the WTO, the GATS, or the general capital flow problems and loss of

national autonomy (discussed above), I have uncovered little technical or practical literature which argues against the overall liberalization of banking, insurance, and securities industries. I believe this is the case because most countries now realize the benefits of reforming the financial sector, provided it is done prudentially and sequenced according to the country's capabilities.

The second methodology used in this dissertation are confidential interviews. These have included personal interviews with government bureaucrats, trade experts, and members of the private financial services sector in the case study countries. Emphasis and time will be focused on Canada because information is more freely available in the Canadian context than it is in India and Singapore. Questions were developed to explore the negotiating positions in financial services negotiations, their position toward foreign financial services providers, how the country perceives the potential benefits and drawbacks of liberalization, and how they see the significance of financial services for economic development.

Why Choose Canada, Singapore, and India?

These countries were chosen for many different reasons. First, the countries have very different histories, have developed under different circumstances, and are at different stages of liberalization. Canada is a developed economy. India and Singapore have relatively stable governments and are significant players as developing/ newly developed economies in the GATS due to their relatively large financial market sizes. Most importantly, financial services liberalization is an essential factor in the current and future economic development of India and Singapore. Second, the three countries differ in terms

of “restrictiveness” in banking. In a study by McGuire and Schuele⁷⁵, measures of restrictions in banking services were gathered from numerous sources.⁷⁶ Canada was determined to be ‘relatively open’ in trade in banking services, indicating few restrictions on the ability of foreign banks to operate. In Canada, foreign banks are treated as relatively equal to domestic banks. Singapore was characterized as having a ‘moderate’ level of openness, meaning that it has at least one significant restriction that limits foreign access to its market for banking services. For example, Singapore’s banking sector has been limited through foreign ownership restrictions, and restrictions on ATM machines. Finally, India was characterized as having ‘very tight’ entry controls and restrictions on business operations in banking. Foreign banks have generally been denied access to the domestic market in India. When foreign banks can get established, they are generally treated much less favourably than domestic banks. These differences will now be considered in more detail.

Canada

In Canada the government has long played a role in shaping the economic landscape in order to achieve growth. The condition of the economy has also been an important policy-making variable. In more recent times, the changes which have been happening at the international level have made it more urgent for countries to maintain an updated regulatory framework relating to financial services. In Canada, these changes have been the focus of

⁷⁵ McGuire, Greg, and Schuele, Michael, (2000), “Restrictiveness of international trade in banking services”, Chapter 12 in: Findlay, Christopher, and Warren, Tony, (eds., 2000), Impediments to Trade in Services, 208.

⁷⁶ Since information on restrictions is difficult to find, the authors gathered information from the WTO schedules, the US Trade Representative, APEC, WTO Financial Leaders’ Group, and the TradePort Website. See pg. 203 of McGuire and Schuele.

frequent review since the 1950's. Canada is a unique case because it is a country with a highly concentrated banking sector, a dependency on natural resources, and a relatively small population. More importantly, Canada's relationship with the US has provided both opportunities and constraints. The government has recognized the importance of bringing foreign bank legislation in line with policies that have already been implemented in other developed economies. Canada also has experience in financial services negotiations. Having negotiated the Canada-US Free Trade Agreement (FTA) and the North American Free Trade Agreement (NAFTA), it entered the WTO's GATS negotiations well prepared. Chapter Three demonstrates that the financial services activity in the WTO has not been a major pressure on Canada to liberalize its regulations dealing with foreign financial institutions. In fact, Canada debated the benefits of liberalization decades before. Canada's latest financial services commitments to allow limited foreign bank branching have gone hand-in-hand with national financial regulatory reforms.

In the 1997 World Competitiveness Survey by the World Economic Forum, Canada ranked a strong 5th out of 53 surveyed countries for *competitiveness* of the domestic banking sector, but only 41st out of 53 for the degree of competition from foreign banks. Though Canada remains relatively open to foreign banks, the latter number reflects the saturation of retail banking services offered by, and consumer loyalty to, Canada's largest domestic banks. The new legislation governing the operation of foreign financial institutions, which may eventually improve this latter statistic, brings Canada on par with other developed nations and took effect June 28th, 1999. In this respect, Canada's foreign banking legislation in WTO terms is still new and compares nicely with the experiences of India and Singapore.

Singapore

Singapore has developed in roughly 40 years from a small trading city to an advanced urban city and international business center. Early on in Singapore's industrialization there was a shift from Import Substitution Industrialization (ISI) to Export-Oriented Industrialization (EOI) and subsequent strategies to foster higher value-added production under a 'developmental model'. This cannot be simply understood as consistently good leadership decisions, nor as a efficient responses to pressures exerted by international capital. Rather, Singapore's policy decisions, shaped by the People's Action Party (PAP) and the Monetary Authority of Singapore (MAS) have been made possible by a social and political environment which can be traced as far back as the social and political conflicts of the 1950's and '60's which have had a lasting impact on development. Singapore combined this with a pro-business environment, quick responses to economic slowdowns, and regular government re-evaluation of development policies. Singapore's economic policies have been reaching outward even more through the negotiations of bilateral free trade agreements and the promotion of the city as an international financial center. As an internationally competitive 'niche' state, Singapore constantly seeks out ventures in which it can excel, thereby showing that the state can play a major role in shaping its own comparative advantage.

In part because of its high economic standing, Singapore also does not share many of the concerns that other developing countries may have when deciding to liberalize in financial services. Singapore's geopolitical location for manufacturing, shipping, telecommunications and financial services make it a special place in Asia as a financial

center and fulcrum of Asian trade. Extensive modern financial reform characterizes Singapore's economy. Long considered to be one of the most protective governments in Asia, Singapore has been consistently moving forward on a restructuring program for the financial services sector. In May 1999, Singapore began a five-year program to liberalize the banking sector and it has now begun to allow foreign competitors to compete more actively with domestic banks. However, there is still a clear lack of commitment to lifting some of the restrictions in Singapore's financial services sector, especially in the retail banking sector. As a result, Singapore maintains a relatively controlled financial services market. The rationale is to manage the process of liberalization and avoid a disorderly "big-bang" which could lead to unhealthy market practices and banking crises. The issuance of licences pays strict attention to the prudential soundness of applicants and their commitment to Singapore's domestic market. To what extent these licenses represent legitimate prudential measures as opposed to protectionism will be discussed.

India

The history of Indian financial services makes it an interesting case study for this dissertation. India has recently weathered more than a decade of financial and economic reforms and has maintained a mostly state-owned financial structure. India's 14 largest banks were nationalized in 1969, leaving 19 banks wholly owned by the government throughout the 1970s and 1980s. During this time, the government held a monopoly on investment and production in most sectors of the economy. Foreign investment was negligible and the domestic financial sector was dominated by the nationalized banks, which diverted investments towards "priority projects" at the discretion of the government. There

were few prudential standards and international trade was highly controlled and protected.⁷⁷ Beginning in 1985, moderate attempts were taken to liberalize the economy to overcome slow growth and poverty which was thought in part was caused by the inefficiencies of state-owned industries.

Commercial banking in India is dominated by 28 government-owned banks, which control about 85% of the banking business in India, and typically account for 90% of all lending.⁷⁸ However foreign banks are now beginning to play a more important and innovative role in India's banking sector as regulations have been significantly relaxed since the late 1990's. The Reserve Bank of India (RBI) has also been strongly pushing international accounting and capital standards in order to strengthen domestic financial reforms. Financial liberalization has allowed foreign banks to introduce a newer and broader range of products. Government regulations still significantly limit new foreign bank activities by restricting their branch expansions along with a court system, contract law, and clearing systems which are notoriously inefficient. India is still reluctant to abandon its reliance on public ownership because of its important role in development goals - especially in the highly restricted insurance sector. India finally began to open up the public-sector monopoly in its insurance industry in October 2000. Representatives of the insurance industry have said that the importance of the deregulation is not the legal ruling itself, but whether or not these private companies will be able to compete with the two massive state-

⁷⁷ Dobson, Wendy Jacquet, Pierre, (1998), Financial Services Liberalization in the WTO, 185.

⁷⁸ EIU, November 30th, 2000. From 'Country Commerce India'.

owned insurance companies. This is an indication that foreign providers do not share an equal competitive footing with the domestic state-owned monopolies. All of the financial services reforms happening in India have been occurring independently from the WTO liberalization program.

Summary

The liberalization of trade in financial services is related to increased financial integration, but it is also directly linked to the program of trade liberalization being undertaken by most countries. This dissertation argues that countries have a significant role to play in orchestrating their own financial liberalization as they recognize that accommodating market preferences in lieu of protectionism is a better path to policy effectiveness and financial efficiency. This approach will discount the argument of the critics of liberalization who suggest that a lack of authority and legitimacy in the international system, along with the dominance of private interests, limits the policy-making capacity and the autonomy of the state. Finding that trade protectionism in financial services, which does exist to some extent in most countries, is the product of unique economic and political considerations and not arbitrary discrimination illustrates two important ideas: that countries are not simply ignorant of the relationship between their domestic policies and trade protectionism, and that they are not simply invoking protectionist policies out of greed. Essentially, the nature and extent of liberalization arises from the prevailing authority of the state in financial liberalization as it works to satisfy domestic interests and improve policy effectiveness. Examining the cases of financial services liberalization in Canada, Singapore, and India will provide evidence to support this claim. These findings will give a broader

understanding of the relationship between the liberalization of trade in financial services and effective prudential regulation. Finally, it will offer valuable insight into the positions of countries as they negotiate the continuing rounds of WTO financial services negotiations.

Initially adhering to protectionism in the face of liberalization may be an important example of these domestic processes at work but it often cannot be sustained. Business groups and neo-liberal advocates are generally against restrictions as they are seen as barriers to opportunity.⁷⁹ The government tries to shift their strategy for maintaining policy effectiveness from one where they use restrictive regulations to a strategy of more market-supporting interventions, competition for regulatory jurisdiction and international regulatory co-operation.⁸⁰ Reform then becomes the option pursued when the government attempts to improve its policy effectiveness under the existing market conditions by accommodating important domestic players. Second, governments often liberalize in order to attract foreign capital. This involves regulatory changes consciously promoted by government officials and shaped by domestic approval that attempt to increase the attractiveness of their market. The financial sector is also secretive by nature, a quality originating both from its fiduciary role and the history of independence in central banking. This can facilitate liberalization because governments will face less collective action problems in this sector than would be the case when liberalizing trade in other services or goods. In sum, the extent of government involvement in financial liberalization described here indicates that significant authority

⁷⁹ Helleiner, Eric, (1994), "Freeing Money: Why have states been more willing to liberalize capital controls than trade barriers?", *Policy Sciences*, 27, 299-318.

⁸⁰ Holt Dwyer, Jennifer, (1997), "The Dynamics of Financial Market Reform in Japan, 1975-95", 197-198.

prevails at the level of the state.

Chapter 2

Financial Services Liberalization and the GATS

This chapter's purpose is to outline the key features of trade in financial services. Section I includes a background discussion on the nature of trade in services, how they are traded, how they are different from goods, and the types of financial services the dissertation will consider. Section II examines the importance of domestic regulations and the many ways that they can be protected from the process of liberalization. Finally, Section III begins by defining liberalization and examines the General Agreement on Trade in Services (GATS). The structure of the GATS as well as its key sections relating to financial services, the Financial Services Agreement (FSA), is discussed. The importance of prudential regulation in financial services is discussed along with a brief history of the negotiations to create the FSA. In general, the chapter attempts to highlight the significance of trade in financial services by explaining the complex relationship between international efforts at liberalization and the demands of domestic political autonomy. In doing so, it examines whether in fact the FSA severely restricts a state's capacity to take initiatives to manage its economy and the welfare of its citizens.

Section I: Introduction and Types of Financial Services

In the early 1980's, many Western governments were faced with concerns about a world-wide recession and a crisis in the GATT trade regime. The GATT trading system was considered 'seriously endangered' because the contracting parties were routinely ignoring

trade rules and many goods were being traded entirely outside of its rules.⁸¹ During this time there was also growing awareness of the economic importance of international services and how they were complementing activities traditionally based on goods sectors. The issue of including services in the system eventually came to be discussed more often into the late 1980's in the GATT after an initial push by the US at the November 1982 GATT Ministerial Meeting.⁸² The regime development process for services trade has been one of continuous negotiation and incremental refinement since the creation of the GATS agreement at the end of the Uruguay Round in 1993. Today services account for almost 70 per cent of GDP in industrialized countries, and close to 50 per cent in developing countries. Services also account for at least 20 per cent of world trade, and close to 60 per cent of the world's FDI.⁸³

The exchange of services across international borders is far more complex than is the movement of goods. This is mainly because it is nearly impossible to separate the production of services from their consumption; either the producer must move to the consumer, or vice versa. In addition, many services are heavily regulated for very important reasons, and regulations cannot be simply equated with other trade restrictions. Services are subject to a variety of government regulations which were initially designed to serve other goals before trade in services was as important as it now is, but they also demand new regulations which

⁸¹ Jarreau, Steven, J., (1999), "Interpreting the General Agreement on Trade in Services and the WTO Instruments Relevant to the International Trade of Financial Services: The Lawyer's Perspective", 14-15.

⁸² "The Process and Background to the Uruguay Round", South-North Development Monitor (SUNS).

⁸³ Daniels, Peter, W., (2001), "Globalization, Producer Services, and the City: Is Asia a Special Case?", 221.

have more far-reaching implications for domestic politics than do those which cover the trade of goods. To address these problems, it was believed that increased legal predictability and a gradual reduction of regulatory barriers would be the way to initiate a framework for trade in services.⁸⁴

Financial services play a central role in all economies by tying together three important economic variables: macroeconomic management, financial regulation and supervision, and the trade regime. When these three areas of the economy are working together efficiently there can be many positive benefits. First, a liberal financial services regime is important for sound macroeconomic management. Monetary policy is likely to improve when repressive controls and inappropriate government interventions are removed.⁸⁵ A healthy and competitive financial sector also tends to attract productive investment in a competitive international environment. Increased foreign investment in financial services demands better standards and improved functioning of domestic financial systems.⁸⁶ Second, multilateral commitments tie down liberalization and weaken the power of privileged domestic interest groups (essentially preventing “policy slippage”).⁸⁷ Integrated with commitments in prudential regulation, signs of policy stability and intent to foreign investors are developed, and this induces other countries to follow the lead for mutual benefits. The

⁸⁴ See for example, Key (1999), “Trade Liberalization and Prudential Regulation”, 62, and Kampf, R., (1998), “Financial Services in the WTO: Third Time Lucky”, 113.

⁸⁵ Kono, Masamichi, (1997), “Opening Markets in Financial Services and the Role of the GATS”, 1.

⁸⁶ Das, Dilip, “Trade in Financial Services and the Role of the GATS: Against the Backdrop of the Asian Financial Crises”, 85.

⁸⁷ Tamirisa, et. al., (2000), “Trade Policy in Financial Services”, 21.

strengthening of the domestic financial infrastructure then promotes improvements in regulation and supervision. Third, the offering of financial products internationally and the establishment of financial institutions in foreign countries requires rules and regulations in order to establish legal predictability and prevent discrimination among services providers. As in goods, this encourages specialization based on comparative advantage, the dissemination of know-how for best practices (management & accounting practices), and the realization of economies of scale and scope.⁸⁸ Together these factors are thought to indirectly improve the ability of countries to intermediate financial investment and increases the quality and variety of domestic financial services.⁸⁹

International agreements in banking and finance are generally built out of necessity based on the fact that existing domestic regulations have not been able to adequately deal with the complexities and competition in modern financial industries. While the responsibility for regulating and supervising financial institutions still lies ultimately with national authorities, the consequences of poor regulatory and supervisory oversight has consequences well beyond a nation's borders. These problems can be complicated further by technological advances in information services, increases in the numbers and size of corporate mergers & acquisitions (M&A's), and the overall global reach of financial business.

⁸⁸ See Hindley, Brian and Smith, Alasdair, (1984), "Comparative Advantage and Trade in Services", 386.

⁸⁹ Sauve, Pierre, and Steinfatt, Karsten, (2001), "Financial Services and the WTO: What Next?", 375.

International agreements in financial services have three separate purposes.⁹⁰ First, agreements can facilitate cross-border business by setting technical standards, codes of conduct, and accounting standards. An example is the International Accounting Standards Board (IASB) based in London, which works to achieve enforceable and transparent global accounting standards that are compatible with national accounting practices. Second, agreements can be designed to help promote and maintain overall financial stability, as do the core banking standards of the Bank for International Settlements (BIS).⁹¹ Finally, agreements can focus on the expansion of cross-border competition, which the relevant parts of the North American Free Trade Agreement (NAFTA) and GATS aim to do. This dissertation will focus strictly on this third purpose of international agreements and specifically on the financial services agreement of the GATS. The first two types of financial services agreements are outside the scope of this dissertation, but their significance warrants some mention in the next chapter. The NAFTA financial services chapter is important for Canada's experience in financial services and will be covered in Chapter 3.

Types of Financial Services

While banking is commonly known to be the most central and important type of financial service, securities and insurance services have become equally important in modern economies. In developing and emerging markets, banking is usually the main focus of

⁹⁰ White, William, R., (1996), "International Agreements in the Area of Banking and Finance: Accomplishments and Outstanding Issues", 3.

⁹¹ The Core Principles for Effective Banking Supervision are a comprehensive set of twenty-five Core Principles that have been developed by the Basel Committee as a basic reference for effective banking supervision. The Principles are designed to be applied by all countries in the supervision of the banks in their jurisdictions.

reform efforts because of the central role it plays in financial intermediation and in the economy overall. The WTO defines financial services to include the following two categories: all insurance and insurance-related services, and all banking and other financial services (excluding insurance).⁹² Insurance services include direct insurance (life and non-life), reinsurance, insurance intermediation (brokering) and auxiliary services to insurance such as consultancy and risk assessments. Banking and other financial services (which covers securities) includes acceptance of deposits, lending, leasing, payments, guarantees, trading, money brokering, management, settlement, information services, and advising. Banking, Insurance, and Securities will now be outlined in greater detail.

Banking

Banks were traditionally differentiated from other financial institutions by their principal functions of accepting deposits and making loans. However, financial firms around the world have been undergoing processes of de-segmentation, which are breaking down the traditional boundaries that once divided banks, insurance companies, and securities providers. Modern financial services companies now involve themselves in all areas of stock trading and derivatives, as well as commercial banking, and insurance. The basic function of banks is to act as ‘intermediaries’ which channel funds from individuals, organizations, and governments who have surplus funds to those who wish to use those funds. Banks are also very important because they operate the payments system in economies, and thus have an impact on the efficiency with which the country’s resources are allocated. Banking is one

⁹² For categorization see WTO, “Annex on Financial Services”, section 5, “definitions”.

of the most heavily regulated financial activities because of the central role that it plays in an economy. Governments regulate to protect the stability of the banking system in the face of many modern challenges. Structural changes in the industry such as the consolidation of financial firms and advances in technology calls for appropriate prudential policies which ensure fair competition, corporate governance, and ultimately, the protection of depositors.

Minimum standards and best practices for international banking have been evolving since the creation of the Basel Committee on Banking Supervision in 1974 at the Bank for International Settlements (BIS).⁹³ The Basel Committee itself is an informal group of central bank officials and supervisory authorities from the G10 countries. In 1988 it produced the Basel Risk-Based Capital Accord, an informal agreement that sets capital measurement standards for internationally active banks. In 1997 the Committee established the Core Principles for Effective Banking Supervision which are designed to provide a generally accepted set of principles for effective supervision of national banking systems that can be used throughout the world. They have now been widely used by authorities from both developed and developing countries.

Insurance

Because insurance companies are also financial intermediaries, they perform the same types of functions and provide similar benefits to a national economy as do banks. Insurance can help to promote financial stability by encouraging individuals and firms to create wealth with the assurance that their resources can be protected. Insurance can also substitute for, and complement, government security programs by relieving pressure on social welfare

⁹³ “BIS History”, Bank for International Settlements.

systems while reserving government resources for essential social security and other purposes. In Asia, for example, the life insurance markets are highly developed, reflecting the lack of public sector retirement schemes, which force individuals to look after their own retirement needs.⁹⁴ The emergence of a substantial middle class over the last ten years has accelerated this trend in Asia. Insurance can also facilitate trade and commerce since many products and services can only be produced and sold if adequate insurance is available. Finally, insurance helps to make risk management more efficient through diversity and mobilizes savings by reducing the transaction costs of individual transactions which makes it important for economic development.⁹⁵

Government intervention and regulation in insurance markets serves the same purposes as it does in banking. The industry is protected and regulated for prudential reasons, and/or in response to the lack of skilled management or weak market development. The development of insurance markets requires the same competition laws, prudential regulation, and regulatory effectiveness as does banking. In the eyes of strong foreign insurers, developing countries face important challenges to build regulatory capacity for institutions and 'best practices' in order to cope with the regulatory requirements they face. Significant barriers to establishment and operation exist in developing country insurance

⁹⁴ Singapore implements a mandatory pension fund, the Central Provident Fund (CPF), for its citizens and permanent residents. Introduced in 1955 for retirement provisions, the CPF has 2.9 million members with a total of S\$90.3 billion (US\$50.2 billion) in their accounts. Initially an old-age social security scheme, the CPF has gone through a series of changes to allow its members to use their CPF savings for housing, medical expenses and education.

⁹⁵ Skipper, Harlold, D., (2001), "Liberalization of Insurance Markets: Issues and Concerns", 130.

markets, often resulting from long-established practices and monopolies, despite the FSA and other international initiatives in insurance.⁹⁶

The international body which oversees the technical aspects of insurance regulation and greater business facilitation is the International Association of Insurance Supervisors (IAIS). It was established in 1994 with the purpose of guiding domestic insurance regulators and supervisors, on a voluntary basis, through industry issues and cooperation with other regulators and monetary authorities. The IAIS works at the technical supervisory level and does not normally extend to broader public policy issues. For governments seeking direction in insurance development, the IAIS helps with coordination and harmonization in line with existing best practices, rather than dealing with emergent problems and new issues.

Securities (“asset management”)

The general perception of securities (stock) markets is that they are completely international, running 24 hours a day. Consistent with this perception, it is true that the large, internationally active securities traders account for the significant portion of international *trade* in securities. Furthermore, capital mobility, or the potential ease for money to move between countries, has increased because of better technology and communications, financial firm innovation, and domestic market liberalization.⁹⁷ However, despite their significant

⁹⁶ Malaysia for example imposes strict limitations on the entry of foreign insurance companies and makes no commitments on issuing new licenses. (Malaysia, GATS Schedule of Specific Commitments, Financial Services, Insurance). Indonesia for example remains mostly “unbound” for insurance services. (Indonesia, GATS Schedule of Specific Commitments).

⁹⁷ Andrews, David, “Capital Mobility and State Autonomy: Toward a Structural Theory of International Monetary Relations”, 214.

growth, the markets are still mostly national exchanges regulated in the national context.⁹⁸ The business of traditional commercial banking, where the bank accepts deposits and lends out the money, is now being overshadowed by investment banking - the raising of funds for customers by dealing in securities (capital markets). There are two main reasons for this trend.⁹⁹ First, finance from securities is cheaper and more flexible than bank loans. Second, governments are still restricting the issuance of new bank licenses, and so the entry into securities dealing is seen by banks as the only path to growth. For these reasons, a substantial percentage of equity trading is now done by commercial banks. Two other important functions of the international securities industry include the operation of corporate finance (advising, mergers, acquisitions) and investment/management services.

International oversight of the securities industry exists through the International Organization of Securities Commissions (IOSCO). It was founded in 1984 as a response to problems with international regulation in securities. At the time no single regulator was able to deal with the growing concerns of prudential regulation in the expanding international markets. Pressure was also exerted from industry to attempt regulatory harmonization and convergence. The objective of the IOSCO is to enhance cooperation among members in order to promote and establish regulatory standards to facilitate international securities transactions. The IOSCO is thought by some to be a non-governmental organization (NGO)

⁹⁸ Underhill, Geoffrey, R.D., (1995), "Keeping Governments out of Politics: Transnational Securities Markets, Regulatory Cooperation, and Political Legitimacy", 261.

⁹⁹ Wahba, J., Mohieldin, M., "Liberalizing Trade in Financial Services: The Uruguay Round and the Arab Countries", 1337.

based on a long tradition of self-regulation in the industry. Critics of the self-regulation tradition suggest that important decisions can be made outside the traditional democratic process and that this affects the ability of governments to develop policies. This is seen to be especially important because the securities business has a close association with the movement of capital. With greater levels of autonomy placed with market actors outside the democratic realm, the resulting lines of accountability are not as clear as they should be.¹⁰⁰

However, the IOSCO involves itself in coordination and harmonization issues, not in the policy aspects to achieve greater cross-border competition which is the domain of the democratically representative Members of the GATS.¹⁰¹ The IOSCO is also primarily made up of official securities regulators from several countries and while they do have some autonomy, it may be a stretch to call them ‘non-governmental’.¹⁰²

Section II: Financial Services and Liberalization

The Meaning of “Liberalization” in Financial Services

Trade liberalization in the context of financial services focuses on the removal of the restrictions that discriminate between domestic and foreign financial services providers; it should not be equated with deregulation. In other words, the intent of measures which liberalize is to create equally competitive opportunities for domestic and foreign financial service providers. National Treatment is a key part of liberalization which ensures that

¹⁰⁰ Underhill, Geoffrey, R.D., (1995), “Keeping Governments out of Politics: Transnational Securities Markets, Regulatory Cooperation, and Political Legitimacy”, 253.

¹⁰¹ White, William, R., (1996), “International Agreements in the Area of Banking and Finance: Accomplishments and Outstanding Issues”, 9.

¹⁰² Personal correspondence, June 2003.

foreign financial services providers are treated in at least the same way as domestic ones. Most-favoured nation treatment (MFN) is also an element of liberalization which aims to prevent situations where foreign service providers from a certain country are granted preferential treatment or market access in areas beyond those open to providers from other countries.

Liberalization also includes removing restrictive barriers which might prevent foreign companies from entering and establishing their businesses, or from performing cross-border transactions. Standards of publication and accessibility (i.e., transparency) of regulations and information usually complement other measures to ensure the fair application of national policies and regulations. The liberalization of financial services can also be aimed at identifying and reducing less obvious non-discriminatory *or structural* barriers which are embedded in all domestic financial regulatory systems (e.g., licensing procedures, network accessibility). These barriers arise out of regulatory systems that have evolved differently from others and therefore unintentionally disadvantage firms that are not accustomed to them.

The changes brought about by liberalization are likely to induce short-term adjustment costs and focused opposition. Economic challenges to liberalization generally revolve around issues of financial stability. Since there is usually a positive relationship between overall financial liberalization and increased capital movements, some critics will argue that the level of financial volatility is bound to increase.¹⁰³ This volatility is thought to negatively affect the economy and is further complicating when there has been an

¹⁰³ Strange, Susan, (1988), States and Markets, 96.

improper sequencing of liberalizing reforms.¹⁰⁴ For example, liberalization cannot proceed effectively during periods of political or economic unrest, such as war or hyperinflation. The reform process in turn raises questions about the maintenance of macroeconomic stability and the overall safe regulation and supervision of financial institutions. Firms that are inherently less efficient are likely to feel the brunt of strong competition as they lose their protected status. Liberalization tends to be a contentious issue in most countries but the literature generally suggests that if it is done cautiously and sequenced appropriately, it contributes to positive growth in the long run.

The subject of this dissertation deals fundamentally with the removal of discriminatory barriers to trade in financial services. While this process facilitates ‘intermediation’, or the financial services transactions through which capital is moved among countries, it does not aim to directly open up the capital account¹⁰⁵ or directly affect a Member’s macroeconomic freedom.¹⁰⁶ The liberalization of financial services in the WTO is just one way countries can improve the quality of investment in their country in addition to other international initiatives which aim to improve financial regulation.¹⁰⁷ The focus of this dissertation is trade liberalization, and hence, the removal of discriminatory measures between WTO Members trading in financial services.

¹⁰⁴ Proper sequencing is described in: Das, Dilip, “Trade in Financial Services and the Role of the GATS: Against the Backdrop of the Asian Financial Crises”, 90.

¹⁰⁵ “Capital Account”: A country’s international transactions arising from changes in holdings of capital assets.

¹⁰⁶ “Macroeconomic” factors include: level of employment, the price level, economic growth and the balance of payments.

¹⁰⁷ For example: *codes of conduct*, as in the International Accounting Standards or the Basel Core Principles for Effective Banking Supervision.

The GATS: Trade in Services

The GATS emerged out of the Uruguay Round of trade negotiations and it represents the first multilateral attempt to establish rules governing services trade. Initial endeavours to bring financial services into the trade realm, as in the NAFTA, for example, were realized by supplementing existing bilateral and regional agreements. Because these often included only minimal coverage in services, it was believed that a multilateral agreement on services under the auspices of the GATT could offer more comprehensive coverage. It is argued by some that regional and sub-regional agreements can provide more far-reaching liberalization in services than can the GATS because they involve smaller memberships and can more easily define their goals in negotiations.¹⁰⁸ However, the main significance of the GATS is that measures relating to trade in services will be subject to multilateral rules on a broader permanent basis, rather than on an interim or piecemeal basis.

The GATS has been publicly less-well understood than the GATT, but it has steadily been generating more widespread interest. The agreement has generally not been seen to be very relevant to those who should benefit most from it (e.g., the services industry).¹⁰⁹ Industries are generally pro-active and make the initiative to campaign on behalf of themselves through the powerful services coalitions and industry associations, in addition to what they and governments are doing in the WTO, in order to make progress.¹¹⁰ In many

¹⁰⁸ Stephenson, Sherry, M., (1999), "Approaches to Liberalizing Services", 36.

¹⁰⁹ Hoekman, Bernard, (2000), "The Next Round of Services Negotiations: Identifying Priorities and Options", 31.

¹¹⁰ For example the Coalition of Service Industries (USCSI) based in Washington is a leading international business organization dedicated to the reduction of barriers to services exports, and uses services trade negotiations to advance the interests of its

services sectors, governments have been relying on industry itself to take the lead in identifying key issues and on economic and legal experts to tell them which regulatory reforms should be of interest to them.¹¹¹ In other words, governments are generally reactive to developments in services as the real world is forced onto their agendas.¹¹² This is understandable given the experience in other trade agreements, which suggests that such agreements often need to mature for a decade or two before governments fully utilize them to manage their trade.¹¹³

The GATS is designed to lock in progressively higher levels of commitments for trade in services through successive rounds of negotiations. In practice, achieving this will require governments to identify for themselves which domestic reforms will be most effective for spurring economic development. Financial services liberalization happens to be one of the best starting points because it is central to advanced economic efficiency, and enhances the credibility of its Members' economic orientations.¹¹⁴ This last issue can be especially true in countries with histories of policy uncertainty.

Structure of the GATS

The GATS is structured in two parts. The first part is the text of the Agreement - its Articles and Annexes. The second part is the schedules of specific commitments undertaken by WTO Members. The general obligations of the main part of the GATS agreement are

members.

¹¹¹ Personal interview, November 1999.

¹¹² Personal interview, October 2001.

¹¹³ Feketekuty, Geza, (2000), "Improving the Architecture of the GATS", 20.

¹¹⁴ Van Empel, Martijn, Morner, Anna, (2000), "Financial Services and Regional Integration", 57.

intended to ensure the equitable application of general rules affecting trade in services. These general rules, unlike the specific sectoral commitments, are equally applicable to all WTO Members. The structure of the GATS clearly separates the general obligations that are accepted by all parties from the optional sectoral commitments with respect to market access and national treatment.

Services covered under the GATS include any service in any sector, except those supplied in the exercise of governmental authority, such as social security, central banking, military, and police services. The GATS covers four ways (modes) by which services are provided.¹¹⁵

(i) Four modes of supply.

Mode 1 - Cross-border supply

Cross-border supply is the supply of a service from the territory of one Member into the territory of any other Member. This is the type of transaction analogous to trade in goods. For example: A Canadian insurance company writes a policy for an American factory.

Mode 2 - Consumption abroad

This happens when the consumer moves to the territory of another country and buys services there. For example: tourism or when a Canadian visiting Hong Kong exchanges traveller's cheques for cash at the local American Express office.

Mode 3 - Supply through commercial presence

This involves direct investment in the export market through the establishment of a

¹¹⁵ GATS Agreement, Part I, "Scope and Definition", Article 1 (2).

business there for the purpose of supplying a service. For example, The Bank of Nova Scotia (Scotiabank) establishes an office in Singapore to provide commercial banking to corporate customers.

Mode 4 - Supply through the presence of natural persons

This means the temporary presence in the export market of an individual for the purpose of supplying a service. This person could be the service supplier himself or an employee of the service supplier. In both cases, the GATS definition covers only the temporary stay of such persons. For example, a US-based risk specialist for Citibank moves to Malaysia for a 6-month period in order to complete an assessment.

(ii) Obligations under the GATS.

Obligations contained in the GATS may be categorized into two groups: General obligations which apply directly and automatically to all Members, regardless of the existence of sectoral commitments; and specific commitments whose scope is limited to the sectors and activities where a Member has decided to assume market access and national treatment obligations.

(a) General obligations

MFN Treatment: Under Article II, Members are held to extend immediately and unconditionally to services or services suppliers of all other Members "treatment no less favourable than that accorded to like services and services suppliers of any other country". The only possible derogation from the MFN principle exists in the form of a so-called Article II-Exemption. Members were allowed to take such exemptions at the time of acceptance of the GATS. Also, exemptions may be granted either at the time of a country's accession or,

for current Members, through negotiating a waiver under Article IX of the WTO Agreement. Any such exemption is subject to review and should in principle not last longer than 10 years.

Transparency: The GATS requires the publication of all relevant general material and international agreements which pertain to or affect the operation of the Agreement and Members are required to respond to other Member's information requests. The purpose of this requirement is to make the legislative and regulatory processes more visible so as to achieve better regulation and compliance by services providers.

(b) Specific Commitments

Market Access: The granting of market access is a negotiated commitment undertaken by individual Members in specified sectors. It may be made subject to one or more limitations (listed on next page) enumerated in Article XVI(2). Commitments which are made by Members are *binding* in that they set out the minimum treatment that a foreign service provider is to receive (*de jure*). They also do not prevent a Member from offering better treatment in practice (*de facto*).

National Treatment: In any sector included in its Schedule of Specific Commitments, a Member is obliged to grant foreign services and service suppliers treatment no less favourable than that extended to its own like services and service suppliers. In this context, the key requirement is to abstain from measures which are liable to modify, in law or in fact, the conditions of competition in favour of a Member state own service industry. Members are entitled to make the extension of national treatment in any particular sector subject to conditions and qualifications. At the present time two of these Modes are more significant

than the others in financial services - *mode 1* (cross-border supply) and *mode 3* (commercial presence).

Schedules of Specific Commitments

Each WTO Member is required to have a set of national schedules in which they make specific commitments. These specific commitments are the liberalizing component of the GATS. A schedule is a document, which identifies the services sectors, sub-sectors or activities subject to Market Access and National Treatment obligations and any limitations attached to them. The necessary indications must be entered with respect to each of the four different modes of services supply.

The GATS does not impose the obligation to assume market access or national treatment commitments in a particular sector. In scheduling commitments, Members are free to tailor the extent of the commitments they take so as to avoid or modify obligations that they consider too demanding at present.

(i) GATS requirements

Article XVI sets out six forms of limitation on market access that may be specified in national schedules. They are:

- limitations on the number of service suppliers;
- limitations on the total value of services transactions or assets;
- limitations on the total number of service operations or the total quantity of service output;
- limitations on the number of persons that may be employed in a particular sector or by a particular supplier;

- measures that restrict or require supply of the service through specific types of legal entity or joint venture;
- and percentage limitations on the participation of foreign capital, or limitations on the total value of foreign investment.

Article XVII deals very similarly with national treatment, although it does not follow Article XVI in setting out a list of measures that would be incompatible with such treatment. It states that in the sectors covered by its schedule, and subject to any conditions and qualifications set out in the schedule, each member shall extend to foreign services and service suppliers treatment, in measures affecting the supply of services, no less favourable than it gives to its own services and suppliers.

Any market access or national treatment obligations inscribed in schedules must be granted unconditionally to all Members, without discrimination (i.e., on an MFN basis). Any reciprocity provision in areas not subject to specific commitments would need to be listed as an Article II-Exemption as it contravenes the basic MFN requirement. The nature of these exceptions generally deal with approval procedures in foreign investment laws and limitations placed on the presence of particular natural persons arising out of immigration laws. Pursuant to Article XXI, specific commitments may be modified not earlier than three years after their entry into force. However, countries that can be affected by such modifications may request the modifying Member to negotiate compensatory adjustments. Any such adjustments are also to be granted on an MFN basis. Any commitment can be added or improved at any time.

(ii) Understanding the scheduling of commitments

The basic principle in scheduling commitments is that if a service sector (eg, financial services) is listed in a country's service schedule, the liberalizing rules of GATS will apply to trade in that sector unless limitations are identified at the time of scheduling. If national legislation in a listed sector is inconsistent with the GATS and no limitations are identified, then national legislation must be brought into conformity with the GATS. The most notable features of a schedule is the distinction between the four modes of service delivery (cross-border, consumption abroad, commercial presence, presence of natural persons) and the basic requirements in Part III of the GATS on market access (Article XVI), national treatment (Article XVII), and possible additional commitments (Article XVIII). The services schedule of a fictitious country, "Norland", is divided into four columns (See next page). The first specifies the sector or sub-sector covered by the information in the other columns. The second column sets out any limitations on foreign service suppliers to market access for the sector and for the mode of delivery. The numbers 1 through 4 in each column indicate the mode of delivery to which the limitation applies. The third column specifies limitations that are placed on national treatment for foreign suppliers of the service. The last column can list any additional commitments as listed in Article XVIII.

Service schedules consist of both horizontal and sectoral sections. The section dealing with "Horizontal Commitments" contains limitations that apply across all sectors included in the schedule. Usually, entries under Horizontal Commitments come from laws of general application, especially concerning investment or immigration. The entries under "Section-Specific Commitments" contain limitations that apply only to the particular sector,

sub-sector or activity to which they refer. Norland's schedule includes examples of three kinds of annotation found in all schedules. At one extreme, the entry "none" means that no limitations have been placed, or may be placed in the future, on market access or national treatment for that service by the mode of supply concerned. At the other extreme, "unbound" means that a Member has undertaken no commitment and retains the freedom to act as it desires. The absence of a commitment does not mean that supply is outlawed. Countries may maintain *de facto* very liberal services regimes while making no GATS commitments whatsoever. Other listed information found in the columns describes in detail the nature of a market access or national treatment limitation.

Norland's schedule can now be read and understood more clearly. The horizontal commitments show that any foreign service supplier who wants to acquire, merge, or take-over companies requires approval. Norland accepts no commitments, except as specified, to allow entry of foreigners to its national territory to deliver services. The specific sectoral commitments in financial services (sub-sector, banking) indicates that Norland has made no commitments to allow foreign service providers to offer services by cross-border supply. For consumption abroad, foreign service providers face no limitations in Norland's legislation. Foreign banks which have a commercial presence in Norland are required to incorporate subsidiaries and acquire Ministerial approval to open additional branches. Finally, Norland has made no commitments regarding the presence of banking personnel, meaning that it is free to introduce restrictions at any time, except as it has indicated in the horizontal commitments with respect to intra-corporate transferees and specialists. This example of a GATS schedule is realistic but artificially short because it contains commitments in only one

Table 1. Norland: schedule of specific commitments

Modes of Supply: 1) Cross-border supply 2) Consumption abroad 3) Commercial presence 4) Presence of Natural Persons			
Sector or sub-sector	Limitations on market access	Limitations on national treatment	Additional commitments
I. HORIZONTAL COMMITMENTS			
ALL SECTORS INCLUDED IN THIS SCHEDULE	3) Acquisitions, mergers and takeovers of Norland companies requires approval according to Foreign Investment Act. 4) Unbound, except for measures affecting the temporary stay of natural persons defined below: a) Intra-corporate Transferees may stay for a period up to 1 year. b) Specialists may stay for a period up to 90 days.	3) Approval required for acquisition of land, property or real estate undertaken for non-productive or speculative purposes. 4) Unbound, except as indicated in the market access column.	
II. SECTOR SPECIFIC COMMITMENTS			
FINANCIAL SERVICES			
A. <u>Banking</u>	1) Unbound 2) None 3) None, other than: Foreign banks must incorporate subsidiaries in Norland to undertake the business of banking. 4) Unbound, except as indicated in the horizontal section.	1) Unbound 2) None 3) None, other than: Ministerial approval is required for foreign bank subsidiaries to open more than one branch. 4) Unbound, except as indicated in the horizontal section.	

sub-sector. It should be recalled that these commitments are binding, in that, if a WTO Member abrogated its commitment, it could give rise to a panel under the Dispute Settlement Understanding (DSU), and possibly retaliatory action by other WTO Members.

(iii) The process of making commitments

Commitments in trade agreements are usually made by one of two ways: Negative List (Top-Down) or Positive List (Bottom-Up). The negative list approach is used by the

NAFTA, or example, and the positive list approach is used by the GATS. Under the negative list approach, trade in services are to be free of conditions for all sectors unless otherwise specified in the lists of exceptions. This approach does not require the negotiation of schedules of commitments since liberalization is to be guaranteed for all sectors and for all service suppliers under unrestricted MFN and national treatment. By contrast, the positive list approach requires that commitments made by a country be indicated in its national schedule along with any conditions corresponding to that particular service activity.

The negative list approach is generally more liberalizing because it automatically provides national treatment and market access to areas that have not yet been formally discussed in negotiation.¹¹⁶ This approach is also more transparent because it provides much more information to other WTO Members since the importing country has to indicate restrictions on market access or national treatment in their schedules. In the Uruguay Round negotiations, some WTO Members simply did not have the necessary regulatory development or bureaucratic personnel to identify the laws that would conflict with their commitments (as would be required in the negative-list approach).¹¹⁷ As a result, a “hybrid approach” evolved for scheduling commitments which combines one aspect from the negative list approach and one aspect from the positive list approach. That is, in sectors where countries want to make commitments, they must list their *reservations* to national treatment and market access as in the negative list model, but they take on no commitments

¹¹⁶ See Sorsa, Piritta, (1997), “The GATS Agreement on Financial Services - A Modest Start to Multilateral Liberalization”, 8., and Dobson, Wendy, Jacquet, Pierre, (1998), Financial Services Liberalization in the WTO, 74.

¹¹⁷ Feketekuty, G., (2000), “Assessing and Improving the Architecture of the GATS”, 98.

in sectors that are not listed in their schedules, as the positive list model allows.

Key GATS Provisions Relating to Financial Services

(i) Transparency

Transparency is a key obligation in financial services because it helps ensure the non-discriminatory application of national policies and regulations to the operation of foreign service suppliers. Because financial services operations operate largely based on information, service operators would not be able to access or operate in markets without access to regulatory information. There is now a general consensus view that regulations that are applied consistently, comprehensibly, fairly and equitably by governments, regulators, and the international financial institutions, promote the best markets for investors without sacrificing the right of governments to regulate.¹¹⁸

(ii) Domestic regulation

Article VI on domestic regulation requires that members should ensure that all areas where commitments are undertaken are administered in a reasonable, objective and impartial manner. It disciplines the more hidden forms of protectionism that are often buried in domestic regulations and their administration. An example would be the *de facto* differential treatment of foreign services providers operating in a developing country because of extra “administrative burden” placed on the country’s bureaucracy to administer foreign firms.¹¹⁹

¹¹⁸ Securities Industry Association Discussion Paper, (2000), “Promoting Fair and Transparent Regulation”, 31 August, 2000. Collaboration work has been ongoing between the IOSCO, IMF, and SIA on standardized transparency rules.

¹¹⁹ See for example Secretariat notes by the WTO’s Working Party on Domestic Regulation, “Report on the Meeting Held on 2 October 2001”, 3.

In policy terms, this means that countries should be able to regulate their services sectors while the standardization of national laws and regulations should be sought.

(iii) Right to regulate

The potential interference of market access provisions in the domestic politics of WTO Members necessitated a condition in the GATS which ultimately gives Members the right to regulate their own economies.¹²⁰ When problems arise with the balance of payments, as happened in Argentina in early 2002, for example, a Member is permitted to introduce restrictions of a temporary nature on trade in services as they see fit. Other governmental financial policies that are compatible with broad market access, national treatment, and scheduled commitments to liberalize, can still be maintained transparently. With the exception of safeguarding the economy through the balance of payments, the GATS does not allow members to apply restrictions on international capital transfers or payments relating to specific commitments.¹²¹ If a member is committed to the cross-border supply of a service, for example, the movement of capital risks associated with that commitment are to be assumed by the importing country. With respect to developing countries in particular, the GATS allows that particular account should be taken of their potentially serious difficulties

¹²⁰ Annex 1B to the GATS states: “Recognizing the right of Members to regulate, and to introduce new regulations ... in order to meet national policy objectives and, given asymmetries existing with respect to the degree of development of services regulations in different countries, [the GATS recognizes] the particular need of developing countries to exercise this right;”

¹²¹ Article XII (Restrictions to Safeguard the Balance of Payments) states that “In the event of serious balance-of-payments and external financial difficulties or threat thereof, a Member may adopt or maintain restrictions ... on which it has undertaken specific commitments”.

and that they will only be required to undertake commitments and concessions to the extent consistent with their individual development, financial and trade needs, or their administrative and institutional capabilities.¹²²

Prudential Regulation: The Right to Regulate in Financial Services

In general, prudential regulations are geared to protect the financial sector, and ultimately the stability of the economy and the welfare of consumers.¹²³ Because banks provide credit and operate the payments system, their failure can have a more damaging effect on the economy than the collapse of other businesses. Governments thus pay particular attention to the regulation of banks. The collapse of one bank can spread trouble throughout the financial system as depositors from other healthy institutions fear for their savings. Therefore subjecting financial institutions to more stringent supervision and disclosure rules helps them to measure and manage their exposure to risk.¹²⁴ In addition, when funds are insured and public confidence in the viability of financial institutions is maintained, consumers are generally protected.¹²⁵ These measures are also intended to minimize the harmful effects of financial disruptions. More specifically, this includes preserving solvency, limiting risks, and protecting bank deposits. Capital and liquidity requirements are common forms of prudential regulation. Banks are required to hold

¹²² GATS Annex 1B, Articles IV, V, XII.

¹²³ Walter, Ingo, (1988), Global Competition in Financial Services: Market Structure, Protection, and Trade Liberalization, 184.

¹²⁴ BIS, (1997), “Core Principles for Effective Banking Supervision”, 24.

¹²⁵ While most developed economies have deposit insurance schemes, relatively late developers like Singapore are only now considering them after the Asian financial crisis and increased global financial integration. See Monetary Authority of Singapore (MAS) policy speech: “Managing the Liberalization Process”, 25 June, 2002.

minimum levels of capital to reduce the risk of loss to depositors, creditors, and other stakeholders and to assist regulators in pursuing the overall stability of the industry. These regulations are designed to limit the risk and to preserve the solvency of banks. While prudential regulation adds to system stability, it also can impose direct costs on the system in the form of inefficiencies.¹²⁶

The strategic importance of financial stability necessitated provisions in the FSA which preserve and emphasize the right of governments to intervene in the management of the sector. First is the ‘prudential carve-out’ of the FSA, which states that: “Notwithstanding any other provisions of the Agreement, a Member shall not be prevented from taking measures for prudential reasons, including for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial service supplier, or to ensure the integrity and stability of the financial system.”¹²⁷ This means that even specific market-access commitments may be set aside if a government considers it necessary to take such measures, though they must not of course be used simply as a means of avoiding commitments or other obligations under the agreement. Secondly, the GATS excludes services provided when a government is exercising its authority over the financial system. For example, the activities of central banks and other monetary authorities in the pursuit of monetary or exchange rate policies, and macro-economic policy management in general, are

¹²⁶ For example, India places restrictions on the convertibility of its currency. While this helped India escape relatively unscathed from the Asian financial crisis, these restrictions also introduce inefficiencies on the cross-border trade in financial services (Mode 1). Personal interview, November, 2002.

¹²⁷ Paragraph 2(a), The Fifth Protocol of the General Agreement on Trade in Services (GATS), (Financial Services Agreement).

excluded from the scope of the agreement. The same applies to activities forming part of a statutory system of social security or public retirement plans. In theory these two caveats to liberalization in financial services under the GATS agreement maintain the thrust of liberalization without compromising the right of governments to regulate their economies. These considerations, along with the fact that WTO Members voluntarily commit to liberalization in their services schedules, protects the sovereignty of WTO Members by allowing them to liberalize their financial services markets on their own terms.

Prudential issues are also dealt with in other international forums respective to banking, insurance, and securities and are slowly becoming standardized across various economies. Banking standards, for example, are increasingly based on the Core Principles for Effective Banking Supervision of the Basel Committee on Banking Supervision.¹²⁸ These principles, or rules very similar to them, have been adopted by many economies and are also used by the IMF and the World Bank for evaluating supervisory regimes around the world. The Core Principles are basic requirements and they are usually supplemented by countries with other measures designed to address specific characteristics of individual economies. One of the key Core Principles deals with capital adequacy and suggests that countries should set aside minimum levels of capital which reflect the risks that they carry. Essentially this allows for better risk management and allows banks to bear losses when they happen.¹²⁹ Since such common principles are now being more widely accepted as prudential,

¹²⁸ The Basel Committee on Banking Supervision is housed in the Bank for International Settlements (BIS).

¹²⁹ “Core Principles for Effective Banking Supervision” (Basel Core Principles), September 1997.

governments should prefer to respect each others' decision on which rules are in fact prudential when it comes to evaluating the prudential necessity of domestic regulations.¹³⁰

The Negotiations to Form an International Agreement in Financial Services

At the end of the Uruguay Round negotiations in 1993, final agreement could not be reached on a number of sectors in the GATS, including financial services.¹³¹ The politically sensitive nature of this sector made progress in the negotiations generally difficult.¹³² Nearing the December 1993 deadline to complete the Uruguay Round negotiations, the United States (US) intended to pull back from its offer in financial services, mainly because of insignificant levels of offers from the developing countries. The developing countries maintained higher barriers to trade in financial services relative to the Members of the Organization for Economic Co-operation and Development (OECD), and this proved to be a significant impediment to concluding the agreement.¹³³ Without significant liberalizing initiatives by the developing countries, the developed countries, especially the United States, feared that they were making far better offers and receiving potentially fewer benefits. Thus, the United States was not prepared to lock in its commitments and was only prepared to commit to an agreement on the basis that it would maintain broad MFN exemptions in

¹³⁰ Key, Sydney, J., (1999), "Trade Liberalization and Prudential Regulation: The International Framework for Financial Services", 68.

¹³¹ The other services sectors where agreement had not been reached were maritime services, basic telecommunications, and movement of natural persons.

¹³² Sectoral comparisons showed lower levels of complete commitments in financial services compared to tourism services, where significant progress was made, for example. See Das, Dilip, K., (1998), "Trade in Financial Services and the Role of the GATS: Against the Backdrop of the Asian Financial Crises", 99.

¹³³ Department of Finance, Canada., "The General Agreement on Trade in Services: The Financial Services Sector", December 1995, 2.

financial services. One important reason behind this stance by the US was the dissatisfaction that its major private financial institutions had with existing offers on the table.¹³⁴

In an effort to avoid a complete failure of the negotiations, and pursuant to a proposal put forward by the European Union (EU), it was agreed that the six month deadline in financial services would be extended to July 28, 1995. This second extension to the Uruguay Round proposals offered time to consult on whether it would be possible to secure a deal, even if the US were to keep its reduced offer on the table. Under this “interim” agreement, specific commitments made by individual countries could be modified or removed at the end of 1997 without penalty. As a result of the 1995 negotiations, 29 WTO Members (counting the EU as one) *improved* their schedules of specific commitments and/or removed or reduced the scope of their MFN exemptions in financial services. These commitments were locked-in by being annexed to the Second Protocol to the GATS. By mid 1997, and considering new accessions to the WTO, 97 Members had *actual* commitments in financial services, compared to only 76 countries at the end of the Uruguay Round.¹³⁵ The permanent agreement reached on December 12th 1997 replaced the 1995 interim agreement.

Three factors explain the change of opinion which eventually led to a success in financial services negotiations.¹³⁶ First, the US and the EU eventually showed an increased attitude of cooperation in financial services, largely due to the EU’s positive push for success

¹³⁴ Dobson, Wendy, Jacquet, Pierre, (1998), Financial Services Liberalization in the WTO, 82.

¹³⁵ WTO, “The Interim Agreement of 1995”, 1.

¹³⁶ Dobson, Wendy, Jacquet, Pierre, (1998), Financial Services Liberalization in the WTO, 84-85.

in the sector. Second, private firms in the US and the EU created the Financial Leader's Group (FLG) in 1996 under the auspices of the US Coalition of Services Industries (CSI) with the purpose of seeking common objectives. Finally, the Asian Crisis of 1997 highlighted major problems with the financial systems of emerging economies in Asia, and this prompted governments to attempt to restore confidence, and shifted the opinion of the developed countries toward agreement.

The new commitments in financial services contained significant improvements in allowing the commercial presence of foreign financial service suppliers by eliminating or relaxing limitations on foreign ownership of local financial institutions, on their form (e.g., branches & representative offices), and limitations on the expansion of existing operations. Improvements were made in all of the three major financial service sectors - banking, securities, and insurance, as well as in other areas like asset management and transfer of financial information.¹³⁷

Governments were given until January 29th 1999 to finally ratify the agreement. On this date, the Schedules and MFN Exemption Lists were annexed to the "Fifth Protocol" of the GATS.¹³⁸ The actual WTO financial services agreement is correctly called *The Fifth Protocol to the General Agreement on Trade in Services*, but will be called the Financial Services Agreement (FSA) from here on. The agreement officially came into force on March

¹³⁷ WTO, "The Negotiations in 1997", 2.

¹³⁸ The Fifth Protocol encompasses the Schedules and MFN Exemption Lists of the actively negotiating members before the 1997 deadline. The existing Schedules and MFN Exemption Lists of all other Members remained unchanged. See WTO, "Results of the Negotiations on Financial Services", 1

1st 1999.

The WTO Financial Services Agreement (FSA)

The FSA of the WTO is generally regarded as a solid start to the long process of liberalization in the area of financial services. The agreement has several positive attributes. In general, it is thought to promote growth and welfare by providing a legal framework that reassures foreign institutions with long-term investments.¹³⁹ Through this legal framework, market opening commitments are “bound”, meaning that liberalization cannot be reversed. As a result, national financial reforms send outward signals of having credibility and sustainability.¹⁴⁰ It also provides external pressure for changes that promote sound financial institutions, which domestic groups often resist to protect their own interests.¹⁴¹ Although increased international competition is an important objective, it must still be weighed against the other important goals of macroeconomic and systemic stability. The GATS and the Financial Services Agreement both address this concern.

Key Sections of the Financial Services Agreement

Apart from the sections of the GATS which have already been described (the framework Agreement, The Annex on Article II Exceptions, and the Specific Schedules), the Financial Services Agreement is comprised of two other key legal texts: the Annex on Financial Services and The Understanding on Commitments in Financial Services.

¹³⁹ Kono, Masamichi, (1997), “Opening Markets in Financial Services and the Role of the GATS”, 5.

¹⁴⁰ Tamirisa, et. al., (2000), “Trade Policy in Financial Services”, 21

¹⁴¹ Dobson, Wendy, Jacquet, Pierre, (1998), Financial Services Liberalization in the WTO, 3.

A. The Annex on Financial Services: The Annex on Financial Services is an integral part of the GATS which is designed to provide greater specificity with regard to trade in financial services. The Annex is divided into five sections, each relating to a specific article or articles of the framework agreement. Section 1 covers *Scope and Definition*. The second section corresponds to Article VI of the GATS (Domestic Regulation). It authorizes each WTO Member to establish “prudential” regulatory measures to protect consumers and suppliers of financial services, as well as the domestic financial system. Section 3 corresponds to and expands the provisions of Article VII of the GATS (*Recognition*), relating to authorization, licensing, and certification of service suppliers. Section 3 provides that a “Member may recognize prudential measures of *any other country* in determining how the Member’s measures relating to financial services shall be applied”.¹⁴² Section 4 supplements the *Dispute Settlement and Enforcement* measures of Article XXIII of the GATS. Section 5 details *Definitions* of financial services covered by the Agreement.

B. The Understanding on Commitments in Financial Services: The Understanding is not an integral part of the GATS; it is an optional agreement in financial services applying to Part III of the GATS (*Specific Commitments*), referring to *Market Access*, *National Treatment*, and *Additional Commitments*. The Understanding is only binding on those Members who state specifically in their schedules of commitments in financial services that their commitments are to be interpreted in accordance with it. The purpose of the Understanding is to offer an “alternative approach” by which Members accept a higher level

¹⁴² WTO, Section 3, “The Annex on Financial Services”, GATS.

of commitments.¹⁴³ The Understanding is thought to offer greater predictability in financial services by refining the obligations in market access and national treatment.¹⁴⁴ As a result, all OECD countries are committed to allowing at least the supply of some economically important insurance services such as marine, air and transport insurance, and reinsurance. In addition, the OECD countries generally guarantee the consumption abroad (Mode 2) of all financial services.¹⁴⁵

Modal Coverage in Services and Financial Services

The modes of services supply which countries most commonly commit to in their GATS Schedules are Consumption Abroad (Mode 2) and Commercial Presence (Mode 3). There are generally more full commitments on both market access and national treatment for Mode 2 than for any other mode of supply because it tends to have the least legal and economic consequences for host countries. Commercial presence (Mode 3) generates greater commitments because it involves the inward movement of foreign-direct investment, which can also bring the inward transfer of technologies, increased employment, and new management techniques. Despite the potential benefits of greater liberalization in commercial presence, most developing countries are not in a position to benefit from it due to the high costs of establishment in foreign markets. That is, their firms are relatively weak by international standards, lacking financial and human capital, as well as access to essential

¹⁴³ The text of *The Understanding* uses the term “alternative approach”.

¹⁴⁴ Jarreau, Steven, J., (1999), “Interpreting the General Agreement on Trade in Services and the WTO Instruments Relevant to the International Trade of Financial Services: The Lawyer’s Perspective”, 40.

¹⁴⁵ Kampf, Roger, (1998), “Financial Services in the WTO: Third Time Lucky”, 115.

distribution networks and information channels.¹⁴⁶ By contrast, supply through cross-border trade (Mode 1) has been left unbound in many Member schedules because it generally involves greater portfolio capital inflows and outflows.¹⁴⁷ For example, technical innovations in financial services such as online transactions has widened the choice of avenues by which financial services can be traded across borders.¹⁴⁸ In addition, for cross-border supply, there is a greater challenge to regulate foreign firms that are legally registered in foreign jurisdictions, but want to operate in the domestic market.¹⁴⁹ These two factors make it more attractive for countries to make liberal commitments in commercial presence (mode 3) because it is associated with more long-term Foreign Direct Investment (FDI) in the domestic economy.

Commercial presence (mode 3) is probably the most important mode of service delivery for financial services. From the perspective of the financial institutions, the efficient trade in financial products generally requires the local presence of the bank, or insurance company because they need accurate information, including local conditions and the nature of the local business environment, in order to serve local needs. From the perspective of local regulators, they also may *require* a local presence in order to have more control, for prudential reasons, over foreign firms about which they have limited information.¹⁵⁰

¹⁴⁶ Personal interview, November 2001.

¹⁴⁷ Tamirisa, Natalia, et. al., (2000), "Trade Policy in Financial Services", 9.

¹⁴⁸ Dobson, Wendy, Jacquet, Pierre, (1998), Financial Services Liberalization in the WTO, 112.

¹⁴⁹ Personal interview, November 2001.

¹⁵⁰ Das, Dilip, K., (1998), "Trade in Financial Services and the Role of the GATS: Against the Backdrop of the Asian Financial Crises", 86.

Problems with the GATS and the Financial Services Agreement

A. Challenges to the GATS

Criticisms of the GATS suggest that the agreement itself is to be blamed for poor levels of multilateral liberalization in services because it allowed for too much discretion in making liberalization commitments.¹⁵¹ The factor most responsible for this problem is the structural framework on which the GATS is based - the GATT. During the negotiations, negotiators frequently relied on traditional GATT language in order to draft the legal text of the GATS, despite the fact that fundamental differences exist between trade in goods and trade in services.¹⁵² For example, in services trade market access commitments are more far reaching because they usually require the alteration of domestic regulations, and this can cause countries to hesitate when scheduling commitments in services sectors.

Dobson and Jacquet have identified three other problems with the GATS and the lack of potential to liberalize.¹⁵³ First, liberalization (esp. market access) is not automatic, but requires an actual commitment. Since market access in services can jeopardize existing domestic regulations, countries usually choose to leave important sectors unbound.

¹⁵¹ Sorsa, Pritta, "The GATS Agreement on Financial Services - A Modest Start to Multilateral Liberalization", 4

¹⁵² Feketekuty, Geza, (2000), "Assessing and Improving the Architecture of the GATS", 93. One specific example used by Feketekuty is that national treatment in the GATS is defined as per the GATT agreement as: "treatment no less favourable than it accords its own like services and service providers." (GATS Article XVII) Thus, quantitative limits placed on foreign services or service providers could fall under both market access and national treatment, depending on how one interprets the phrase "conditions and qualifications" in GATS Article XVII (National Treatment), See Feketekuty, 95.

¹⁵³ Dobson, Wendy, Jacquet, Pierre, (1998), Financial Services Liberalization in the WTO, 96.

Essentially this suggests that the use of a negative list approach to scheduling commitments, instead of the 'hybrid' approach, would have prevented the irregular degree of commitments across sectors and modes that now exists.

Second, the WTO's "reciprocity" approach to negotiation creates a conflict between the goals of different countries in negotiations. In negotiations, for example, developed and developing countries do not negotiate with the same goals in mind. While developing countries may focus on the tourism and agricultural sectors, for example, they do not have significantly developed markets in financial services and usually have quite restrictive regulations to protect what they do have. As developed countries seek access to broader financial markets in negotiations, the developing countries may feel they are giving up more than they might ever receive.

Finally, WTO negotiations separate goods from services and this makes reciprocity less effective because reciprocal arrangements are kept in individual sectors. Many developing countries are interested in exporting their agricultural and textile goods as well as labour and tourism services. Dobson and Jacquet suggest that these particular problems could be overcome in subsequent services negotiations by placing the negotiations in a broader framework to achieve a better linkage of issues across services sectors.

B. Challenges to the Financial Services Agreement

Although the FSA agreement will form an important basis for future liberalization in the financial services sector, its main immediate importance is thought to be systemic and

political.¹⁵⁴ In general, it is argued that the FSA agreement simply does not go far enough in addressing the need to reform financial systems to promote growth. One consequence of this is that there has been less allowance of competition through new entry than on allowing (or maintaining) foreign equity participation and protecting the position of incumbents.¹⁵⁵ In countries where the introduction of competition was not deemed to be prudential at the time of the financial services negotiations, countries still did indicate an interest in market access commitments for the future.

The special nature of financial services also makes it difficult to accurately measure the quantitative value of their trade, and the effects of liberalization on them. But the GATS also contributes to these problems. It consists of complex schedules where many reservations were attached to country commitments and there is no information on the non-listed sectors - a problem that a negative-list approach avoids. Furthermore, not all countries strictly followed the classification of financial sectors into the original categories.¹⁵⁶ For example, in financial services the distinction between protection and prudential measures can be unclear. Some countries listed all applicable rules in the sector in their schedule, while others left purely prudential rules out, leaving room for judgement-based scheduling. Another scheduling problem was that the limitation statements of many Members were neither clear nor explicit enough, and therefore were difficult to classify according to the

¹⁵⁴ Das, Dilip, K., (1998), "Trade in Financial Services and the Role of the GATS: Against the Backdrop of the Asian Financial Crises", 101.

¹⁵⁵ Mattoo, Aaditya, (1998), "Financial Services and the WTO: Liberalization in the Developing and Transition Economies", 1.

¹⁵⁶ Sorsa, Piritta, (1997), "The GATS Agreement on Financial Services - A Modest Start to Multilateral Liberalization", 12.

criteria listed in Article XVI (market access).¹⁵⁷ With emerging issues like market de-segmentation and e-commerce, this problem will continue to persist. Finally, financial services are regulated by many prudential rules wherein the distinction between protection and prudential supervision is often blurred. Those measures that restrict market access and/or national treatment should be included in the schedules, and those that pursue public policy objectives of a non-restrictive nature need to be excluded from the schedules.¹⁵⁸ Failure to do this makes commitments subject to discretion and judgement.

This chapter has given an overview of services, the WTO GATS FSA, and the challenges in making multilateral commitments for countries. It has demonstrated overall that states retain a high degree of autonomy in their capacity for prudential regulation and their ability to control their pace of liberalization. In those areas in which they have made binding commitments, they have done so because they have perceived these commitments as being in their own interest and the interests of their citizens.

Section III: Domestic Regulation and Protectionism in Financial Services

Domestic regulation is important in services liberalization because when countries make commitments to liberalize services under the GATS framework, they primarily do so by altering specific legislation in their domestic regulations. Now that the technical nature of financial services and liberalization have been described, it is possible to examine if, in fact, the state's capacity to act is reduced by this agreement. The GATS specifically

¹⁵⁷ Das, Dilip, K., (1998), "Trade in Financial Services and the Role of the GATS: Against the Backdrop of the Asian Financial Crises", 98.

¹⁵⁸ Mattoo, Aaditya, (1998), "Financial Services and the WTO: Liberalization in the Developing and Transition Economies", 11.

recognizes the right of Members to regulate, and introduce new regulations, in order to meet objectives and differences in degrees of development between countries.¹⁵⁹ Recognizing the right to regulate is also important in preserving the authority of the state in the essential areas of public health and safety, prudential soundness, the rights of consumers, and the quality of services. The WTO's current work in this area is done by the WTO Working Party on Domestic Regulation. Its agenda includes examining key aspects of regulation identified in GATS Article VI (domestic regulation). Since 1999 it has focused on the development of general disciplines for professional services, and on concepts related to the development of regulatory disciplines generally. For the latter issue, it is focusing on the necessity and transparency of regulations. Transparency, or the publication of all relevant information about regulations, entry qualifications, and technical standards, has been an important focus of The Working Party.¹⁶⁰ The ongoing discussions are now indicating that the agenda may need to be broadened in order to focus on the relationship between general principles affecting domestic regulation and specific issues of regulation in individual sectors.¹⁶¹ In financial services, this broadening would involve the relationship between the WTO and other international bodies concerned with sectoral regulation (in the case of insurance, the International Association of Insurance Supervisors (IAIS)). Other issues might be a consideration if such external associations should play a role in providing consultation or

¹⁵⁹ GATS, Annex 1B (preamble).

¹⁶⁰ See for example WTO WPDR document S/WPDR/M/13, entitled "Report on the Meeting Held on 2 October 2001", which describes the work done in all of these areas.

¹⁶¹ Cooke, John, A., (2000), "The Emergence of Domestic Regulation as a Focal Issue in the GATS 2000 Services Negotiations", 143.

experts for Dispute Settlement Panels.

To accommodate these issues, the Uruguay Round services negotiations arrived at two sets of compromises which recognized the need for liberalization on the one hand, and the sensitivities of domestic regulation, on the other. First, for services in general, some requirements were introduced in GATS Articles VI (domestic regulation) and VII (recognition). Article VI requires domestic regulation to be “reasonable, objective and impartial”, with information on procedures to be followed, general requirements covering objective and transparent criteria, a requirement that regulation should be non-burdensome and should not, in itself, restrict service supply, together with a reference to international standards. Article VII provides for mutual recognition for countries’ respective regulatory regimes, on the basis of multilaterally agreed criteria, where possible. Secondly, a compromise was also written in the Annex on Financial Services in the form of the “prudential carve-out”.¹⁶² This was intended to be used by members for issues of safety and soundness, and in reality it is not restricted by the above GATS provisions. Together, these measures combine the need for services commitments on the one hand, and the sensitive concerns for domestic regulatory reform on the other.

Suggestions for improving on the GATS compromises are now being forwarded in the financial services arena in the context of “pro-competitive” regulation.¹⁶³ Pro-competitive regulation favours the development of a more competitive marketplace and

¹⁶² GATS Annex on Financial Services, Paragraph 2 (a).

¹⁶³ Cooke, John, A., (2000), “The Emergence of Domestic Regulation as a Focal Issue in the GATS 2000 Services Negotiations”, 142.

comes with certain important characteristics. First, market access and right of establishment must allow freedom of forms of commercial presence and the guarantee of existing rights. Second, national treatment must allow the freedom to compete for the long-established domestic services business. As for prudential regulation, it should focus on the soundness of companies and their controllers. Finally, there is a strong focus on transparency; regulations should be publically available and changes to them should be explained and should be justifiable. The regulators administering them should be free of arbitrary or non-transparent political control.

These principles have now been put forth for the accounting, securities, and other sectors. In the accounting sector, they were echoed in the 1988 “Disciplines on Domestic Regulation in the Accountancy Sector”.¹⁶⁴ In securities, a discussion paper by the Securities Industries Association dealt with “Promoting Fair and Transparent Regulation”.¹⁶⁵ The OECD has published a text on “Strengthening Regulatory Transparency”¹⁶⁶ and recent proposals by the WTO’s Working Party on Domestic Regulation have proposed the same general ideas. The challenge for these sectoral and horizontal improvements to the compromises in domestic regulation will be to integrate them into the multilateral services

¹⁶⁴ The *disciplines* were developed by the WTO’s Working Party on Professional Services and adopted by the WTO at the end of 1998. The disciplines apply to commitments made in the accountancy sector and are significant because they represent one of the first efforts to develop GATS Disciplines on the domestic regulation of services.

¹⁶⁵ The paper urges processes and regulations relating to securities that are: consistently applied, comprehensible, transparent, and fair and equitable. See Securities Industry Association (SIA), (2000), “Promoting Fair and Transparent Regulations”, SIA Discussion Paper, p.2.

¹⁶⁶ OECD, (2000), “Strengthening Regulatory Transparency: Insights for the GATS from the Regulatory Reform Country Reviews”.

agenda.

The 'Necessity' of Domestic Regulations

The GATS goes further in trying to ensure the transparent application of domestic regulations. GATS Article VI:4 calls on “the Council for Trade in Services, or any appropriate bodies it may establish”, to develop any “necessary disciplines” to ensure that “measures relating to qualification requirements and procedures, technical standards and licensing requirements do not constitute unnecessary barriers to trade (GATS Article VI:4).” To be clear, ‘qualification requirements’ refer to professional accreditation, educational requirements, certification of competency, and the like. ‘Licensing requirements’ include professional licensing, but may come to include many other matters. Finally, ‘Technical standards’ refer to regulations affecting the technical characteristics of the service itself, and to the rules according to which the service must be performed. The important point is that regulations need to be administered in an objective and impartial manner. The “disciplines” of Article VI are largely directed towards *non-discriminatory* regulations. Non-discriminatory regulations are those which are not usually tabled in a country’s services commitment schedules, but nevertheless can represent significant barriers to trade in services. This makes the subject of the necessity test a sensitive issue for the WTO Member in question and other negotiating Members.

To maintain such restrictions, governments are required to demonstrate two important things: first, that such non-discriminatory regulations were “necessary” to achieve a legitimate objective in the eyes of the WTO, and second, to show that no less commercially restrictive alternative measure was possible. According to WTO critics, this would mean

that the responsibility for complex judgements in deciding the appropriateness of non-discriminatory domestic regulations would be left up to representatives appointed to WTO dispute settlement panels. This is seen by critics as shifting the authority of elected government representatives and the public interest into the hands of WTO-appointed technocrats.¹⁶⁷

This highly contentious “necessity” test is a requirement that any measures relating to licensing, technical standards and qualifications should not be more trade-restrictive than necessary to fulfill a legitimate objective. In practice, such exceptions allow governments to justify measures that are otherwise inconsistent with the WTO, on the grounds that they are necessary to achieve certain legitimate objectives such as the protection of human, animal, and plant health. In relation to standards, for example, legitimate objectives include the protection of consumers, the quality of the service, and professional qualifications. This provides for trading partners to question requirements which they believe are unnecessarily burdensome or restrictive. The burden of proof falls on the government that maintains the exception to prove that the measure is not WTO-inconsistent and that it falls within the scope of the WTO’s exceptions. It is designed purely to maintain GATS-consistent measures. In financial services this has not been seen to be a problem up to this point because most regulations which are clearly not discriminatory are those which are recognized as being universally prudential for most countries and therefore not contentious.

Critics of the necessity test believe that these WTO rules, and the GATS more

¹⁶⁷ Sinclair, Scott, (2000), GATS: How the World Trade Organization’s new “services” negotiations threaten democracy, 77.

generally, ultimately constrain governments' legitimate routine and non-discriminatory exercise of their regulatory authority.¹⁶⁸ They believe that governments are giving in to powerful corporate lobbies who methodically seek to diminish governmental regulatory authority and empower themselves. They see such restrictions as impeding effective governmental regulation and destabilizing domestic political compromises. Democratic policy-making usually entails a compromise between commercial interests and public and/or community interests. Critics argue that democracy is severely threatened by granting to a distant and secretive panel the ability to destroy the compromises set up by domestic stakeholders, and this leads in the end to a serious diminution of democratic accountability.¹⁶⁹

The response to these criticisms is that the objective of the GATS is the liberalization of services trade, not the deregulation of services. The right to supply a service under a GATS commitment is a right to supply subject to whatever domestic regulations are in force; there is no implication whatsoever that standards or *other* regulations will be modified to facilitate competition. National regulations which do not restrict market access or national treatment are not subject to scheduling or to negotiations on liberalization. In addition, the WTO does not set standards for the regulation of services, nor is there a chance that Members would ever agree to set limits on their powers to regulate. It will take time to

¹⁶⁸ For example activist NGO's such as ATTAC International, which is an "international movement for democratic control of financial markets and their institutions" <<http://attac.org>>, and GATS Watch, which argues that the GATS regime seeks to subordinate democratic governance in countries throughout the world to global trade rules established and enforced by the WTO as the supreme body of global economic governance, <<http://www.gatswatch.org>>.

¹⁶⁹ Sinclair, Scott, (2000), GATS: How the World Trade Organization's new "services" negotiations threaten democracy, 80.

evaluate whether the necessity test becomes a serious impediment to the domestic autonomy of government policy-making, but thus far it has not been a subject central to dispute settlement proceedings.

There are now increasing concerns about liberalization in the GATS and the demands that are being placed on domestic policy capacity. For example, international services trade rules have been taking a more active part in domestic regulations (i.e., “positive rule-making”) by merging national and international agendas.¹⁷⁰ These divided concerns arise from the fact that services regulations typically apply to the services provider while their intention is to protect the services consumer. The result is that areas of the domestic realm (including policymaking by bureaucracies and various levels of government) that were untouched by trade regulations in the past are now either partially or fully subject to liberalization through trade negotiations. This has the potential to alter the government’s policy-making attitude towards economic development, its capacities, and how it ultimately distributes its resources. Protectionist measures that are based on these concerns generally take the form of discriminatory obstacles to trade, such as entry or branching restrictions, but can also include *non-discriminatory* measures which are disguised in national regulations, such as licensing standards. These barriers will be examined further below. Liberalization aims to remove those measures that go above and beyond the basic safety and soundness of the economy and therefore discriminate against foreign service providers.

Financial regulators are especially guarded when considering potential changes to

¹⁷⁰ Dymond, William, A., Hart, Michael, M., (2000), “Post-Modern Trade Policy - Reflections on the Challenges to Multilateral Trade Negotiations after Seattle”, 33.

their laws which may involve the introduction of competition into the financial sector. Their concerns can be prudentially founded, but are also explained by the fact that many countries have adopted policies to develop their own domestic financial industries and markets.¹⁷¹ Their policies in support of financial modernization thus typically include issuing more domestic banking licenses (excluding foreign firms) and allowing consolidations and mergers of existing financial services firms. These policies restrict the conditions or requirements facing foreign firms wishing to enter domestic markets and extend beyond prudential objectives such as the soundness and competence of applicants. Many of the *discriminatory* restrictions have already been identified and become inscribed in the GATS schedules as limitations on market access and national treatment.

The FSA itself is partly responsible for potential protectionism as is seen in the wording of the prudential carve-out. It gives members the discretion ‘...to ensure the integrity and stability of the financial system’ of which a broad interpretation can be made.¹⁷² Understanding this clause ultimately necessitates a differentiation between the *intent* of the prudential carve-out as a trade law, and the reasons that countries protect certain financial services under it. As these aspects of prudential regulation are clarified and those which are legitimately prudential are recognized, they may no longer need to be included in the schedules as trade restrictions, but presently there is still the issue of whether they are trade restrictions.

Non-prudential restrictions (those which are protectionist) directly affect a foreign

¹⁷¹ Bhagwati, Jagdish, (1987), “Services”, 211.

¹⁷² See the WTO Annex on Financial Services, Part 2 (a), GATS.

firms ability to operate efficiently in a market.¹⁷³ Examples may include restrictions on branching and access to networks, and these clearly limit the ability of foreign banks to penetrate and effectively compete on an equal basis with domestic institutions. However, classifying a financial regulation as prudential or non-prudential often raises difficulties. The licensing of banks, for example, has both competition and prudential aspects. Factors affecting competition may include limitations on the number of licenses as well as conditions on a licence, such as being directed to lend to specific sectors. Such limitations have been treated as restrictions on competition. On the other hand, regulations which specify the initial capital and liquidity requirements needed to obtain a banking license have been treated as prudential.

Discriminatory Barriers to Trade in Financial Services

In financial services, control over the establishment and operation of foreign firms determines the degree to which access to a market is open to foreign competition. These controls have typically been selective in protecting certain domestic financial institutions at the expense of other firms in the national economy. Correcting this problem may require an adjustment of the design of liberalization by the form of establishment, the type of intermediary, and the type of restriction.¹⁷⁴ While such partial liberalization allows for

¹⁷³ Domestic firms are affected as well. The reason for this is that traded services are often intermediates. Thus, protected sectors result in higher costs for importing and exporting as well as overall efficiency. For the economic details see: UNCTAD, 1994, "Recommendations and Guidelines for Trade Efficiency", From the International Symposium on Trade Efficiency, 25.

¹⁷⁴ The WTO notes that "...there is no universally applicable liberalization strategy and that the specific circumstances of each country should be taken into consideration." in WTO, (1997), "Liberalizing Trade in Financial Services: Why it Matters", 2.

flexibility in the implementation of reforms, it may also limit the gains in liberalization because granting equally competitive opportunities helps maximize the gains from trade.

Typical discriminatory restrictive measures include the following:

A. Entry Restrictions are restrictions which can be described as “quota-like”.¹⁷⁵ They specify whether or not a foreign financial institution can operate in the domestic market, and if so, how it may do so. The type of participation allowed can range from a representative office to a separately capitalized and locally incorporated subsidiary, or to separate finance companies that are not allowed to take deposits. Often, entry is completely restricted because there are said to be “already enough banks”, or because of the “fragility of the domestic banking structure”.

B. Branching/ Activity Restrictions take the form of operating barriers that are used by some countries to restrict the competitive positioning of foreign financial institutions once they have gained access to the domestic market. These restrictions can include restrictions on the employment of foreigners, the number and location of offices, the types of business that may be engaged in (e.g., insurance, deposit-taking), the establishment of ATM machines (which are usually considered bank branches), or the formation of holding companies.

Non-Discriminatory Barriers to Trade

Non-discriminatory barriers have been termed “new barriers to trade on a less transparent level”.¹⁷⁶ They take the form of domestic regulations and can be seen either as

¹⁷⁵ Walter, Ingo, Global Competition in Financial Services, 131

¹⁷⁶ Kampf, Roger, (1997), “Liberalization of Financial Services in the GATS and Domestic Regulation”, 160.

important indirect barriers to trade or as valuable means of protecting domestic services providers. The “non-discriminatory” label refers to the fact that it is not usually clear whether such measures are legitimate for prudential reasons or whether they are domestic regulations based on a protectionist policy. Though they are called “non-discriminatory”, these barriers to trade do in fact disadvantage foreign service providers (FSP’s) even if they do not explicitly discriminate against foreign firms. This can be true, for example, if domestic firms are accustomed to operating under existing conditions and enjoy privileged access in the market. Uncovering and removing nondiscriminatory barriers to trade in services is usually the task of domestic regulatory reform.¹⁷⁷ Typical non-discriminatory regulatory measures can include:

A. Measures which require market segmentation, such as the Glass-Steagall Act of 1933 in the United States, which prohibited financial conglomeration by prohibiting banks from offering a full range of financial products. Banks were not allowed to underwrite securities, and securities firms were not allowed to engage in banking. The Act, a depression-era safety measure, was repealed in late 1999 to reflect the already changing financial services market.¹⁷⁸ The Act constituted a significant barrier to foreign financial institutions wanting to enter the US market by restricting the terms on what types of financial firms were allowed to operate, and in which financial sectors. While Glass-Steagall has now been changed, other countries still maintain regulations which clearly restrict the operation

¹⁷⁷ Feketekuty, G., (2000), “Assessing and Improving the Architecture of the GATS”, 96.

¹⁷⁸ Labaton, Stephen, (1999), “Accord Reached on Lifting of Depression-Era Barriers Among Financial Industries”, New York Times, Saturday, October 23, 1999, B1, B4.

of foreign financial firms. Japan, for example, has a relatively liberal set of specific commitments with regard to market access and national treatment for financial services. However, other significant regulatory barriers exist that restrict competition from foreign firms. Trade in securities is subject to a rigid regulatory framework, commercial and investment banking is separated, and there is a general lack of transparency in the regulations.¹⁷⁹

B. Quantitative Restrictions (QR's) take the form of specific financial activity quotas which are applied to foreign service providers (FSP's), and are often offered based on strict reciprocity. They can include price controls which involves price setting, monitoring, and/or approval procedures for industries and their products, and restrictions on the types of products which may be offered. They also frequently involve services provision by government-owned or sanctioned monopoly. This can include government procurement where procurement and sourcing policies may also be designed to discriminate in favour of domestic services providers. For example, many countries have "unwritten rules" under which accounting and/or advertising business goes to local firms.¹⁸⁰ In financial services, governments can set minimum or maximum prices, enforce a price-setting rule or formula, or require uniform pricing. Industries can also be supported through explicit or implicit subsidies. Simple prohibition of trade is also used and it is sometimes conditional based on the country's foreign policy goals.

¹⁷⁹ Kampf, Roger, (1997), "Liberalization of Financial Services in the GATS and Domestic Regulation", 160.

¹⁸⁰ Hoekman, Bernard, Primo Braga, Carlos, A., (1997), "Protection and Trade in Services: A Survey", 11.

C. Standards, Licensing, and Networks often require foreign services providers to obtain certification or licensing in local markets. Such procedures can be used to restrict entry to foreigners and suppliers, allowing prices to be driven up. Examples include the non-recognition of imported services, or the non-recognition of professional certifications obtained abroad. Thus, different regulatory approaches may act to protect domestic industries and may therefore have a negative impact on consumer welfare.¹⁸¹ Finally, foreign financial services firms need to use existing distribution and communication infrastructures (e.g., telecommunications networks, payments and information networks) to operate in a country. Regulatory intervention is often required to correct differences to ensure the incumbent firms allow access to these systems.

Scheduling such non-discriminatory restrictions in the Schedules of Specific Commitments in the GATS can be a difficult process. This is not because it would be difficult to identify which restrictions would fall under market access or national treatment limitations under the GATS definition,¹⁸² but rather because the Member in question may claim that such a restriction needs to be maintained for prudential reasons.¹⁸³

The Economic and Regulatory Elements of Protection

The arguments used in support of protection include those of an economic nature and

¹⁸¹ Skipper, Harlold, D., (2001), "Liberalization of Insurance Markets: Issues and Concerns", 139.

¹⁸² See GATS Article XVI, XVII.

¹⁸³ See the GATS, "Annex on Financial Services", Prudential Reasons include "the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial service supplier, or to ensure the integrity and stability of the financial system."

those which reflect regulatory concerns.¹⁸⁴ Economic arguments are based on the idea that protecting domestic financial services providers will provide economic gain. Regulatory arguments point out that a more complex and open financial sector has regulatory requirements which are unmanageable by many governments. All proponents of protection in financial services argue that foreign domination of the domestic financial system must be avoided at all costs. Allowing foreign firms to enter the market, they argue, risks leaving the financial system to the mercy of indifferent interests. Arguments for protection often gather support through populist appeal which is based on a failure to clearly elaborate the costs and benefits of foreign participation. The WTO has been actively working to clarify the benefits of foreign participation and the role of the organization in the process of globalization more generally.¹⁸⁵ The reasoning behind these arguments for protectionism and why they fail are briefly described in turn.

The main *economic* argument for protection is the ‘infant industry argument’. This suggests that local firms require a certain period of time to learn and mature. This argument fails in most cases because domestic firms have already been operating for long periods of time and still have not become profitable. A variant of this argument occurs where countries reach out to join regional agreements. South-south agreements in particular are seen to be gradual paths to liberalization which allow firms to gradually prepare for global competition. Supposedly, countries would be more willing to accept broad-based liberalization in the

¹⁸⁴ Hindley, Brian, (2000), “Internationalization of Financial Services: A Trade-Policy Perspective”, 22.

¹⁸⁵ See World Trade Organization, (2001), Annual Report, 23.

future.¹⁸⁶

A second argument for protection suggests that foreign firms will only operate in the most profitable market segments (often called “Cream-Skimming”) and reduce the capability of domestic firms to offer financial products to less profitable market segments by reducing their overall profits. This argument is generally weak because it assumes that the provision of financial services is essentially a public good. That is, it makes the assumption that financial services firms have a public obligation, for example, to service undesirable rural markets where most firms could never become profitable. In strictly economic terms, financial firms have no such obligation to assure that their services are non-excludable. Governments, however, do have a public obligation, and they should therefore play a role in deciding what financial firms can do.

Other arguments for protection claim that opening domestic markets to foreign firms increases the links of a country with the international economy and will eventually cause harm, or that foreign firms will lack commitment to the local economy. This incorrectly assumes that an inefficient and weak domestic financial sector will be maintained. Rather, when foreign firms enter markets with well established international networks and experience, inexperienced domestic firms should see it in their interest to get up to par and gain the knowledge and skills from these foreign firms.¹⁸⁷

The main *regulatory* arguments for protection suggest that domestic regulators have

¹⁸⁶ Mattoo and Fink, (2002), “Regional Agreements and Trade in Services: Policy Issues”, 16

¹⁸⁷ Graham, Edward, M., (2001), “Opening to Foreign Competition”, 289.

a limited ability to monitor more complex financial systems.¹⁸⁸ Foreign firms are more accustomed to operating in a sophisticated international regulatory environment and this puts domestic firms at a disadvantage. In the absence of prudential supervision, the commercial presence of foreign firms may contribute to instability and negatively affect the way the financial sector develops. In addition, with a more complex system to regulate, domestic regulators could allow domestic financial firms to take excessive risks. These arguments generally neglect the fact that regulators themselves need to improve their competence and sophistication and that the liberalization of financial services trade promotes this.¹⁸⁹ In many developing countries, there is still the problem of finding the resources to train the regulators and policy makers, an issue that is now receiving due attention at the WTO.

Protection in Developing Countries

Protectionist sentiment may be especially prevalent in many developing countries that do not have a history of being particularly open and liberal. There are two unique political explanations as to why developing countries use protective policies. First, understanding trade and investment and the links with the domestic economy is not an easy and straightforward task. Many developing and emerging economies simply do not have the technical knowledge or manpower to establish an effective reform plan.¹⁹⁰ Consequently, the government bureaucrats remain uninformed and are less likely to entertain ideas about liberalization. Protectionism also directly benefits those who actively support political

¹⁸⁸ Hindley, Brian, (2000), "Internationalization of Financial Services: A Trade Policy Perspective", 33.

¹⁸⁹ WTO, (1997), "Liberalizing Trade in Financial Services: Why it Matters", 4.

¹⁹⁰ Personal interview, March 4th, 2002.

regimes that are willing to allow the protection to continue or increase. For example, local big businesses which are well connected at the international level can use their influence over local policymaking and political choices for self gain.¹⁹¹ Second, developing countries have tended to view the financial services industry as part of their 'infrastructure' which they must control to satisfy domestic political demands.¹⁹² In other words, the sector is somehow 'strategic' for development because it is related very closely to the macro-economy, and therefore its control should remain largely in domestic hands.

The complex and contentious relationship between domestic regulation and protectionism arises, on the one hand, out of the process of making legal commitments in the WTO, and the need to maintain domestic regulatory authority, on the other. In the WTO, countries become parties to the Agreements, based on the understanding that their regulations need to be 'reasonable, objective and impartial', transparent, yet not prevent Members from taking actions for purely prudential reasons. These paragraphs are built into the GATS to promote equally competitive opportunities among countries, the latter of which provides the safeguard designed to allow Members to manage their economies. A necessity test may be required to determine if regulations are in fact as least restrictive as they can be, or if they have been designed to protect certain sectors. This process, which has been described as 'positive rule-making', is made difficult by the need to distinguish which regulations are in fact protectionist, from those that are discriminatory, to those that are non-discriminatory.

¹⁹¹ Armijo, Leslie, E., (ed., 1999), Financial Globalization and Democracy in Emerging Markets, 30-31.

¹⁹² Bhagwati, Jagdish, (ed., 1997), Writings on International Economics, 456-457.

It is more complex in developing countries where the links between investment and the domestic economy are not yet fully understood, and where financial services is often seen to be strategic as part of the economic 'infrastructure'. However if regulations have not been designed to effectively protect certain service sectors, then the GATS does not threaten the ability of states to manage the well-being of their citizens.

Chapter 3

Protecting the Public Good: Canada's Standing Policy on Foreign Financial Institutions

“Reining in Canada’s doggedly neo-liberal negotiators and ensuring that the Canadian government position reflects a broader view of the public and Canadian interests will be one of the key challenges facing Canadians in the coming debate.”¹⁹³

Section I: Introduction and History

This chapter explores the evolution of Canada’s policy on foreign financial institutions. In the context of this dissertation it is also intended to serve as a conceptual reference for a well-developed financial services regulatory regime which may be compared to that of other countries. The chapter assesses the degree to which the Canadian government has been able to maintain its capacity to regulate and manage its financial sector despite its commitments to the financial services provisions of the FTA, NAFTA, and FSA. Since Canada has well-developed financial services regulations, it is less important to question to what extent the WTO FSA has pressured the government to liberalize. It is more relevant to focus on how the process of liberalization has been conditioned in Canada by various issues facing politicians and regulators at the domestic level. These issues can be generally classified to include: local politics, institutions, regulations, and processes. Local politics have been important because banks in Canada are required to take into account the ‘public good’, a fact that affects the ensuing relationship between foreign and local banks.

¹⁹³ Sinclair, Scott, (2000), GATS: How the World Trade Organization’s new “services” negotiations threaten democracy, 27.

Institutions, including the previous trade agreements in which financial services have been included, have offered significant experience, and have influenced Canada's participation in the GATS FSA negotiations. Regulations, which have been restructured over roughly the last four decades, and which include the 'widely-held rule', have been important objects of domestic financial reform. This includes the process of regular reviews of the financial sector, including the 'sunset clause', which have updated Canadian legislation and brought it up on par with international standards. Since the beginning of the financial services initiatives through the WTO, Canada has been an active participant in negotiations and has made significant commitments. It has illustrated how conservative levels of liberalization, including the accessibility of foreign financial institutions, can be balanced against domestic concerns for both social and private interests.

Trade is considered important to Canada's financial services industry because Canada is well represented in international financial markets.¹⁹⁴ Reciprocally, one of the benefits of allowing foreign financial institutions to operate in Canada is thought to be the greater innovation in the range of financial products available to Canadians.¹⁹⁵ In addition to periodical overhauls to financial services legislation, other influences, including the free trade agreements that Canada has signed and developed experience in, have helped to

¹⁹⁴ The six major domestic banks have a significant presence outside of Canada in the US, Latin America, the Caribbean, and Asia. International operations accounted for approximately 50 per cent of net revenue earned by Canada's "big six" banks in 2000. See Finance Canada, Publications, "Canada's Banks", August 2001.

¹⁹⁵ Foreign banks operating in Canada account for almost 7 per cent of the assets held by the banking industry. See Finance Canada, Publications, "Canada's Banks", August 2001.

facilitate some of the changes with respect to the treatment of foreign financial firms. Canada's relationship with the US has been particularly significant in these respects offering both opportunities and constraints. In the early 1980's, for example, when Canadian banks began expressing interest in further expansion into the US market, Treasury Secretary Donald Regan stated that he would not hesitate to take vigorous action to protect US interests if attempts to persuade other countries to loosen their regulations for US banks were unsuccessful.¹⁹⁶

The government has long played a role in shaping the economic landscape in Canada in order to achieve economic growth. The state of the economy has also directed many of our policy choices in this regard.¹⁹⁷ The recent changes which have been happening at the international level have also made it more urgent for countries to maintain an updated regulatory framework relating to financial services. In Canada, these changes have been the focus of 'regular' reviews since the 1950's initiated by the 'sunset clause'.¹⁹⁸ The subject of

¹⁹⁶ Quoted in Chant, John, F., (1985), "The Canadian Treatment of Foreign Banks: A Case Study in the Workings of the National Treatment Approach", 216.

¹⁹⁷ John Odell makes the case for a 'rational' understanding of international trade policies by showing how market conditions and factor endowments shape trade policy. He quotes Magee and Young who write: "Our empirical work indicates ... 2/3 of the changes in US tariffs this century are explained by unemployment, inflation, and the US terms of trade. Odell, John, S., (1990), "Understanding International Trade Policies: An Emerging Synthesis", 141-143.

¹⁹⁸ A "sunset clause" in the Bank Act requires regular review and updating of laws governing financial institutions (the Bank Act, the Trust and Loan Companies Act, the Insurance Companies Act, and the Cooperative Credit Associations Act). Amendments were done in 1954, 1967, 1980, and 1992, 2002 (forthcoming). WTO Trade Policy Review, Canada (1998), 97.

these reviews has been related to increased internationalization and securitization¹⁹⁹, the review and liberalization of regulatory regimes²⁰⁰, and the expansion of international financial markets. Under the heading of globalization, technological innovations, such as electronic clearing systems, compress the time and space necessary for financial transactions to occur. While these changes have happened mostly in the absence of leadership from any particular country, they are in turn matched by a process of re-regulation involving enhancements in the capability to supervise financial firms.

Canada is an interesting case-study in the context of WTO financial services because, prior to comprehensive liberalization in the WTO in 1997, valuable experience had been gained in two other free trade agreements. Canada and its free trade partners in North America had already developed significant financial services liberalization and a framework through which it could take place. Canada's bilateral experience in the Canada-United States Free Trade Agreement, and its multilateral experience in the North American Free Trade Agreement created the necessary conditions for the movement and success that has been achieved in the WTO financial services agreement. Nevertheless, Canada still maintains a guarded financial policy framework which has evolved from political and economic considerations which are not significantly different from those found in other advanced

¹⁹⁹ The displacement of bank loans by securities markets - an important factor behind the deregulation of securities markets and the proposed reform to Glass-Steagall in the US. This has also been related to the emergence of conglomerates in the non-bank area including insurance and trust companies and other financial institutions under a common ownership.

²⁰⁰ Tax and other regulations have been reformed regularly for decades in industrial countries to allow greater foreign access.

nations. In maintaining certain restrictions, like limiting foreign ownership of big banks and domestic mergers, the government has recognized its responsibility to ensure that regulatory policies are prudential, that they balance conflicting social and private interests, and that they must effectively manage the financial system. In broad terms this can be called financial *governance* - a process in which the government effectively exercises its regulatory authority.²⁰¹

This perspective also recognizes the difficult choices faced in Canada when considering changes to sensitive financial legislation. Canada is a country with a highly concentrated banking sector²⁰², a dependency on natural resources, a relatively small population, and a huge and financially integrated trading partner, the United States, to the South. Even though progress has been made in important areas, the existing literature tends to be largely critical of Canada's progress in both autonomous liberalization and liberalization formally committed in trade agreements. In the GATS, Canada's financial services commitments allow limited foreign bank branching and have gone hand-in-hand with national financial regulatory reforms. This has brought Canada's foreign bank legislation in line with policies that have already been implemented in other developed economies. The financial services activity in the WTO, however, has not been a major pressure on Canada to make these changes. Canada debated the benefits of liberalization

²⁰¹ Litan, Robert, E., et. al., (eds., 2002), Financial Sector Governance: The Roles of the Public and Private Sectors, 2.

²⁰² As of October 2002, Canada's five major domestic banks accounted for 92% of the assets held by the banking industry, while foreign banks accounted for only 6.2% of assets. See WTO Trade Policy Review, Canada (2003), 127.

decades before. This begs the question: What are the benefits, beyond updating legislation, in negotiating financial services as part of a larger deal in free trade? The answer proposed here is that because financial services are quite different from other areas of trade, there is much less interest for cross-border trade than there is with the right to establish in another country, and to generate profits and employment from those establishments. This fact also tends to disengage liberalization in financial services from many of the criticisms which have been developed against freeing up capital flows discussed in Chapter 1. The benefits to Canada come in the form of greater freedom of establishment for Canadian banks in foreign markets in return for allowing foreign banks to compete here.

The opening of the financial sector to complete foreign competition in Canada has been slower than in many other industrialized countries because we have gone through a process more of restructuring than of revolution. The delays in this internationalization reflect the long-standing concerns of much of the Canadian public about foreign ownership and control in key sectors of the economy.²⁰³ Chapter two showed that foreign ownership in financial services cannot be based solely on economic factors and must consider other prudential issues, as well. In Canada, many of the changes have been due to rapid shifts in the financing requirements across the economy - changes which have occurred in response to changing market conditions and the evolving economic environment. These realities were seriously recognized as early as 1984 in the federal government's Agenda for Economic Renewal. It recognized that "Many of the recent changes have both benefitted the Canadian

²⁰³ Handfield-Jones, Stephen, (1988), "Adjusting to New Market Realities: The Canadian Financial Services Industry in Transition", 9.

public and increased the efficiency of the Canadian capital markets ... However, the current regulatory framework has not come to grips with the evolving needs of the financial community or the public and there is a need to ensure that legislation reflects the reality of a rapidly changing financial sector.”²⁰⁴

Another potential source of delay is outlined in a now classic book on Canadian banking, “Different Drummers”, by Robert MacIntosh, who argues that the banking system in Canada has been a mirror of social and political change.²⁰⁵ The most visible sign of this was the Canadian perception that banks are a part of the public domain - “quasi-public utilities” as some suggest.²⁰⁶ Essentially we have been conditioned to believe that banking services should be available to us at very little cost and that the banks should accommodate social and political objectives before thinking about their profits.²⁰⁷ Probably the most sensitive issue is based around our expectations that bank branches should continue to service rural areas and to provide basic and affordable banking services. Canada’s big banks have therefore had to sustain their established branch network across the country, which is costly in economic terms, but politically very difficult to streamline.

This sentiment was clearly argued recently by the Public Interest Advocacy Centre

²⁰⁴ Finance Canada, “A New Direction for Canada: An Agenda for Economic Renewal”, presented by the Hon. Michael H. Wilson on November 8th, 1984.

²⁰⁵ MacIntosh, R., (1991), Different Drummers: Banking and Politics in Canada, 3.

²⁰⁶ Bond, David, (2000), “Financial Services Reform will Eviscerate Bank Sector”, *Globe and Mail*, Friday March 10, Report on Business, B11.

²⁰⁷ Public goods by definition are characterized by non-rivalrous consumption (consumption by one individual does not detract from that of another) and non-excludability (you cannot exclude anyone from using the good).

on the issue of rural bank branch closures.²⁰⁸ On the basis of a study of rural bank branch closures, they found between 1989 and 1998, about 45% of rural bank branches had closed. After 1998, many more closures were announced. The two recommendations of the Advocacy Centre study were, first, that the problem needed to be considered under the legislation at that time, implying that it was a governmental responsibility, and second, that the banks needed to be more accountable to consumers by reporting what they were doing to solve the problem, making it also the bank's problem. This perception that Canadian banks must be closely regulated and accountable to the public as well as their private shareholders has placed them in a peculiar position among banks in the world.

These issues seem to indicate that Canadians are not sure how they want their financial landscape to evolve. This has left the question of the public utility of banks front and center and still unresolved. Have Canadians decided if they want the banks to remain natural monopolies which are entitled to a guaranteed rate of return and still provide adequate service? For example, the system in Canada is modern and efficient and is seen to work well for most people, so we might not want to make controversial changes to such a system. Or do Canadians accept the uncertain promise of internationally competitive financial services companies and greater consumer service and choice? As long as Canadians remain undecided on what is wanted from the financial system, the government can use this uncertainty to its advantage by deflecting the issue to a time when the tough issues like job losses and branch closures will inflict the least damage with respect to voter

²⁰⁸ Statement by Angie Barrados, Public Interest Advocacy Centre, speaking to the Standing Committee on Finance, October 17, 2000.

opinion. Since financial regulatory policy is industry-specific, politicians are only willing to reward the industry if the political benefits exceed the costs.²⁰⁹ Specifically, this means that politicians and bureaucrats will only supply policies that are, at worst, sure to maintain the state of the economy. These considerations interfere with competition in the market, and the federal government needs to “de-politicize” the banking policy environment, critics argue, if it hopes to develop a more competitive industry.²¹⁰

The banks, which at one time welcomed and enjoyed the market protection offered by restrictive foreign bank legislation, have done an about-face and are now the prime lobbyists in favour of domestic bank mergers and allowing foreign branching. From the economic perspective, they look forward to the day when they will first be allowed to merge with other Canadian banks and then consolidate their banking, insurance, and securities functions and make them all available at the local bank branch. The banks understand that while government has an important part to play in the management of the financial sector, knowledge-based industries such as financial services need to be free of public-sector objectives and the slower pace of the governmental legislative process.²¹¹ The Chairman and C.E.O. of the Bank of Montreal, Matthew Barrett made the modern banker’s position clear: “We should begin by welcoming full-scale competition in our domestic market from the banks of any nation that gives Canadian banks equal regulatory treatment... What was once

²⁰⁹ Harris, Stephen, L., (1998), “The Politics of Financial Services Liberalization: The Case of the Canadian Investment Dealer Industry”, 530.

²¹⁰ Dobson, Wendy, (1997), “Prisoners of the Past in a Fast-Forward World: Canada’s Policy Framework for the Financial Services Sector”, 35.

²¹¹ Williams, Hugh, (1999), “Searching for a Vision: Financial Services in Flux”, 8-9.

protection for the country has become a prison for our banks. I believe we should throw the doors wide open in both directions.”²¹² The domestic banks might also welcome foreign competition to demonstrate that mergers between them would not create monopoly operators in the Canadian banking system.²¹³ From the political perspective, the banks are seen to be wanting competition in order to end the perception of them by the public and the expectations by government that they fulfil their role as quasi-public utilities with social responsibilities.²¹⁴

Aside from the economic and political debates, Canada’s policies with respect to foreign financial firms are not significantly different from the international standard. As Neufeld and Hassanwalia have noted: “The ownership policy governing banks has two apparent objectives: separating [general] commerce from finance [financial services] and maintaining Canadian control over the financial system.”²¹⁵ On both counts, Canada’s policies are not that different from policies of other countries. Through explicit laws or *de facto* practice, most countries have a separation of banking from commerce, and almost all the largest banks in the world are free from [corporate] commercial control. Furthermore, most jurisdictions have explicit or implicit provisions to prevent control of the financial

²¹² Input to the Standing Senate Committee on Banking, Trade and Commerce, Oct. 2, 1996

²¹³ Harris, Stephen, L., (1999), “The Globalization of Finance and the Regulation of the Canadian Financial Services Industry”, 383.

²¹⁴ Gouvin, Eric, J., (2001), “The Political Economy of Canada’s “Widely Held” Rule for Large Banks”, 9.

²¹⁵ The separation of “commerce” from “financial services” refers to the fact that most countries have prudential laws which prohibit the cross-ownership of general companies and financial services firms (real-estate and banking, for example).

system from slipping into foreign hands.”²¹⁶ In fact New Zealand is the only country in the OECD that has allowed its banks to become foreign-owned.²¹⁷ These issues remain contentious and unresolved in Canada.

History of Canadian Foreign Bank Legislation

The following discussion introduces Canadian domestic financial institutions, regulations and the changing government attitudes towards foreign competition in the banking sector since the 1960's. It also highlights the importance of the US and its banks in this competition, the most important influence that would surface in the FTA and NAFTA. Banking in Canada falls exclusively under federal jurisdiction, while the regulation of securities companies falls under provincial control.²¹⁸ Insurance and trust and loan companies are free to incorporate under either federal or provincial law, but are required to be licensed in the province(s) in which they operate.²¹⁹ The Department of Finance plays the

²¹⁶ Neufeld, Edward, P., Hassanwalia, Harry, (1997), “Challenges for the Further Restructuring of the Financial Services Industry in Canada”, 91.

²¹⁷ New Zealand’s banks are still largely owned by neighboring Australians. See Dobson, Wendy, (1999), “Memo to Mr. Martin: For Higher Productivity, Our Financial Sector Needs More Freedom”, Institute for Research on Public Policy, Policy Options, May 1999, 51-53.

²¹⁸ The regulation of securities firms has been under constant discussion recently. While some provinces argue for a single national regulator, others have wanted to retain their regulatory oversight. At the national level, a self-regulated forum called the Canadian Securities Administrators (CSA), consisting of the thirteen provincial and territorial securities regulatory authorities coordinate and harmonize the regulation of Canadian capital markets.

²¹⁹ Over 80% of insurance companies in Canada are incorporated federally, representing over 90% of premium income. Since the largest insurance and trust & loan companies operate nation-wide, they have incorporated under federal law. Each province’s insurance regulator oversees terms of contracts, licensing, and incorporation matters. See WTO, Trade Policy Review (TPR), Canada, 1996, 104-106.

lead role in defining domestic banking and insurance policy as well as Canada's trade stance on these issues, but usually does so only after consultation with the financial sector itself. Although this basic level of consultation exists between the government and the financial sector, it is important to note that the two parties remain as rivals defending their respective realms in the financial system, a theme that would emerge clearly in the FTA negotiations.²²⁰ Because all securities and some insurance matters fall under provincial jurisdiction, cooperative procedures exist between the federal and provincial regulators for information exchange and to harmonize approaches.²²¹ Another important institution in Canada is the Office of the Superintendent of Financial Institutions (OSFI), which was formed in 1987 and is both a regulator and a supervisor for all federally chartered financial institutions. Its regulation function involves developing and interpreting legislation and regulations, issuing guidelines, and approving institutional requests while its supervisory function involves assessing the safety and soundness of federally regulated financial institutions. Also involved is the Canada Deposit Insurance Corporation (CDIC), a federal Crown Corporation which was formed in 1967 and provides deposit insurance and contributes to the stability of the financial system. The financial community tends to gather the necessary technical expertise and attempt to work through their differences by exchanging their views and position papers. All of the agencies involved, including Finance, OSFI, CDIC, maintain

²²⁰ This is a main characteristic of a capital market-based system. See Zysman, John, (1983), Governments, Markets, and Growth: Financial Systems and the Politics of Industrial Change, 81.

²²¹ Personal interview, January 2003.

close contacts with associations and individual firms.²²²

The legislation governing banking in Canada is found in the Bank Act and was initially passed in 1871. The Bank Act established a “rules” approach to banking regulation in Canada, which was based on the idea that the government only intervenes if the rules are broken. This approach avoids any discretionary tendencies which would involve governmental intervention in regulation for political reasons or otherwise. The Bank Act is an example of industry-specific regulation wherein regulations are structured particularly to the operation of the banking industry in Canada. Banks are also subject to the general regulations dealing with operating a business in Canada including tax laws, employment regulations, etc.,. Industry-specific regulations can be difficult and slow to change because the government usually has to spend considerable resources to administer and supervise the increasingly complex sets of regulations. Another problem is that the benefits of the whole structure of regulations and potential benefits go mainly to the regulated industry and do not directly benefit the government in return.²²³

Prior to 1964 there were no constraints on foreign banks entering Canada. After 1964, Canada introduced new restrictions on foreign entry into banking, but applied a relatively laissez-faire approach to existing banks. Over the following decades, several Royal Commissions, White Papers, and Senate Committees would consider the state of the Canadian financial system and reactions against foreign banks in Canada. One of the first

²²² Coleman, William, D., (1990), “ The Banking Policy Community and Financial Change”, 105.

²²³ Personal interview, March 2002.

was the 1957 Royal Commission on Canada's Economic Prospects (the Gordon Commission).²²⁴ Reflecting the statism of the time, it strongly argued for maintaining Canadian control of domestic financial institutions and recognized the importance of maintaining domestic control of financing in Canada. It noted: "...the role of banks and insurance companies in financing economic activity in Canada might be adversely affected, if control of these important institutions were in the hands of non-residents with major interests in other countries to consider."²²⁵

Similar ideas were echoed in the 1964 Royal Commission on Banking and Finance (the Porter Commission).²²⁶ It noted various concerns about unrestricted ownership and control in the financial sector as well as the potential benefits of some foreign participation in Canadian banking. The Commission did, however, make an effort to argue for greater competition, less regulation, and more consistency into the federal government's treatment of foreign banks. It suggested the establishment of foreign bank 'agencies' which would could bring some innovative products to consumers. The agencies, however, would be restricted from the more desirable business of taking deposits and expanding their numbers of offices.²²⁷ The Commission also thought it important to define more specifically what "banking" meant in Canada. As we will see in discussion below, definitions in financial services have been particularly useful tools used in protectionism. Because of this the government eventually avoided defining the term because it wanted to maintain the

²²⁴ Named after Walter Gordon who became Minister of Finance a few years later.

²²⁵ Royal Commission on Canada's Economic Prospects (1957), 397.

²²⁶ Named after the Chairman Dana Harris Porter

²²⁷ Royal Commission on Banking and Finance (1964), 373-4.

ambiguity surrounding the separation of bank subsidiaries and bank branches. The government's official reasoning was that it would be easier to regulate a foreign bank if it was required to incorporate locally as a subsidiary.²²⁸ This lack of specific definitions for many terms in legislation can be linked to the problems that are seen today with respect to the Canadian treatment of foreign banks.

The reworking of the Bank Act in 1967 established a more formalized structure for dealing with foreign financial institutions and it seems that it had heard the concerns being voiced in the Commission. With respect to foreign participation, it introduced a limit of 25 per cent on foreign ownership of any chartered bank and a limit of 10 per cent on any single interest in the shares of a bank (the "10/25 rule"). The 10 per cent limitation was the first appearance of a "widely-held" rule.²²⁹ It was enacted in response to the controversial acquisition of Mercantile Bank by First National City Bank (FNCB, predecessor to today's Citibank) and the fear that the Toronto-Dominion was the intended target of a takeover by Chase Manhattan bank.²³⁰ Thus, the rule seemed to be aimed at preventing potential foreign (i.e., US) takeovers of Canadian banks. While these restrictions were substantial, foreign

²²⁸ MacIntosh, R., (1991), Different Drummers: Banking and Politics in Canada, 169.

²²⁹ The widely held rule is designed to prohibit control of a large financial institution by any single shareholder, or group of shareholders. It originally achieved this by limiting any singly interest to 10 %. This was increased to 20 per cent under the newest legislation, Bill C-8.

²³⁰ Walter Gordon was the Minister of Finance who discouraged the takeover by FCNB, a dominant US bank, though it was eventually successful. From the 1950s to the 1970s Walter Gordon was a strong voice for English Canadian nationalism. In the late 1960s many Canadians supported Gordon's arguments for limits on the level of American investment and influence in Canada.

financial firms did have alternative paths into banking business in the Canadian market.²³¹ These included acquisition of Canadian trust companies, creation of an investment subsidiary, leasing, or venture capital. While foreign institutions were still effectively excluded from major participation in the Canadian big banks, it was becoming harder to exclude US banks from the market. The restrictions on foreign financial institutions throughout the 1970's were seen as increasingly out of step, as Canadian banks and insurance companies expanded their operations abroad following the trend of increased internationalization in the industry.²³² There were also sentiments forming in Canada believing that the maintenance of major participation restrictions on foreign banks might draw retaliation from the Americans.²³³

Legitimate signs of change occurred just before the scheduled revision of the Bank Act scheduled for 1976. The Economic Council of Canada (ECC) prepared a report entitled "Efficiency and Regulation: A Study of Deposit Insurance" to provide some independent input into banking legislation. The Council suggested that the limitation on equity holdings by any one interest (the 10 per cent limit) constituted a major obstacle to entry into banking. It proposed a 'foreign-owned banks act' that would equalize the conditions for new banks whether established by foreign or domestic concerns. The only difference would be that a

²³¹ MacIntosh, R., (1991), Different Drummers: Banking and Politics in Canada, 171.

²³² Coleman, William, D., (1990), "The Banking Policy Community and Financial Change", 96.

²³³ Chant, John, F., (1997), "Canada's Economy and Financial System: Recent and Prospective Developments and the Policy Issues they Pose", 12.

foreign bank would have its power to branch and expand restricted.²³⁴

In 1976, the federal White Paper on the Revision of Canadian Banking Legislation repeated some of the conclusions of the ECC Study, but also stressed the need for dispersed ownership. The 10 per cent rule, it stressed, “ensures that a chartered bank does not become captive to a person ... who have business interests other than banking, thus avoiding ... conflicts of interest or possible risks to the bank’s depositors.”²³⁵ Continuing their lobby efforts, foreign banks continued to criticize Canada’s restrictive measures, including the ceiling on overall foreign bank participation, the need for license renewals, the need for branch approvals, and most importantly, the discretionary power of the inspector general with respect to foreign banks operating in Canada.²³⁶ The government believed that Ministerial approval would ensure reciprocity across the border and better regional distribution of foreign bank subsidiaries. The critical view suggests that these measures reflected a ‘statism’ of the time, wherein the economic levers in Canada needed to be kept in line with state objectives.²³⁷

In Canada we have a nation-wide bank branching system which reflects the absence of restrictions on banking across provincial boundaries. In the US, by contrast, each state has its own legislation for regulating banks, which has made national branching impossible. A

²³⁴ Chant, John, F., (1985), “The Canadian Treatment of Foreign Banks: A Case Study in the Workings of the National Treatment Approach”, 226-7.

²³⁵ White Paper on the Revision of Canadian Banking Legislation (1976), 27.

²³⁶ Chant, John, F., (1985), “The Canadian Treatment of Foreign Banks: A Case Study in the Workings of the National Treatment Approach”, 230.

²³⁷ Owens, Richard, C., and Guthrie, Neil, (1998), “Foreign Banks and the Business of Banking: Reforming Canada’s Foreign Bank Access Regime for the Global Marketplace”, 347.

common problem faced by both systems of regulation is that foreign banks do not all fit into a common category of regulation and therefore can be difficult to classify. The revisions to the Canadian Bank Act in 1980 tried to deal with the foreign bank issue by creating two classes of banks - Schedule A and Schedule B banks - a division which stood until very recently. Schedule A was the category for existing large Canadian banks that were subject to the widely-held rule. The Schedule B category allowed the entry of foreign banks subject to the same restrictions as domestic Schedule B banks (smaller banks). With respect to their operations, Canadian banks have been active in the US for a long time since confederation, while US banks have only been able to provide a full range of banking services in Canada since 1980.²³⁸ In securities, access to the US market has also been essentially unrestricted for Canadian dealers. This is probably because regulatory reform in the US has been far less advanced than in Canada and the relationship between the federal and state levels remains more complex. In Canada, the development of federal bank branching legislation is thought to hinder such freedom. Prior to 1980, US firms did have a presence in Canada through representative offices, but the revision of the Bank Act in 1980 formally gave US banks limited access to the Canadian market. The Bank Act allowed for entry of foreign banks via the establishment of Canadian subsidiaries, but not as branches of the parent bank. This remains an important feature of foreign bank presence in Canada. By 1984, the limits imposed on foreign bank expansion were more relaxed and provincial governments deregulated securities markets and offered unrestricted access. At the federal

²³⁸ Fry, Earl, Radebaugh, Lee, (1987), The Canada-US Free Trade Agreement: The Impact on Service Industries, 12

level, the government was taking steps to significantly alter the regulation of financial institutions and was paving the way for greater foreign presence in Canada.²³⁹ These measures relaxing specialization and establishment rules marked the real beginning of deregulation in the Canadian financial services sector.

More pressure came in 1983 when the Standing Committee on Finance, Trade and Economic Affairs argued on the side of more openness and noted that, even if Canada removed its ceiling limitation on foreign banks (the 16 per cent participation limitation), other features of Canadian legislation could still constrain their operations. These included reciprocity rules with the home country of the foreign bank and the contribution of the foreign subsidiary to competitive banking in Canada.²⁴⁰ These arguments, however, were soon calmed by the news of some troubled institutions and the 1986 failures of the Canadian Commercial Bank and Northland Bank.²⁴¹ This reflected the fact that one of the most important forces that has allowed legislative change in financial services has been the condition of the economy.

Section II: The Canada- United States Free Trade Agreement (FTA)

This section highlights the challenges Canada faced in negotiating a financial services chapter in the FTA. Although the resulting chapter of the FTA did make progress by reducing trade barriers in financial services, negotiators failed to establish sufficiently broad

²³⁹ Rochon, Paul, (1989), "Strengthening Market Access in Financial Services: The Financial Services Provisions of the Canada-U.S. Free Trade Agreement", 2.

²⁴⁰ Standing Committee on Finance, Trade and Economic Affairs (1983), 31.

²⁴¹ Chant, John, F., (1997), "Canada's Economy and Financial System: Recent and Prospective Developments and the Policy Issues they Pose", 15.

principles in the sector. This was the case for two key reasons. First, there were significant differences between the national regulations of Canada and the US which hindered progress. Second, both countries wanted to be assured of the preservation of existing access they had to each others' financial systems. The FTA represented the first major experience for Canada in balancing domestic political concerns with the creation of rules governing foreign financial institutions.

On October 4th 1987, officials from Canada and the US signed the Canada-US Free Trade Agreement (FTA). The financial sector components of the FTA are contained in the pages of provisions of Chapter 17. At this time the idea of rules for international trade in services was a relatively new concept, and also was not covered by the General Agreement on Tariffs and Trade (GATT).²⁴² The resulting priority in the negotiations for services in the FTA was to 'cast the net as wide as possible' to capture the greatest number of services sectors. There was no common definition for what the term 'services' encompassed or what service sectors should be included in the agreement, and this required some work.

The financial services negotiations were kept entirely separate from the general services negotiations because banking and trade had traditionally operated as separate areas of the economy. The financial services chapter was negotiated by the US Treasury Department and the Canadian Department of Finance, while the general services agreement was negotiated by the US Trade Representative's Office and the Canadian Trade Negotiations Office. While the Treasury and the Finance Department both had the necessary

²⁴² A notable precedent was the establishment of broad principles for trade in services including right of establishment and national treatment in the mid-1985 preparatory discussions leading up to the US-Israel FTA.

authority and expertise to conclude the financial services chapter, the lack of coordination with the trade negotiators was thought to be the product of an extreme over-sensitivity based on intra-agency ‘turf’.²⁴³ Simon Reisman was Canada’s chief negotiator until the Agreement’s completion. Towards the end of the negotiations Finance and Treasury people were more involved in negotiating the implementation details and to “get the deal done”.

The resulting financial services agreement did make progress by reducing some existing trade barriers. However, by pursuing an entirely separate course, the financial service negotiators failed to establish broad trade principles that would apply to most other services under the agreement. Part of this was because both parties wanted to preserve the existing access they had to each others’ financial systems. There were concerns that changing regulations might have restricted some types of activities which already existed between the two countries.²⁴⁴ Liberalization therefore was bargained item-by-item, rather than as part of an expansion of the general services regime.

A proper analysis of the FTA negotiations in financial services requires an understanding of the context of Canada-US bilateral relations at the time. The motivations of each country were important because there was significant concern about political issues resulting from what was happening in goods trade and the auto pact. The common goal was to reach a formalized arrangement in free trade in the midst of intense disagreements in steel, lumber, and agricultural products. Services were discussed early on in the negotiations and

²⁴³ Fry, Earl, H., Radebaugh, Lee, H., (eds., 1987), The Canada-US Free Trade Agreement: The Impact on Services Industries, 58

²⁴⁴ Chant, John, (1992), Free Trade in the Financial Sector, 10

cultural issues were avoided due to their sensitive nature. A big problem for the negotiators was that there was no model agreement in existence dealing extensively with financial services.²⁴⁵ Throughout the process leading up to the FTA, papers were presented and exchanged among those involved which discussed the subject of national treatment and modeled how specific GATT ideas could be altered for the purpose. The important financial services-related issues that were discussed in the negotiations included the general principles of national treatment, transparency, compatible language, and labour mobility. The US was not committed to these in principle at the time, since they saw the financial services negotiations only as a way to get what they wanted in other areas of trade. The GATT text itself, as we have seen, was not the best model for services, including financial services, but its principles were eventually utilized.²⁴⁶ Under the expertise of Canada's John Curtis, Raymond Labrosse, and 'treasury types' like Frank Swedlove, David Dodge, David Lee and Bill Hood, financial services were successfully brought into the FTA on the basis of being GATT-compatible.

Domestic politics in Canada played a significant role in slowing and complicating the progress of the negotiations in financial services. First, the banks themselves were divided on the free trade issue both during the negotiations and after the agreement was signed.²⁴⁷ While some of the banks supported the agreement for its potential to help economic growth,

²⁴⁵ Personal interview, March 2002.

²⁴⁶ The financial services provisions in the FTA and NAFTA were both scheduled according to a "negative-list" approach whereby a basic agreement was agreed upon and supplemented with lists of exceptions.

²⁴⁷ Doern, G. Bruce, Tomlin, B., (1991), Faith & Fear: The Free Trade Story, 117.

others opposed it because of the perception that the agreement would favour the US banks. Second, many politicians and bureaucrats were not admirers of the banks.²⁴⁸ The banks themselves perceived that the government of Brian Mulroney, including many MP's, generally disliked and mistrusted them.²⁴⁹ The priorities of the Conservative government were focused on the lead-up to another round of deregulation in the banking industry, so that the government was less concerned with the issue of liberalization of foreign entry in the FTA. As a result, the Conservative government did not need the banks on its side through either the negotiations or for electoral support in the 1988 Federal election.²⁵⁰ Furthermore, the interests of the banks were at odds with those of the securities industry in Canada. Finance Minister Michael Wilson was originally from the securities industry, which had a long history of conflict with the banks.²⁵¹ In addition, the pressures for financial deregulation had been building, particularly after the "big bang" deregulation of the London financial market.²⁵² In Britain and in Canada, one of the major factors for reform had been the relative decline of their securities markets. In December 1986, Ontario decided to fully deregulate its securities industry for competitive reasons and allow banks to buy securities firms.²⁵³ The

²⁴⁸ Personal correspondence, April 2003.

²⁴⁹ Doern, G. Bruce, Tomlin, B., (1991), Faith & Fear: The Free Trade Story, 118.

²⁵⁰ Personal correspondence, April 2003.

²⁵¹ Doern, G. Bruce, Tomlin, B., (1991), Faith & Fear: The Free Trade Story, 118.

²⁵² The British "big bang" involved the liberalization of fixed commissions, the removal of the Independent Certification System which limited members of the stock exchange from performing certain activities, and the restriction over non-stock exchange members investing in stock members' companies was removed.

²⁵³ In June 1982, the Ontario Securities Commission (OSC) liberalized commissions, over four years before the London big bang. See Harris, Stephen, L., (1999), "The Globalization of Finance and the Regulation of the Canadian Financial Services

domestic banks were given one year to purchase securities firms before foreign banks, giving them a strong incentive to do so. The overall effect kept the banks detached from the FTA negotiations in financial services for fear that their industry was one that was being traded-off for gains in other sectors.

Financial services tends to be a very autonomous, specialized and sensitive area due to its increasing encroachment into domestic politics. This trend can be traced back in history to the origins of central banks and the special nature of prudential rules and the importance of currencies. This has also made it extremely political. Because it was intended to become a separate chapter in the FTA, financial services was handled mainly outside of the Department of Foreign Affairs and International Trade (DFAIT). In fact, DFAIT is less in control of the Canadian trade agenda than academics assume.²⁵⁴ For example, the bigger and older areas of trade, like tariffs and antidumping and countervailing duties, are handled by the Department of Finance, while customs valuations are handled by National Revenue. The role of DFAIT has been to play a ‘coordinating, political-economic role’ (e.g., dealing with NGO’s), and not a functional or instrumental role in the most specialized and protectionist areas of international trade. Financial services legislation, but not policy, is drawn up by lawyers working for the Department of Justice and the in-house counsel at the Department of Finance. In current financial services negotiations, DFAIT and Finance sit together but the initial position going into talks and the lead is taken by Finance.

The FTA was also negotiated amidst a vigorous movement towards financial

Industry”, 373.

²⁵⁴ Personal interview, October 2001.

deregulation in both countries.²⁵⁵ While there were additional fears that a trade deal would tie the hands of either government on fiscal and monetary policy, Canada was successful in its insistence on keeping these issues out of the trade discussions.²⁵⁶ The creators of the FTA did not intend to integrate or harmonize the Canadian and US financial sectors, but rather wanted to preserve the *status quo*.²⁵⁷ Although the FTA was intended to liberalize financial services, changes were perceived to be forthcoming that could have cut off some existing access, such as the existing powers of Canadian banks in the US or the access that US banking professionals had to Canada. These concerns led each country to make specific requests based on their own interests and failed to give any ‘bilateral balance’ to the commitments of the two parties.²⁵⁸ Article 1701 (2) clearly limited the scope of financial services commitments by stating that financial services would not apply to political subdivisions in Canada or the US (i.e., provinces or states). This excluded its application to important provincial and state laws and regulations governing financial institutions.

With respect to bank branching, the American request for the liberalization of Canadian legislation was a sensitive issue in Canada for many reasons. First, it was politically difficult, given the history of debates surrounding banking in Canada as outlined above. Second, Canada had little experience with bank subsidiaries at that point and wanted to wait longer for this area to mature. Third, the fast action taken against the fraudulent

²⁵⁵ Chant, John, F., (1992), “Free Trade in the Financial Sector: Expectations and Experience”, 12.

²⁵⁶ Personal interview, March 2002.

²⁵⁷ Chant, John, F., (1992), “Free Trade in the Financial Sector: Expectations and Experience”, 10.

²⁵⁸ Personal interview, October 2001.

activities of the Bank of Credit and Commerce International (BCCI) was a case-study of good prudential control and the potential dangers of branching in the minds of Canada's policy-makers at that point in time.²⁵⁹ Finally, Canada lacked the staffing and expertise to administer a potential branching regime. Branching regulation is very difficult, requiring experts in the field who have the necessary specialized tools and knowledge. In 1987 the Inspector General of Financial Institutions office was all that existed, and it had minimal staffing.

It is also important to understand just how relevant the retail branching issue was in the context of the big picture. Prior to the FTA, US banks could operate with minimal restrictions in Canada in the areas which were of interest to them (i.e., wholesale banking). Retail banking, where Canadian regulations were mostly restrictive, was not a sector that was of interest to the foreign banks. The US banks realized that cracking the concentrated Canadian retail banking market was difficult. This was because the Canadian banks were already well-established, had strong customer loyalty, and actively protected their position. While domestic Canadian banks are now fully supportive of greater foreign competition, the concentration issue persists. For example, Citibank is the world's largest retail banker and Merrill-Lynch is the largest securities dealer, yet neither has been able to gain a significant

²⁵⁹ Described as the 'biggest bank fraud in history', BCCI encompassed a network of bad lending practices, financial shell companies and institutions operating in nearly 70 countries and which had managed to escape full regulation. Though it was officially shut down July 5, 1991, regulators were examining its activities through the mid to late 1980's but were unable to take action until the bank's activities were sorted out (Erisk.com Case Study).

foothold in Canada for this reason.²⁶⁰

In the area of securities, many assumed that the Glass-Steagall Act in the US would be a major obstacle in the financial services area.²⁶¹ In fact, Canadian firms operating in the US were already doing a combination of banking and securities-related activity. This was because existing Canadian securities firms operating in the US had as their main business the underwriting of Canadian government business (i.e., hydro deals, etc.) and this is where they primarily made their money. Glass-Steagall, however was changed in the FTA to accommodate such corporate underwriting, and Canadian securities firms were allowed to operate without reference to it.²⁶² Thus, Glass-Steagall was not limiting for Canadian banks, and it represented merely a convenient lobby issue at the time for the Canadian banks in their attempt to discredit Glass-Steagall itself.²⁶³ The US was granted the right under the FTA to acquire securities dealers in Canada.

The Provisions of the Free Trade Agreement

The provisions on financial services in the FTA applied to banking and securities services only . Insurance was covered under the general services chapter and not under

²⁶⁰ Personal interview, March 2002.

²⁶¹ Recall that the Glass Steagall Act of 1933 in the US required the separation of commercial banking and securities functions for prudential and conflict of interest reasons.

²⁶² Since Canadian banks could own securities firms after the legislative changes of 1987, a number of indirectly owned US securities subsidiaries of the Canadian banks had been granted orders under Section 20 of the Glass-Steagall Act which allowed them to engage in equity underwriting activities in the US on a limited basis, restricted in part based on their specified eligible activities in the US. See Lindzon, Ralph, E., (1992), "A North American Free Trade Zone in Financial Services?", 40.

²⁶³ Personal interview, March 2002.

financial services.²⁶⁴ The special characteristics of the FTA financial services provisions should be noted. First, the understandings on financial services were distinct from other FTA chapters. Financial services required special consideration in the FTA because of the general need to include freedom of establishment beyond that found in free trade in goods. Where the rest of the FTA required observance of measures by state, provincial, and local governments, the financial services provisions did not apply to state or provincial measures. The agreement did not apply, for example, to state US bank branching laws or Canadian provincial securities regulations. Second, financial services provisions were exempt from the dispute settlement mechanism applied elsewhere in the FTA. The term “dispute settlement” is not found in Chapter 17, but Article 1704 does allow for “Consultation” between the Canadian Department of Finance (Finance) and the United States Department of Treasury (Treasury). The details of the procedure were not outlined.

Dispute settlement is a recurring peculiarity in financial services because even in the WTO there have been no initiations of dispute settlement cases. Peter Nicholson, Senior Vice-President, The Bank of Nova Scotia, said in testimony to the Standing Committee on Foreign Affairs, observed in reference to the FTA: “There is not even any language suggesting that an aggrieved party is entitled to take retaliatory measures of equivalent commercial effect.”²⁶⁵ While the negotiations protected the status quo in terms of actual

²⁶⁴ The US did not categorize insurance as a ‘service’. While the Treasury Department was responsible for banking and securities, the Department of Commerce handled insurance.

²⁶⁵ Quoted in Rochon, Paul, (1989), “Strengthening Market Access in Financial Services: The Financial Services Provisions of the Canada-U.S. Free Trade Agreement”, 5

legislation for Canadian firms, it did not protect against discretionary changes in the *application* of regulation.²⁶⁶ There are two possible explanations for the lack of dispute settlement in financial services. The first relates back to the tradition of secrecy in the financial policy-making arena discussed earlier in this chapter. Described as an ‘old boys network’, policy makers from one country would not want to initiate a formal complaint for fear of seeming out of step with the expectations of policy makers in other countries.²⁶⁷ In trade negotiations, the problem of secrecy in Canada is further complicated by the fact that specific trade negotiation objectives are not in the public domain due to cabinet confidence rules.²⁶⁸ The other reason could be that trade in financial services has just not been as economically significant as in other areas, such as steel and softwood lumber, where many of the disputes are taking place.

In the negotiations, the concept of reciprocity could not be pursued because of the huge differences in national regulations (i.e., minimal harmonization existing between the two countries and the dissimilar regulatory structures). Under the US regulatory model, the universal application of NT is more difficult because of shared banking jurisdiction between the states and the federal levels. For example, US states themselves tend to have widely varied rules with respect to treatment of foreign financial institutions. In Canada by contrast, banking jurisdiction is exclusively under the power of the federal government, so that, regulatory changes apply equally to all institutions in all provinces. What resulted from this

²⁶⁶ Chant, John, F., (1992), “Free Trade in the Financial Sector: Expectations and Experience”, 18.

²⁶⁷ Personal interview, October 2001.

²⁶⁸ Personal interview, January 2003.

disparity was a “menu” option for requests and offers, under which each country chose the issues most important to it, and this has been described as a “pragmatic application of the principle of national treatment”.²⁶⁹ In the end, the FTA left each country’s powers unchanged with respect to financial sector domestic regulation.

Canada’s Commitments in the FTA Understanding

There were some major sticking points in negotiating the financial services agreement. The first was that Canada had been imposing limitations on the foreign ownership of Canadian banks after the revisions to the Bank Act in 1980. Canada treated Schedule A and Schedule B banks (this latter class included foreign banks) differently, and this was obviously incompatible with the principle of national treatment. The differential treatment of banks in Canada was a source of friction between Canada and the US, but the reality of the situation was open to interpretation. Unlike the US system, Canada’s banking legislation was completely a federal responsibility and provincial securities markets were already highly deregulated. The reality was that US banks faced few restrictions in the business operations in which they wanted to operate in, and were already established in (i.e., mostly commercial activities, not retail banking).²⁷⁰ Looking at the US, even after it introduced the International Banking Act of 1978, which committed to national treatment for foreign banks, some thirty-three states still maintained explicit restrictions against foreign

²⁶⁹ Rochon, Paul, (1989), “Strengthening Market Access in Financial Services: The Financial Services Provisions of the Canada-U.S. Free Trade Agreement”, 6.

²⁷⁰ Personal interview, March 2002.

banks.²⁷¹ The second sticking point, discussed above, was that while the US market for financial services was generally open, the Canadians did have reason to be concerned that the US could impose new limits on Canadian firms. And it was a primary objective of the Canadians that the US would move toward deregulation of financial services. One of the biggest problems in this area was the Glass-Steagall Act, which barred common ownership of banks and securities firms. The worry for the Canadians was that they would actually have to reduce their activities in the US while American firms expanded in Canada under the FTA. Given these concerns the FTA offered some solutions.

First, there was a relaxation of restrictions on the acquisition of Canadian-controlled firms. Under the so called "10/25" rules, foreign insurers were prevented from acquiring more than 10 percent of a federally chartered insurance firm.²⁷² Also, foreign bank subsidiaries in Canada, as a group, were not allowed to hold more than a 16 percent share of the total capital of the Canadian banking industry. This limit would be removed for US banks and their assets would no longer be included in the calculation of the asset ceiling, so the ceiling was reduced to 12 per cent for non-US foreign banks.²⁷³

Second, US-controlled banks in Canada would now be permitted, subject to

²⁷¹ Other restrictions added to the barriers faced by Canadian banks. See the section below entitled "The National Treatment Issue". Chant, John, F., (1985), "The Canadian Treatment of Foreign Banks: A Case Study in the Workings of the National Treatment Approach", 235.

²⁷² Recall that the "10/25" rule refers to a 10-percent individual and a 25-percent collective limitation on foreign ownership of Canadian-controlled federally regulated insurance companies and trust and loans companies.

²⁷³ Article 1703 (2).

prudential requirements, to transfer assets to their parent banks.²⁷⁴ Prior to the FTA, it was possible for Canadian borrowers to book loans directly with the US parent bank. However, transfers of loans between the Canadian subsidiary and the parent bank were not permitted.

Third, US banks were no longer required to obtain Ministerial approval prior to opening additional branches in Canada.²⁷⁵ However, US banks have not typically moved into Canadian retail banking because there are significant capital costs associated with entering the highly concentrated Canadian market and the level of retail service offered in Canada was already high. Furthermore, the growing involvement of insurance and trust companies in the retail market made the retail banking sector even less attractive as an area for expansion.²⁷⁶

Finally, Canada agreed not to apply the review powers contained in section 307 of the Bank Act in a manner that was inconsistent with the agreement on financial services.²⁷⁷ Section 307 required foreign banks to obtain consent from the Governor in Council before establishing or acquiring an interest in a financial institution in Canada. The agreement on financial services, therefore, could be taken to imply that US financial institutions would be subject to review on that basis of prudential regulations only.

Commitments of the US

In 1989 regulatory reform in the US was far less advanced than in Canada because control over institutions was still divided between state and federal levels. Nevertheless,

²⁷⁴ Article 1703 (2) (d).

²⁷⁵ Article 1703 (2) (c)

²⁷⁶ Rochon, Paul, (1989), "Strengthening Market Access in Financial Services: The Financial Services Provisions of the Canada-U.S. Free Trade Agreement", 13

²⁷⁷ Article 1703 (3).

Canadian institutions had generally had access to the US market for some time and enjoyed national treatment there.²⁷⁸ The 1978 International Bank Act (US) offered market access on a national treatment basis. The commitments of the US would be less broadly based than those of Canada but did include improved market access in a few areas. This was because most foreign financial institutions were already offered *de jure* national treatment. The US negotiators were also under considerable pressure to go beyond broad principles to ensure that Canadian financial services barriers were eliminated in the overall trade deal.²⁷⁹ The US made three main commitments. First, it committed to allowing both domestic and foreign banks to deal in and underwrite securities of Canadian governments and their agents.²⁸⁰ Second, the right of Canadian banks to engage in retail and other banking operations in the US which were previously “grand fathered” for 10 years under the 1978 International Bank Act, were now done so indefinitely under the FTA.²⁸¹ Finally, national treatment was promised when the changes to Glass-Steagall were completed and would apply equally to Canadian, and to US-controlled financial institutions.²⁸² Possibly because they recognized the shortfalls of the FTA with respect to full national treatment, both the US and Canada finally agreed to “consult and to liberalize further the rules governing its markets and to extend the benefits of such liberalization to [the other party].”²⁸³

²⁷⁸ Personal interview, March 2002.

²⁷⁹ Fry, Earl and Radebaugh, Lee, The Canada-US Free Trade Agreement: The Impact on Service Industries, 55

²⁸⁰ Article 1702 (1).

²⁸¹ Article 1702 (2).

²⁸² Article 1702 (3).

²⁸³ Article 1702 (4) [US], Article 1703 (4) [Canada].

The Difference between Subsidiaries and Branches

It is important to note here why the distinction between branches and subsidiaries has been so important. The main difference between a subsidiary and a branch is that a subsidiary is limited by banking law in the size of loan it can make to a single borrower. Subsidiaries are also limited to their Canadian capital rather than the much larger pool of their parent company's capital. This can give an advantage to domestic banks, which can draw on a much larger pool of their own capital for operations. The establishment of subsidiaries also comes with considerable set-up costs as it would be much cheaper to establish an outlet of the parent company. However, subsidiaries are preferred by many countries because branches operate according to a different set of home country regulations and are not on the same playing field in many legal respects as domestic institutions.²⁸⁴ This raises potential prudential concerns when depositors' funds are potentially at risk. The European Union however, has managed to overcome this regulatory difficulty by establishing its single passport in financial services agreement.²⁸⁵ The branch option is arguably more economical because it avoids the duplication of business expenses. Because branches are

²⁸⁴ Neufeld and Hassanwalia have noted: "Most jurisdictions now require foreign banks that wish to operate with all the powers of domestic banks to establish subsidiaries. For instance, the US requires new foreign bank entrants to establish a subsidiary to engage in retail deposit-taking. The EU also requires the establishment of a subsidiary before extending a foreign bank the full benefits of a single community licence.", (1997), "Challenges for the Further Restructuring of the Financial Services Industry in Canada", 92.

²⁸⁵ The 1989 Second Banking Coordination Directive and the 1993 Investment Services Directive granted European nations broad latitude in establishing their own legal and regulatory framework for financial services. Financial firms were granted a "single passport" to operate throughout the EU subject to the regulations of their home country.

also allowed to utilize the parent company's capital base, they are arguably more stable because of this fact. The allowance of full bank branching capability in the US would therefore make the foreign bank more profitable in relative terms and the domestic lobbies would want to prevent this from happening.²⁸⁶ To summarize, foreign financial services providers have found it very difficult to establish profitable operations in Canada because it is a highly concentrated and well serviced market. Foreign bankers operating in Canada had stated that while the asset ceiling was an irritant to their operations in Canada, it had not served as an effective barrier to their growth.²⁸⁷ Instead, the main barrier to growth in the Canadian market was recognized to be the prudential lending limits applied to all banks, regardless of nationality. As we will see in the chapters ahead, prudential lending limits continue to be the biggest barrier to foreign banks operating in other countries as well.

The Limited Scope of the FTA Financial Services Provisions

In the wake of the bilateral FTA, the status of non-US foreign banks also came into greater focus. The question was whether the concessions offered to US banks should be offered to other foreign banks operating in Canada. Both the Europeans and Japanese were recognized as placing pressure to obtain similar exemptions from the foreign banks regulations.²⁸⁸ The differential treatment was also at odds with the increasing emphasis on most-favoured nation (MFN) treatment in international discussions. Also not discussed in

²⁸⁶ Gouvin, Eric, J., (1999), "Cross-Border Bank Branching under the NAFTA: Public Choice and the Law of Corporate Groups", 287.

²⁸⁷ Rochon, Paul, (1989), "Strengthening Market Access in Financial Services: The Financial Services Provisions of the Canada-U.S. Free Trade Agreement", 11

²⁸⁸ Rochon, Paul, (1989), "Strengthening Market Access in Financial Services: The Financial Services Provisions of the Canada-U.S. Free Trade Agreement", 18.

the FTA was the issue of cross-border trade because of the already close integration of the Canadian and US financial markets. More generally, negotiation was seen to be hampered because of the heavily regulated nature of the industry in both countries at the time.²⁸⁹

The National Treatment Issue

In the eyes of the Canadian negotiators, national treatment in the US had a very different significance than it did in Canada because of the difference in the division of powers. In the US, banking powers are administered by individual states. In Canada, national treatment means nation-wide branch access because banks are federally-regulated. Therefore, any bargaining in the FTA put Canadian banks at a disadvantage from the start. While the negotiators made this case, the reality was that the US was already more open to foreign banking than Canada. When the Canadian government asked the Canadian banks to make a list of barriers to the US market, this fact was confirmed by the short list that was produced.²⁹⁰ The other problem was that in 1988, the 16 US bank subsidiaries operating in Canada could own full-service investment dealerships. In the US, however, commercial banking and investment were separated by the Glass-Steagall Act. Thus, “national treatment” meant that Canadian banks could not own securities firms in the US on paper, even though the major Canadian dealerships were already there. The compromise allowed them to continue operating in the US with the promise that this would be officially extended once Glass-Steagall was amended. As MacIntosh has noted, the US offer was Canada’s bird in the bush while Canada’s offer of nation-wide branching to US banks was the bird in the

²⁸⁹ Personal interview, March 2002.

²⁹⁰ Doern, G. Bruce, Tomlin, Brian, W., (1991), Faith & Fear: The Free Trade Story, 118.

hand.²⁹¹ From the perspective of services negotiations, this makes the concept of national treatment very ambiguous because there is no common working definition. John Chant notes that the concept of national treatment was designed for a system of nation-to-nation bargaining, so implicit in its definition is that national authorities have full jurisdiction over banking regulations.²⁹² A better application of the concept of national treatment would require both federal and state jurisdictions in the US to accord equal treatment to both domestic and foreign banks in their jurisdiction.

These issues also necessitate a more detailed discussion of the difference between *de jure* and *de facto* treatment (barriers that exist in law and those that exist in practice). The US position was that they were essentially working with a trade policy based on national treatment. However, the reality was that the US was offering more treatment *de jure*, but not *de facto*. There were arguably many more barriers to Canadian banks operating in the US. These included individual state barriers to entry, the requirement of standby letters of credit and rules discouraging foreign banks from obtaining FDIC insurance. At the state level, some states restricted foreign banks from establishing a federal agency in their state. Other states restricted branches, while others required state charters. Regional reciprocity rules also discriminated against foreign banks because of specific requirements on geographical concentration of deposits. There were also barriers that could be set up under the Interstate Banking Act and Branching Efficiency Act. In addition, the volume of US financial

²⁹¹ MacIntosh, R., (1991), Different Drummers: Banking and Politics in Canada, 280.

²⁹² Chant, John, F., (1985), "The Canadian Treatment of Foreign Banks: A Case Study in the Workings of the National Treatment Approach", 236.

legislation and regulations at over 220, 000 pages was and is in itself a barrier as it raises the costs of entry and compliance.²⁹³

Final Analysis of FTA Chapter 17

One major area the agreement did not deal with was the liberalization of cross-border trade in financial services. That is, firms that were not established in Canada could not offer financial services in Canada, but would have to establish a subsidiary. The reason this was left out is thought to be that the regulators on either side were unwilling to give up their authority within their own boundaries. Also, and as with most other areas covered in the FTA, the financial services agreement did not cover provincial or state restrictions on financial services. This was not a problem, since most had been eliminating those restrictions as time progressed. Another closely related drawback of the financial services agreement was that it did not provide for any mechanism to actively promote further liberalization.

Another major concern was that the financial services agreement was not covered by the FTA dispute settlement mechanism. Rather, consultations were to be conducted solely by the Canadian Department of Finance and the US Treasury Department. The agreement requires that each country notify the other on new legislation or regulations affecting the agreement “to the extent possible” (Article 1704), and hence was weaker than the provisions for dispute settlement in the overall services agreement.

Despite some of the drawbacks, the FTA financial services agreement showed

²⁹³ Pattison, John, C., (1997), “Trade in Financial Services in NAFTA: A Public Choice Approach”, 152.

promise in that it represented a major first step in long term process of further liberalization. By reducing significant existing barriers and making a promise for resolving future problems, the agreement provided resolution for discrimination and protectionism. Another lesson drawn from the overall FTA services agreement was that the two-tier approach to negotiations was workable; a framework of principles could be supplemented by a series of sectoral agreements. However, the negotiations for specific service barriers within the framework was not easy. Real progress could only be made by a 'hard bargaining' process where trade-offs are made between sectors.²⁹⁴ Progress was achieved in financial services because the agreement on financial services emerged as an essential condition of the overall FTA. Many of the omissions and difficulties in the FTA financial services agreement that were not fully fleshed out in the Canada-US bilateral context pointed to the possible challenge that would lie ahead for liberalization at the multilateral level.

Section III: Financial Services in the North American Free Trade Agreement (NAFTA)

The financial sector again became the subject of trade negotiations when the FTA was expanded in 1994 to include Mexico under NAFTA. Canada's participation in the NAFTA was based on a fundamentally different set of circumstances than was the FTA. Whereas the FTA was based on long-standing trade policy, considerable discussion, and the realities of Canada's trade flows, the NAFTA involved limited domestic debate, and a broader foreign policy view.²⁹⁵ Through the NAFTA, Canada sought more opportunity for

²⁹⁴ Personal interview, March 2001.

²⁹⁵ Winham, Gilbert, R., (1994), "NAFTA and the trade policy revolution of the 1980s: a Canadian perspective", 493.

competitiveness, secure access to the US market, and a rationale to initiate and continue economic reform at the domestic level.²⁹⁶ In financial services, the NAFTA agreement represented more than just a routine expansion of the FTA to another country. Instead of each country adopting a different set of obligations, as in the FTA, the members agreed to a more common set of principles governing the treatment of each other's institutions.²⁹⁷ Canada and the US faced particular challenges based on their different approaches to prudential regulation in the financial services sector. These concerns were partially met by NAFTA's rules on regulatory safeguards and 'investor choice'. Based on the discretion of the negotiators, issues of potential systemic instability left many domestic banking regulations untouched.

Chapter 14, dealing with financial services, maintained the FTA's separation of a general framework agreement and the specific reservations to the agreement which are to be declared by each party in Annexes (i.e., the "negative list" approach to scheduling). NAFTA Chapter 14 also differs substantially in other respects from the FTA in its approach to free trade in this sector. Essentially the NAFTA took a more comprehensive approach to national treatment and was drafted around the broader principles of free trade in financial services. Leading into the negotiations, Canada, the US, and Mexico each maintained a separate agenda, which was largely a reflection of the bilateral experience in the FTA and their

²⁹⁶ Winham, Gilbert, R., (1994), "NAFTA and the trade policy revolution of the 1980s: a Canadian perspective", 480, 485.

²⁹⁷ von Furstenberg, George, M., (ed., 1997), The Banking and Financial Structure in the NAFTA Countries and Chile, 18

economic interests.²⁹⁸ For Canada, the NAFTA negotiations were an extension of the protective measures that were achieved for Canadian financial institutions in the FTA. Canada's general attitude in the NAFTA financial services negotiations was to protect Canadian businesses and their well-established activities in the US. For the US, the negotiations were seen as an opportunity to open up Mexican financial markets to US institutions because it was believed that the Mexican markets were at a key stage of development for such participation.²⁹⁹ For Mexico, the timing of the NAFTA negotiations was coincident with a financial crisis, so the negotiations were a trade-off between the preservation of a national presence in their vulnerable financial system and the benefits to be had in other areas. In the NAFTA, Mexican negotiations sought access to the US market for their goods, so they agreed to phase out foreign ownership restrictions in their financial services market with delayed transition periods. In this respect, Chapter 14 is arguably the price Mexico paid for the rest of NAFTA's advantages.³⁰⁰

The negotiations on Chapter 14 were carried out relatively quietly among government officials and the relevant industry players. Unlike some of the other sectors negotiated in the NAFTA, it received little attention from the press or consumer groups.³⁰¹ Concerns about

²⁹⁸ Wethington argues: "...all three participating countries believed that a liberal financial services regime would facilitate the efficient flow of capital between the countries and thereby promote economic growth.", Wethington, Olin, L., (1994), Financial Market Liberalization: The NAFTA Framework, 4.

²⁹⁹ Chant, John, "The Financial Sector in NAFTA" in Assessing NAFTA: A Trilateral Analysis, 180

³⁰⁰ Trachman, Joel, (1996), "Trade in Financial Services Under GATS, NAFTA and the EC: A Regulatory Jurisdiction Analysis", 58.

³⁰¹ Schefer, K.N., (1999), International Trade in Financial Services: The NAFTA Provisions, 118.

the erosion of Canada's political and economic sovereignty³⁰², the uncertain benefits, and questions surrounding the recently completed FTA³⁰³, did not seem to apply to Chapter 14. In addition, industry organizations such as the Coalition of Service Industries, the American Financial Services Association, and the major commercial and investment banks were active in promoting their own interests. The Canadian negotiation team, led by Frank Swedlove, was drawn from the Department of Finance and also included Bill Bryson, Nicholas LePan, and Pierre Sauvé.

In the 1992 domestic financial sector reforms, in the midst of the NAFTA negotiations, the big banks maintained their objections to the easing of regulations dealing with foreign ownership. They argued that Canada would become the only major industrialized country that permitted concentrated ownership of major financial institutions. Broad ownership, they argued, prevented any misuse of depositor's funds. They also argued that the existing rules prevented conflicts of interest that could lead to credit being denied to competitors of the firm in question.³⁰⁴ Their concerns were somewhat addressed by NAFTA's rules on regulatory safeguards and the maintenance of the widely-held rule, but the momentum of the changes that were happening at both the North American and international levels also marked the beginning of an about-face by the bankers in favour of

³⁰² Toronto Star, "New trade pact seen as threat to nationhood", by Jonathan Ferguson, Thursday November 26, 1992, A16.

³⁰³ Wall Street Journal, "World Business (A Special Report): Looking North – A Disgruntled Canadian: Former Trade Negotiator Gordon Ritchie Warns that the US-Canada Deal is in Jeopardy", September 24, 1992, R18.

³⁰⁴ Chant, John, F., (1997), "Canada's Economy and Financial System: Recent and Prospective Developments and the Policy Issues they Pose", 20.

foreign competition.

NAFTA Chapter 14: Financial Services provisions

In general, Chapter 14 of NAFTA provides a declaration of principles with respect to the openness of the financial sector and safeguards to permit participating parties to maintain distinct approaches to the regulation of their financial sectors.

(1) Regulatory Safeguards

In both the FTA and NAFTA, the financial sector provisions required that the countries would be assured openness to suppliers in the other countries while being able to preserve distinct national approaches to regulation. This was especially relevant for Canada and the US because they had traditionally maintained distinctly different, even incompatible, approaches to the prudential regulation of their financial sector.³⁰⁵ The article also addresses ‘national sovereignty’, assuring that the agreement would not interfere with any country’s ability to carry out stabilization policies in regards to its national interest. This was thought to be important for both Canada and Mexico in regards to their monetary and exchange rate policies.³⁰⁶

(2) Cross-Border Trade

In the FTA, cross-border trade was of little importance because interference in regards to cross-border trade in financial services was a rare occurrence. This issue became more important with the inclusion of Mexico, which had a history of substantial interferences

³⁰⁵ “Prudential” refers in this context to mean the *careful management and exercise of good judgement* which could only be achieved by each country in regards to their distinct approaches to financial services regulation.

³⁰⁶ Personal Interview, March 2002.

to cross-border trade in financial services.³⁰⁷ Chapter 14 requires each party to permit its residents to purchase financial services from suppliers of other parties located anywhere in the free trade area. The agreement also states explicitly that it does not obligate parties to permit foreign service providers either to do business, or to solicit in their territory - so falls short in this respect. NAFTA did allow limited branching of foreign banks in Canada, but this allowance came with very strict limitations. Included in these limitations was a foreign bank asset base of at least \$35 billion, not being allowed to take retail deposits, other asset requirements, and were subject to a supervisory standard of review. Foreign banks were also still restricted by the widely-held rule which excluded any person or group from controlling 10 per cent or more of a schedule I bank unless first obtaining the approval of the Minister of Finance. This maintained the limitation on the acquisition of a Schedule I bank in Canada.

(3) Establishment and National Treatment

The most significant progress in regards to financial services was made in the area of market access. On the right to establish, NAFTA requires that a member must allow financial service providers from other member countries to participate fully in its markets (under the principle of national treatment), either by establishing branches or subsidiaries or by acquiring existing financial institutions in the host country. Furthermore, once a foreign supplier has established a financial institution in the host country, the conditions of national treatment apply to its operations, and the supplier may expand to establish branches. This

³⁰⁷ Chant, John, "The Financial Sector in NAFTA", 182

represented a compromise based on the positions of Canada and the United States.³⁰⁸ Under the FTA, Canada required foreign banks to operate through the establishment of separate Canadian subsidiaries in order to facilitate greater transparency. On the other hand, the US permitted banks to operate through the branches of the parent organization. The US bankers argued that their approach allowed for greater efficiency for expanding into another country because the firm would not have to endure the costs of establishing subsidiaries. In the end, Chapter 14 (4) left the decision to “investor choice” to be reconsidered after establishment in the foreign country.

(4) Dispute Settlement

The dispute settlement provisions in the financial sector generally follow the general model for dispute resolution outlined in Chapter 11 and Chapter 20, but they were geared to the needs of the financial sector.³⁰⁹ Initially, a party may request consultation regarding any matter in the agreement and expect sympathetic consideration. The agreement also provides for a Financial Services Committee to supervise implementation and to participate in the dispute settlement. The Agreement also fills a major shortcoming of the FTA by making disputes in the financial sector subject to the Dispute Settlement Procedures found in Chapter 20 of NAFTA. Under this procedure, disputes are referred to a Tribunal consisting of panelists drawn from a roster of individuals with expertise in the financial sector. If the

³⁰⁸ Aguirre, Ernesto, “International Economic Integration and Trade in Financial Services:”, Law and Policy in International Business, 27, 4, 1064.

³⁰⁹ NAFTA Chapter 11 deals with investment issues, but provided dispute resolution in the form of international arbitration on a state-to-state basis and the investor-state level. Chapter 20 is the general dispute settlement chapter for NAFTA.

complaint is upheld by the Tribunal, the complaining party may suspend benefits in the financial services sector.

Reservations on Chapter 14 of NAFTA

Under the FTA, each country made specific commitments directed at easing the other countries' concerns about access to financial markets in that country. This approach had little need for statements of exceptions because they could be made in the specific commitments themselves. However, as a multilateral agreement, NAFTA required the establishment of a general set of principles rather than specific commitments. The measures taken in the Agreement were designed to incorporate the greatest commitment to openness that any of the parties would be prepared to make. Annex VII of the agreement contains the schedules that set out the exceptions to the agreement registered by the three parties. Schedule A sets out the reservations to the agreement of both federal and provincial or state governments and Schedule B states the areas where the parties reserve the right to derogate (or reserve) provisions of the agreement in the future. Canada only included one reservation regarding the purchase of reinsurance, but this did not represent an overall acceptance of the agreement by the Canadians. For example, the agreement did not include the reservations that would be registered by provincial authorities, and a number of provinces retained restrictions that limited foreign ownership.³¹⁰

Conclusions on NAFTA

The agreement in NAFTA provides a clearer framework of commitments than the FTA, along with a wider encompassing agreement and a common set of principles. It carries

³¹⁰ Chant, John, "The Financial Sector in NAFTA", 187

over the two-tier structure of the FTA agreement that consisted of a framework agreement along with appropriate supplements. More significantly, it duplicates the negotiating format of the FTA where trade-offs between service sectors are made, but services commitments could not be tied to those in goods. As we will see, this was a structural problem in financial services negotiations in general that would become more serious in the shift to encompass the developing countries into the GATS framework. Although the NAFTA established a principles-based approach to liberalization in financial services, Canada and Mexico ensured that their biggest banks would remain under domestic control. Canada tried to give the appearance of a liberal system by engaging in banking legislation reform, but in actuality it clung to protecting the big banks from foreign take-overs. Mexico's subsequent liberalization in the GATS was advanced by its experience in the NAFTA.³¹¹ Mexico was able to expose its financial service industries to other competitors in the NAFTA context in order to prepare their institutions for international competition in the GATS.

Finally, it is significant that the NAFTA financial services negotiations took place at the same time as the WTO's GATS negotiations. Some of the same negotiators worked on both agreement drafts and those who did not were at least aware of the other agreement's proposed texts. The negotiators working on the NAFTA also worked to make its text compatible with the GATS.³¹² One main difference between the two agreements is that the

³¹¹ Schefer, K.N., (1999), International Trade in Financial Services: The NAFTA Provisions, 394.

³¹² The concepts of right of establishment, national treatment, and prudential regulations are meant to be GATS-compatible. See Schefer, K.N., (1999), International Trade in Financial Services: The NAFTA Provisions, 119

NAFTA gives more direct consideration to the principles of free trade and less thought to the interests of financial services regulators and practitioners, than does the GATS FSA.³¹³ This is so because most of the negotiators in the NAFTA came from a free market background and because the GATS gives more extensive treatment to domestic regulation and special and differential treatment for developing countries.

Section IV: Canada and the GATS Financial Services Agreement

This section outlines Canada's experience through the GATS FSA negotiations beginning in 1993. In the process, Canada made significant commitments to lift long-standing limits to foreign participation in the financial sector. These changes, which were designed to effectively increase competitiveness in the domestic banking sector, brought Canadian regulations closer in line with those found in most other developed countries. While the NAFTA and GATS financial services provisions were designed to be compatible, the agreements are fundamentally different. The GATS represents a rule-oriented framework for financial services liberalization while the NAFTA focuses more on specific institutional obligations.³¹⁴ Canada's original obligations under the GATS required that it maintain the level of access that was enjoyed by foreign financial service providers under the existing legislative, regulatory, and policy framework of the time. The Canada Bank Act has also been gradually changed to accommodate changes in the domestic financial landscape and

³¹³ See Schefer, K.N., (1999), International Trade in Financial Services: The NAFTA Provisions, 120.

³¹⁴ The NAFTA outlines how institutions are to be treated rather than setting out principles of liberalization. Wethington, Olin, L., (1994), Financial Market Liberalization: The NAFTA Framework, 67.

what has been going on at the WTO, but has not been changed because of any direct pressure from the WTO FSA.³¹⁵ Unlike some other countries, the changes in Canada's legislation also did not occur in response to crises or general dissatisfaction with the system's performance. The limited duration of the legislation (a built-in 5 year review limit) has allowed for incremental changes. Change has, however, been induced in trade negotiations with other countries and other relevant international agreements have been prompts for change to improve standards.³¹⁶ While Canadian officials generally view the WTO FSA as legitimate and useful, they also realize that the changes happening outside of the WTO, including the work at the BIS, IOSCO, and IAIS are equally important.³¹⁷

At the end of the December 1993 WTO negotiations, concerns about the lack of developing country commitments versus what developed countries were offering threatened to collapse any potential agreement in financial services. Canada did, however, keep its best offer on the table while other countries (Japan, US) were threatening to pull back their commitments and threatening to collapse the financial services agreement. This meant that for the six-month period of extended negotiations after the Uruguay Round, Canada indicated it would allow MFN treatment, but retained the flexibility to put back an MFN exemption if it was not satisfied with the outcome. Several other developed countries, including members of the EC, similarly did not pull back any commitments and provided MFN treatment.

³¹⁵ Personal interview, September 2001.

³¹⁶ Chant, John, F., (1997), "Canada's Economy and Financial System: Recent and Prospective Developments and the Policy Issues they Pose", 22.

³¹⁷ Personal Interview, October 2001.

Canada and the 1995 Interim Financial Services Agreement

When negotiations resumed again in 1995, Canada made an important contribution to the negotiations by tabling a new schedule containing a number of improvements. In exchange for the concessions of other countries in the GATS financial services negotiations, Canada agreed to eliminate the foreign ownership and market share limitations in the federal financial regime. These restrictions had already been lifted under the NAFTA for the US and Mexico. More specifically, Canada had eliminated the following restrictions: the "10/25" limitations on foreign ownership, the 25 percent limitation on the foreign ownership of banks, and the 12 percent asset ceiling on the size of the foreign bank sector in Canada which applied to non-NAFTA countries. Canada also offered to bind its current open regime with respect to market access and national treatment.³¹⁸ Finally, Canada offered MFN treatment by removing the requirement that foreign bank subsidiaries seek Ministerial approval to open additional branches in Canada. This had implications for the reciprocity provisions that then existed in Canadian legislation (through NAFTA) with respect to the entry of foreign financial institutions into its market. The existing Canadian provisions were not consistent with the MFN principle, but Canada had promised to enforce reciprocity over the period of the interim deal in financial services.

The GATS and Financial Services - Towards 1997

There were seven rounds of bilateral negotiations in GATS which occurred from April to December 1997. The reason for this was that the goals of 'significantly improved market access and broader participation' were difficult to achieve under the interim

³¹⁸ Finance Canada, (1995), The GATS: The Financial Services Sector, 8

agreement.³¹⁹ In hindsight this was bad for both general services and financial services because it excluded any cross-sectoral trade-off³²⁰ - a similar problem that was mentioned earlier in this chapter with respect to the 'hard bargaining' in the FTA negotiations.

In the 1997 negotiations, Canada committed in three important areas. First, Canada agreed to maintain its existing open regime for banking, insurance, and securities. Second, it allowed foreign banks to establish in Canada through (limited) branch offices and therefore have the same opportunities as Canadian institutions. Finally, Canada removed the requirement for foreign bank subsidiaries operating in Canada and originating from a non-NAFTA country to seek authorization before opening additional branch offices. These final two points that Canada upheld through both the FTA and NAFTA would bring Canadian policy closer in line with that of other developed countries. Canada would now be giving all WTO members the same access in financial services that it was giving to the United States and Mexico under NAFTA.³²¹ The fact that Canada was bringing their international commitments in line with those it had already made under NAFTA suggests that this was probably not an extraordinary move. Canada was merely updating its commitments at the international level as part of the negotiations while seeking greater market access abroad.

Canada and Insurance in the GATS

In Canada's insurance market, companies can incorporate under provincial or federal law. Until the newest financial services legislation was introduced in late 2001, there had

³¹⁹ These were goals set at the WTO's Ministerial Conference in Singapore, Dec.1996.

³²⁰ Dobson, Wendy, Jacquet, Pierre, (1998), Financial Services Liberalization in the WTO, 96.

³²¹ Finance Canada, "What has Canada committed to in the 1997 agreement?", 3

been no major changes to insurance legislation or GATS commitments in the insurance sector. Foreign ownership remains subject to investment review thresholds and the Minister of Finance retains significant discretion over merger activity and ownership status of insurance companies. In addition, several provinces continue to subject foreign investments in existing, provincially incorporated companies to authorization. There is a strong presence of foreign insurance firms in Canada.³²² Foreign insurance companies may supply their services either directly through branches or subsidiaries with approval by the Minister, and all must establish a commercial presence in the province.³²³

Life insurance companies are not in general allowed to offer other services (except for health, accident and sickness insurance), but may be affiliated to, and distribute the products of, a property and casualty insurer. As in banking, commercial presence is required to offer insurance services in Canada. However, companies may branch from abroad on condition that they maintain trustees assets equivalent to their liabilities in Canada. Insurance companies can own deposit-taking financial institutions, investment dealers, mutual fund dealers and securities firms. In addition, insurance companies may engage directly in lending activities on an equal footing with deposit-taking institutions. The car insurance industry is a publicly-owned monopoly in Quebec, British Columbia, Manitoba and Saskatchewan. All other provinces have regulated premiums.

The industry's view on how the GATS FSA will affect their business is that it will

³²² In health and life insurance, foreign firms collected 27% of premiums in 1998. In property and casualty insurance, they collected 65% of premiums in 1998. See WTO, Trade Policy Review (TPR), Canada, 1998, 101.

³²³ WTO, Trade Policy Review (TPR), Canada, 2000, 47.

form an unofficial stop to any new industry regulation which could be perceived as barriers to entry by foreign insurers. Essentially the FSA is not expected to liberalize the industry's rules and regulations and it is not expected to tighten up regulations by the same token. The industry believes that the agreement reinforces the theory that business of every kind is becoming more global and that geographic borders are slowly disappearing.³²⁴

Section V: Other Domestic Issues and Conclusions

Financial Legislative Reform on the Domestic Front

Beginning in the mid to late 1990's, there was a changing belief that it would now be beneficial to allow foreign financial institutions to enter and operate in Canada more freely. Underlying this was the idea that foreign firms were finding it difficult to establish profitable operations in Canada, and that Canada's biggest banks now required less protection from international competition. These changes were included in the debate after the end of another 5-year review of financial legislation in 1996. In February 1997, just before the beginning of renewed WTO financial services negotiations, the Senate Banking Committee wrote that further liberalization in foreign bank branching should be considered. In December 1996, the Canadian government appointed the Task Force on the Future of the Canadian Financial Services Industry. One of the major themes of the final report (September 1998) was 'enhancing competition and competitiveness'. Echoing the conclusions of the earlier consultation paper released by the Department of Finance (September 1997), and in line with commitments made by Canada in the WTO Agreement

³²⁴ McGillivray, Glenn, (1999), "International Trade Body Turns to Financial Services Competition", 36.

on Financial Services (December 1997), the Task force concluded that, in the interests of enhancing domestic competition, 'it is important that the Government move expeditiously to allow foreign banks to operate through branches in Canada, as well as through subsidiaries.'³²⁵ In the meantime Canada maintained restrictions on branching by allowing foreign bank subsidiaries only in the form of "regulated foreign banks"(foreign banks who dealt primarily in financial services and were regulated as banks in their home country). "Near banks" were the second form of entity allowed to foreign banks and were foreign firms who were not regulated as banks at home but who still wanted to perform banking-type services (e.g., consumer loans).

The review of the Bank Act that took place in 1997 (Bill C-82) removed the requirement that foreign banks had to participate in the Canada Deposit Insurance Plan.³²⁶ The federal government agreed to allow foreign bank branching, although legislation to bring branching into effect had been postponed due to complexity.³²⁷ New financial legislation was introduced as Bill C-67 in February 1999 and passed into law June 1999.³²⁸ On June 25 1999 the government also released its policy White Paper entitled "*Reforming Canada's*

³²⁵ Task Force on the Future of the Canadian Financial Services Sector, final report, September 15, 1998, 99.

³²⁶ Foreign banks which specialize in serving large corporate customers asked the government to allow them to apply for exemption from the existing CDIC coverage. The rationale for allowing financial institutions serving the wholesale market to "opt out" of CDIC coverage was that the vast majority of their deposits are corporate accounts, with balances well in excess of the maximum for insurable deposits.

³²⁷ The complexity and time constraints were described by Mr. Bob Hamilton, Assistant Deputy Minister, Financial Sector Policy Branch, Department of Finance Canada to the Standing Senate Committee on Banking, Trade and Commerce, April 17, 1997.

³²⁸ Bill C-67 ("*An Act to Amend the Bank Act, the Winding-Up and Restructuring Act and Other Acts Relating to Financial Institutions ... Acts.*").

Financial Services Sector: A Framework for the Future". The paper proposed changes to the "widely held rule" so an investor could own up to 20 per cent of voting shares, and 30 per cent of non-voting shares, of a widely held bank, subject to a "fit and proper test".³²⁹ The changes were designed to allow banks to enter into substantial share exchanges to accommodate alliances and joint ventures and were incorporated into upcoming legislation. The Secretary of State for International Financial Institutions, Jim Peterson, indicated the government's balanced concerns: "The new foreign bank branching rules were developed through extensive consultations with all interested parties. They are designed to open the door to increased competition from foreign banks without compromising our high standards of protection of depositors,..."³³⁰

The newest Canadian legislation, Bill C-8 is the culmination of the long process described above.³³¹ The predecessor to this Bill, Bill C-38, was first given reading on June 13 2000. It died when the November 2000 general election was called. The Act was reintroduced on February 7, 2001 with some minor changes. Canada brought a new form of branching into effect in harmony with the terms of the WTO Financial Services Agreement and the new domestic policy framework. This freed foreign banks from having to establish a "foreign bank subsidiary" (though they still may do so). However, foreign banks will require the approval of both the Minister of Finance and the Superintendent (OSFI) to

³²⁹ Bill C-8, Part XII, Division 1, Definitions, #8 ("Person is a Major Owner").

³³⁰ Finance Canada - "Foreign Bank Branching Legislation Comes into Force", June 28, 1999.

³³¹ Bill C-8 (*"Act to Establish the Financial Consumer Agency of Canada and to Amend Certain Acts in Relation to Financial Institutions"*)

establish a Canadian branch so they are still effectively restricted. The principles underpinning the new regime provide flexibility for foreign banks wishing to operate in Canada and to streamline regulatory approvals. They have the option of establishing as an “authorized foreign bank branch” (Schedule III Bank) as either *full service branches*, which are only allowed to take deposits greater than \$ 150,000., or *lending branches* which are not allowed to take deposits and may only borrow from other financial institutions.³³² The new regime brings Canada’s foreign bank entry policies into line with international practices. All other major industrialized countries currently allow foreign banks to operate through branches. Neither may partake in deposit protection under the CDIC in order to protect Canadian depositors’ funds. The requirements to establish a full service branch are however still quite onerous. A company must show that it: 1) is able to make a contribution to the Canadian financial system (at the Minister’s discretion), 2) have a minimum of \$5 billion in assets and a proven track record, 3) be an appropriately regulated bank in their home country, 4) get greater than 50% of their gross revenues from financial services, 5) be widely held, 6) meet BIS risk-based capital ratios, 7) offer national treatment if controlled by non-WTO Member. Foreign banks that wish to take retail deposits in Canada will still have the option of doing so by establishing a fully regulated Canadian subsidiary (Schedule II Bank), and operating under the same OSFI regulations as the domestic chartered Canadian banks (Schedule I Banks). As of April 2003, there were 17 Schedule III banks (13 full-service

³³² Note the “Schedule I, II, and III” classifications are being changed to a size-based ownership regime: large banks (equity > \$5 billion), medium banks (equity \$ 1-5 billion), and small banks (equity <\$1 billion). This new distinction clears up some of the national treatment problems foreign banks had complained of earlier.

branches and 4 lending branches), 31 Schedule II banks, and 16 Schedule I banks in Canada.³³³

The new legislation offers greater flexibility to financial institutions by allowing them to establish regulated, non-operating holding companies. The holding company structure is thought to offer the potential of greater operational efficiency and lighter regulation. It can, for example, allow banks to move certain activities that are currently conducted in-house by a bank to an entity that is subject to lighter regulation than the bank. The holding company structure would allow financial institutions to come together to compete with larger institutions. Supposedly, this provides greater structural flexibility to compete with highly specialized or unregulated firms.³³⁴

Two other amendments to the *Bank Act*, *Insurance Companies Act*, and *Trust and Loan Companies Act* are part of the new legislation and stem from commitments taken by Canada in the WTO FSA.³³⁵ The first releases WTO members from the requirement to seek the Minister of Finance's approval before opening additional branches of a foreign bank subsidiary in Canada. The second removes the application of legislated reciprocity provisions. As reciprocity is inconsistent with the most-favoured nation (MFN) rule of the WTO Agreement, it can no longer be applied to WTO Members. Under the MFN rule, parties to the agreement must not discriminate among financial institutions from different countries. Therefore, Canadian firms can expect to receive the same treatment as firms from

³³³ Canadian Bankers Association, (2003), "Banks in Canada".

³³⁴ Institute of International Bankers, (2002), "Global Survey 2002: Regulatory and Market Developments", 45.

³³⁵ Finance Canada, News Releases, "Backgrounder on Foreign Bank Entry Bill", 4.

other countries in third markets.

The cross-border delivery of financial services is effectively prohibited in Canada because the Bank Act prohibits foreign banks from carrying on banking business in Canada 'except as authorized'. Cross-border banking at the retail level is also generally discouraged in most countries due to prudential concerns of the firm offering the financial products. There may be risks to consumers dealing with a bank that has no establishment in Canada. For example, does the foreign bank have sufficient deposit insurance, offer consumers legal protection in the case of disputes in a foreign jurisdiction, and equivalent prudential regulation? Foreign bank cross-border activity can also have competitive advantage if they operate under lower regulatory and tax requirements in their home jurisdiction. Two possible policy options to update the *Bank Act* and appease these concerns include the regulation of solicitation by foreign banks and strict disclosure requirements to consumers about their operations.³³⁶

Some final thoughts on financial services legislation should make note of some problems with legal text wording. The scope of the provisions intended to benefit foreign institutions have maintained built-in safeguards which have been dependent on rather unspecific definitions. In the FTA, for example, the terms "financial service" and "financial institution" are used throughout Chapter 17 but neither of these terms was actually useful in determining what services were covered by Chapter 17.³³⁷ In the NAFTA, Chapter 14

³³⁶ Finance Canada. <<http://www.fin.gc.ca>>

³³⁷ Richard, John, D., Dearden, Richard, G., (1988), The Canada-U.S. Free Trade Agreement: Final Text and Analysis, 59.

defines a financial institution as “any financial intermediary or other enterprise that is authorized to do business and regulated or supervised as a financial institution under the law of the party to in whose territory it is located.”³³⁸ It has been suggested that, from the regulatory perspective, there was an intended circularity built into the definition so that the countries would be free to decide which businesses would be affected by Chapter 14 and how they would regulate them.³³⁹ This is also a way that Canada could potentially avoid its national treatment commitments in the NAFTA.³⁴⁰ The problem persists in Canada’s most recent financial services legislation, Bill C-8, the term “financial institution” is not defined or referred to specifically, but is substituted for “financial services entity”.³⁴¹ As a result, a subsidiary of a foreign financial firm operating in Canada then merely becomes a general purpose company that is not subject to the national treatment rules of NAFTA Chapter 14 - as long as it is not “regulated or supervised as a financial institution” (Article 1416). While these ambiguities are worth mentioning, for the most part they are not mentioned outside the academic literature. This suggests that they are probably not a major issue for foreign banks doing business in Canada or seeking to expand here.

³³⁸ NAFTA Article 1416.

³³⁹ Schefer, K.N., (1999), International Trade in Financial Services: The NAFTA Provisions, 143.

³⁴⁰ Owens, Richard, C., Guthrie, Neil, (1998), “Foreign Banks and the Business of Banking: Reforming Canada’s Foreign Bank Access Regime for the Global Marketplace”, 371.

³⁴¹ Government of Canada, Statute (2001), Bill C-8, “Act to Establish the Financial Consumer Agency of Canada and to Amend Certain Acts in Relation to Financial Institutions”, Part XII - Foreign Banks, Division 1 - “Interpretation and Application”.

Bank Merger Issue

The political side of banking legislation mentioned at the beginning of this chapter comes out clearly with the recurring bank merger issues in Canada. The former Minister of Finance, Paul Martin, quashed the first proposed bank mergers in 1998.³⁴² The public reason for quashing the proposed mergers was to protect consumers. The government had been closely following the media coverage of the issue and it generally swayed against allowing mergers.³⁴³ Paul Martin also wants to run for the job of Prime Minister so he also could not afford to risk losing electoral support on the sensitive issues attached to the bank merger issue. This could also explain the hesitations in altering the current financial services legislation in Canada. It is quite possible, however, that if Paul Martin does become Prime Minister, bank mergers will be given a green light.³⁴⁴ When this happens, foreign banks will see more opportunities in the niche markets as well as in picking up branches shed by the big banks as a result of the mergers.³⁴⁵

³⁴² The mergers proposed in 1998 were Royal Bank-Bank of Montreal and Toronto Dominion-Canadian Imperial Bank of Commerce.

³⁴³ Tuck, Simon, (2003), "Bank Mergers Yield No Bonanza: Study", Globe and Mail, Monday July 7, B1, B4. A later confidential study, "Consolidation and Efficiency in the Financial Sector: A Review of the International Evidence", by the Department of Finance, the Federal Reserve Board, and the Bank of Italy published in September 2002 concluded that mergers between large banks often fail to produce the intended cost savings and other business advantages (see same article).

³⁴⁴ Reguly, Eric, (2001), "Liberal Caucus may Collide with Bank's Merger Plans", Globe and Mail, Saturday May 26, B7.

³⁴⁵ HSBC Bank Canada and ING Direct have both indicated their interest. See Tuck, Simon, (2002), "Foreign Banks Back Mergers", Globe and Mail, Wednesday, November 27, B3.

Regional and Multilateral Liberalization

Canada's experience in the FTA and the NAFTA illustrate the widely-held view that regionalism can be complementary to multilateralism.³⁴⁶ There are three arguments in favour of regional free trade agreements. First, regional agreements can be formed relatively quickly. Second, they are often smaller and hence more manageable than multilateral arrangements. Finally, they often produce potent results that can go hand in hand to advance the progress of the international trade regime.³⁴⁷ John Jackson has argued that regional approaches can contribute constructively to international economic relations by allowing smaller groupings of economies to establish more significant levels of cooperation than is permitted by a broad multilateral agreement.³⁴⁸ In the Canadian experience, this was not entirely true since the FTA and the NAFTA failed to establish significantly broad liberalization commitments. However, the level of cooperation, which resulted from hard-bargaining tactics, was an important first step in promoting liberalization at the multilateral level.

Regional approaches have also been used to enact rules that respond to specific regional needs, but some caution is warranted. Regional initiatives should not act as a distraction from the need to work on global rules and global liberalization. The NAFTA and

³⁴⁶ Brian Hanson argues that liberalization in trade at the regional level made ineffective national protectionist trade measures and disadvantaged interests seeking new regional protection. (Hanson, Brian, T., "What Happened to Fortress Europe: External Trade Policy Liberalization in the European Union". See also Sylvia Ostry, (1997), The Post-Cold War Trading System.

³⁴⁷ Ostry, Sylvia, (1997), The Post-Cold War Trading System: Who's On First?, 203.

³⁴⁸ Jackson, John, "Perspectives on Regionalism in Trade Relations", 874

WTO negotiations in financial services occurred almost concurrently and there was an intended consistency between the NAFTA and the GATS FSA texts. However, this may have resulted in less progress made in the NAFTA with respect to establishment and prudential regulation. These concerns can be comforted by the fact that Canada did significantly liberalize its commitments after NAFTA with respect to MFN and foreign ownership and market share limitations. The biggest step came in 1997 when Canada agreed to allow foreign banks to establish in Canada by setting up branches. Finally, the growing coverage of the GATS FSA suggests that the agreement is making good progress towards the establishment of a single set of rules as the reservations and exceptions articles diminish.

Repeal of the Widely Held Rule³⁴⁹

Although foreign access to the Canadian financial services sector has improved as a result of the NAFTA and the GATS, the maintenance of the widely-held rule remains contentious. Progress was made by the WTO Agreement Implementation Act, which removed long-standing limitations on non-Canadian ownership of federally regulated financial institutions, lifted a market share limitation on foreign banks, and extended NAFTA thresholds for investment review and control to all WTO members. Under new Canadian financial legislation, the widely held rule has been liberalized, but not eliminated. For financial institutions with \$5 billion or more in equity, there is now a new definition of widely held that permits an investor to own up to 20 per cent of any class of voting shares and 30 per cent of any class of non-voting shares. These rules are subject also to a “fit and proper” test designed to evaluate the applicant’s character and suitability. This would allow

³⁴⁹ The widely-held rule was discussed above on 13. See also footnote #31 same page.

these institutions to enter into substantial share exchanges, including the ability to enter into strategic alliances and joint ventures. The new rules essentially subject banks to different ownership rules based on the size of the institution. The policy reason behind the maintenance of the “widely-held” rule in Canada is that it avoids potential conflict of interest problems and maintains public confidence in the system. Essentially restricting foreign interests from the deposits of Canadians protects them from being subject to risks in non-financial, commercial corporations, and hence, conflicts of interest.³⁵⁰

Arguments in favour of repealing the rule suggest that Canadian banks do not need protection from international competition because the domestic Canadian banking market is small, mature, over-banked, with strong customer relationships. Further, foreign financial institutions have found it difficult to establish profitable operations in the retail banking market in Canada. They thus tend to focus on niche markets like credit cards and business lending. Canada’s banks are also linked to the natural resources and energy sectors, like the rest of our economy, so that economic swings in these sectors affect banking too.³⁵¹ Maintaining the widely held rule may enable Canada to hold onto important bargaining leverage for future liberalizing initiatives in financial services and insulate it from the cycles of the resource economy.

The position of banks in the financial system and the economy overall is one of the most significant issues facing authorities. The existing structure of our banking system

³⁵⁰ Kuchta, Alison, R., (1994), “An Overview of the Bank Act”, 29.

³⁵¹ Gouvin, Eric, J., (2001), “The Political Economy of Canada’s “Widely Held” Rule for Large Banks”, 8.

ensures a common set of interests among bankers unlike in the US. The merit of current legislation in Canada is that it avoids circumstances which lead to problems rather than devising ways of dealing with them. Regulations should only be revised if alternative policies are in place.³⁵² Industry-specific regulations common in financial services can have the negative effect of allowing government to focus too much on the domestic market and pay too little attention to international competitiveness. An overly domestic focus can hamper the evolution of competition from foreign firms, the evolution of new products and services, and unduly restrict the activities that banks may engage in.³⁵³ Another characteristic of industry-specific regulations is that not all members of society can share in the gains achieved by changing them. Governments may therefore try to delay change in ways that are perceived to reduce costs, or to provide compensation to those who stand to lose from the changes. In Canada, the government's refusal to allow banks to sell insurance products directly out of their branches may be a way to defer the costs of competition to the insurance industry.³⁵⁴

Some argue that Canada should shed its institutional approach to regulating foreign financial firms and allow them to operate unregulated with no prudential concerns.³⁵⁵ Where concerns do exist, they argue that regulation should be applied on a purely 'functional' basis

³⁵² Chant, John, F., (1997), "Canada's Economy and Financial System: Recent and Prospective Developments and the Policy Issues they Pose", 40.

³⁵³ Mathewson, G., Frank, and Quigley, Neil, C., (1997), "Reforming the Bank Act: Regulation, Public Policy, and the Market", 6.

³⁵⁴ *Ibid.*, 7.

³⁵⁵ For example see Owens, Richard, C., Guthrie, Neil, (1998), "Foreign Banks and the Business of Banking: Reforming Canada's Foreign Bank Access Regime for the Global Marketplace", 383.

in line with their specific financial activity. In my view this is unacceptable because it is unrealistic in any country's financial regulatory regime. Members of the WTO are currently engaging in the Doha Round of services negotiations and no country currently allows FSP's to operate unregulated. Once the doors are opened to allow FSP's to operate unregulated, *de jure*, this is bound by law and dispute settlement. These obligations cannot be retracted. It is currently better to offer *de facto* access on a case-by-case basis and apply regulation on a functional basis - as is currently the regime in Canada. Edward Neufeld has suggested: "There is every good economic reason to make access to the market by new entrants as easy as prudence permits. But making them too easy simply leads to future bankruptcies and, ... a charge on the public treasury or the deposit insurance fund."³⁵⁶

Most recently, John Chant has argued for a solution which takes the 'middle road' between full competition and protectionism regarding foreign banks in Canada. Chant argues for a mutual reciprocity regime where retail branching is allowed and mutual agreements exist between countries with respect to prudential concerns and home-country regulation.³⁵⁷ The first problem with this proposal has already been discussed: Canada already has an over-banked retail banking market where foreign banks are not banging down the doors to enter the segment. Furthermore Canadian banks already have the option, and are, expanding abroad as desired. Second, universal reciprocity through most-favoured nation treatment is already being developed through the WTO's FSA, currently under

³⁵⁶ Neufeld, Edward, P., (2000), "What Kind of a Financial System Do Canadians Want?", 37.

³⁵⁷ Chant, John, F., (2001), "Main Street or Bay Street: The Only Choices?", 22.

negotiation between all Members. The benefit of the WTO system in this respect is that it in fact moves slowly. Governments are choosing to maintain sure control of banking regulations and are proceeding prudentially with respect to liberalization - especially with respect to cross-border banking. Commercial presence is now largely allowable in the commercial banking segment where big banks want to expand, and this seems to be acceptable by most countries from a prudential point of view. In Canada, the uncertainty surrounding the policy framework dealing with foreign financial institutions seems to be a reflection of the lack of vision about how the legislation should meet the challenges of the future.

Conclusions

This chapter has attempted to show how the process of liberalizing trade in financial services has been conditioned in Canada by various issues at the political and regulatory level. The Canada-US FTA represented a major effort to eliminate obstacles to trade between the two economies to create a single market in which there would be a free flow of goods. Analysis of the financial sector chapter of the FTA suggests that measures taken there are not parallel to those taken for the goods market. The sector posed such different problems from those related to trade in goods that it became a separate and distinct part of the overall FTA. This special treatment reflects the need for financial suppliers to have right of establishment rather than just freedom of trade in order to serve customers in other countries. Since this important difference was now becoming more widely understood and implemented, and there was already a close integration of the Canadian and US financial systems, it meant that the

largest barrier to trade in financial services had already been overcome.³⁵⁸ Finally, the differences in financial regulation between the two countries created problems that had to be overcome in applying the FTA to the financial sector.

The FTA's importance was more significant for Canada's long term economic interests. If the FTA had not been signed, Canada could have been a divided and heavily indebted country facing the prospect of entering into international trade negotiations on trade in financial services in a weakened state.³⁵⁹ The current progress of Canada in financial services in the WTO can also be traced back to the success of the FTA negotiations and results. In addition, the Canadian expansions into the US would not have been as easy without the success of the FTA (e.g., TD overtaking Waterhouse). Glass-Steagall has now been repealed and Canadian banks have been expanding their opportunities in the US building on the original success of the FTA. Today Canadian bankers tend to underestimate the benefits of the FTA financial services agreement, but the reality is that they are now major players in the US and they always quote their share of the US market in stating the success of their business.³⁶⁰

The FTA approach to trade in the financial sector would have been awkward for any agreement designed to extend beyond two countries to embrace other countries. Hence, the NAFTA chapter 14 on financial services went well beyond specific concerns that might have arisen in Canada-US-Mexico negotiations and established a framework for dealing with a

³⁵⁸ Chant, John, (1992), Free Trade in the Financial Sector, 1

³⁵⁹ MacIntosh, R., (1991), Different Drummers: Banking and Politics in Canada, 283.

³⁶⁰ Personal interview, March 2002.

range of issues that could arise in future multilateral negotiations. It has been argued that if it were not for the success of NAFTA, the WTO Uruguay Round itself would not have happened.³⁶¹ NAFTA was also designed to enhance competition. Liberalizing cross-border trade increases competition, eliminates inefficient regulations, and improves the quality of financial services. On the other hand, competition in the financial sector beyond a certain level tends to result in less systemic stability, so much of the existing domestic banking regulation is designed to control competition. Therefore, the NAFTA financial services provisions regulate activities across borders, and in some ways also serves to reinforce the idea of the nation state.³⁶²

The WTO agreement has not yet reached full liberalization of the financial services sector worldwide. The level of market opening varies significantly from country to country. Some countries have reached a stage of almost complete liberalization, while others still maintain considerable barriers. The successful completion of the financial services agreement can be viewed as a major success for the WTO as a whole. As part of the WTO's single undertaking, the Members have strengthened their commitments through the process of liberalization and in turn strengthening the credibility of the WTO.

Article XIX of the GATS contains a built-in agenda to conduct further negotiations

³⁶¹ In financial services, NAFTA's success fueled a number of other regional efforts in to liberalize banking services. Schefer, K.N., (1999), International Trade in Financial Services: The NAFTA Provisions, 393.

³⁶² Gouvin, Eric, J., (1999), "Cross-Border Bank Branching under the NAFTA: Public Choice and the Law of Corporate Groups", .302.

which were initiated by the Doha Round of multilateral trade negotiations.³⁶³ Financial services forms an integral part of the general round of services negotiations in the WTO. The prime objective will be to continue the process of liberalization and to obtain additional guarantees by Members for improved access and non-discrimination. Also, the inclusion of supervisory and regulatory aspects is an issue that the next round will need to address.³⁶⁴ It is broadly recognized that adequate prudential regulation and supervision of financial institutions is at the heart of a sound and stable financial sector, and this is ever more important in a liberalizing environment.

³⁶³ Preliminary discussions took place in Geneva through late 2002 and will have deepened in the spring of 2003 to include clarifications on proposals and measures for scheduling.

³⁶⁴ Kampf, Roger, "Financial Services in the WTO: Third Time Lucky", 117

Chapter 4

The Political Economy of Singapore's

Economic and Financial Liberalization

“The PAP (People’s Action Party) almost certainly became the only socialist party in the world pursuing a capitalist policy of free enterprise on the economic plane, for the purpose of spending the money thus earned according to its socialist principles.”³⁶⁵

Section I: Introduction

This chapter examines the changes in Singapore’s economic policy and legislation with a focus on financial services. The time period examined begins just before Singapore’s independence in 1965 and finishes at the present day with an emphasis on the post-Uruguay Round developments. This historical time line shows how Singapore has continuously renewed and reformed its economic laws, regulations, and prudential standards, with the goal of maintaining a high level of growth and development. These changes were made possible by several domestic factors, including the nature of state-party politics, an orientation towards prudential foreign investment initiatives and regional free trade agreements, and a capable economic bureaucracy. Since the conclusion of the Uruguay Round negotiations, Singapore has not been under the same pressures to open up its financial services market as other developing economies have. This is mainly because Singapore was already a well-established financial centre that continuously focused on improving market openness,

³⁶⁵ Dr. Albert Winsemius, leader of the UN Mission to Singapore in 1960-61 to assist the government in drawing the blueprint for Singapore’s industrialization, was subsequently retained by the government as an adviser for 22 years until 1984.

including minimizing the obstacles to entry and establishment faced by foreign firms. Openness was matched with the development of prudential policies and supervisory oversight by the Monetary Authority of Singapore (MAS), and included capital adequacy ratios, accounting standards, and a concerted focus on corporate governance standards. As a result, the push for the liberalization of trade in financial services through the WTO framework has not been of central importance to Singapore. While the regime has served as a benchmark upon which financial openness could be measured, it has been but one of many international initiatives Singapore has used to gradually improve the functioning and efficiency of its financial services markets. This does not suggest that the WTO regime in financial services is irrelevant for some countries. Participating in the process and making binding commitments in financial services sends signals of policy stability and intent to other WTO Members. In addition, Singapore participates in more current international efforts that aim to improve transparency in financial regulation, and domestic regulation in the GATS. In a broader perspective, the case of Singapore demonstrates how an outward-oriented and gradual program of liberalization in financial services can benefit from the WTO regime in financial services to achieve its economic goals.

In some respects Singapore can be considered a model of how a developing country can develop the absolute 'right' way. It has developed in roughly 40 years from a small trading city to an advanced urban city and international financial center. It is an internationally competitive 'niche' state, meaning it constantly seeks out industry ventures at which it can excel. On the other hand, it is useful to realize that as a model for lesser developed countries (LDC's), Singapore's international services development has *limited*

applicability for other nations. This is because Singapore is strategically located and has well-developed Asian linkages, including its ideal East - West time zone location for financial markets and communications. Prior to World War II, foreign banks in the region used Singapore as their headquarters for this reason. During World War II, Singapore was the key British position in the Far East and so geopolitically strategic that its seizure by the Japanese might have meant decisive success by Germany in The War.³⁶⁶

Early on in Singapore's industrialization there was a defined shift from Import Substitution Industrialization (ISI)³⁶⁷ to Export-Oriented Industrialization (EOI)³⁶⁸ and subsequent strategies to foster higher value-added production. This cannot be simply understood as consistently good leadership decisions, nor as efficient responses to pressures exerted by international capital. Rather, Singapore's policy decisions, shaped by the People's Action Party (PAP) and the Monetary Authority of Singapore (MAS) have been made possible by a social and political environment which can be traced as far back as the social and political conflicts of the 1950's and '60's which have had a lasting impact on development.³⁶⁹ This environment included a one party system, timely World Bank advice

³⁶⁶ Hitler issued "Basic Order No. 24 Regarding Collaboration with Japan". If Japan had invaded Singapore, the US would surely not have risked sending its fleet into Japanese waters, thus bringing England to her knees. See Shirer, William, L., (1959), The Rise and Fall of the Third Reich: A History of Nazi Germany, 873-874.

³⁶⁷ ISI is based on replacing major consumer imports by protecting infant industries through protective tariffs, import quotas, exchange rate controls, and subsidized loans to local industry.

³⁶⁸ EOI typically involves a more outward-looking focus promoted by incentives for export and for inward foreign investment. Economic development and growth is based on foreign exchange earnings.

³⁶⁹ Rodan, Garry, (1989), The Political Economy of Singapore's Industrialization: National State and International Capital, 25.

and the development plan that followed, the switch from low to high value added production, and the switch to manufactures utilizing higher skilled labour. Singapore combined this with a pro-business environment, quick responses to economic slowdowns, and regular government re-evaluation of development policies. Singapore acceded to the GATT in 1973 and those responsible for its economic policies have been reaching outward even more by negotiating bilateral free trade agreements and promoting itself as an international financial centre.³⁷⁰

In light of these facts, Singapore is examined historically through the lens of the ‘developmental’ state model³⁷¹, what Robert Wade has also termed the ‘hard state’.³⁷² Within this framework, the example of financial services liberalization under the WTO trade regime shows how the state can play a major role in shaping its own comparative advantage. Comparative advantage, and the role that government plays to promote it is determined by many factors which the state is able to define. What differentiates the bureaucracies in developmental states from economic planning agencies in other developing countries is their real power, authority, technical competence, and insulation in shaping development policy. Strategic industrial policy forms a central component of the developmental model. The

³⁷⁰ Trade Policy Review (TPR), Singapore, 1996, 90.

³⁷¹ The developmental state model is discussed in detail below but generally it can be characterized as having a development-minded elite which is relatively autonomous from the state, a repressed and weak civil society, and effective management of economic interests. See Leftwich, Adrian, (1995), “Bringing Politics Back In: Towards a Model of the Development State”, Journal of Development Studies, 405.

³⁷² Hard states are able to resist private demands and actively shape the economy and society. See Wade, Robert, (1990), Governing the Market: Economics, Theory, and the Role of Government in East Asian Industrialization, 337.

superior economic performance of the East Asian economies is to a large extent the consequence of very high levels of investment in certain key industries through government intervention, and exposure of many industries to international competition in foreign markets. In Singapore, this strategy has been complemented by regular modernization and strengthening of the rules and regulations in the financial services sectors.

Singapore's classification as a developing or developed country is unclear according to the United Nations (UN) and the international financial institutions. The UN classifies Singapore as a 'small island developing state', but makes the qualification that there is no established convention for the designation of "developed" and "developing" countries in the United Nations system.³⁷³ It is classified by the IMF as an 'advanced' economy, but is still aggregated in IMF data as a 'developing country'.³⁷⁴ Singapore is aggregated with developing countries by the IMF because it shares with them wider output fluctuations over time compared to the developed economies. Specifically, this is because it is a smaller economy and it is more dependent on trade and financial integration with the global economy.³⁷⁵ In the same confusing way, the World Bank considers Singapore to be a 'high-income' economy, but refers to it as a developing country in publications due to its middle-income status.³⁷⁶ According to World Bank data, the size of Singapore's economy ranked

³⁷³ See United Nations Statistics Division, "Composition of macro geographical (continental) regions, geographical sub-regions, and selected economic and other groupings".

³⁷⁴ International Monetary Fund, *World Economic Outlook*, 2001, 80.

³⁷⁵ *Ibid.*, 82.

³⁷⁶ According to the World Bank, "High Income" Countries' people earn a Gross National Income (GNI) of \$9,266 or more (year 2000 figures). The term "Developing Economies" has been used to denote the set of middle income economies, which are classified as (i)

9th in the world in terms of GNP per capita according to 1999 data.³⁷⁷ This ranking is well ahead of Canada, which is ranked at 29th, and India which sits at 162nd. If the ‘per capita’ variable is left out, however, Singapore is ranked at 36th in the world, well behind Canada at 9th, and India at 11th. Singapore’s economy is therefore quite large in absolute terms, but less so in relative terms of sheer economic size.

In part because of its higher economic standing, Singapore also does not share many of the concerns that other developing countries may have when deciding to liberalize in financial services. Firstly, some of the financial reform literature discusses the appropriate ‘sequencing’ of financial reforms in developing countries.³⁷⁸ This includes, for example, making sure institutional reform (e.g., legal and corporate governance standards) is completed before the banking market is opened up to foreign competition. Singapore faces few problems in changing these regulations when it needs to, because it was built on the British system of law, and does not face major challenges when reforming domestic laws through parliament.³⁷⁹ Sequencing also includes the appropriate *rate* of opening, making sure liberalization is done slowly and prudentially. For Singapore, these issues are also not as important because it has long been developing and continues to refine a strong regulatory

lower income: \$756-2995/yr, and (ii) upper middle income: \$2996-9265/yr. However, the term “developing” does not imply either that all the economies belonging to the group are actually in the process of developing, nor that those not in the group have necessarily reached some preferred or final stage of development.

³⁷⁷ ‘Size of the Economy’ (Table 1) in Selected World Development Indicators, from the World Bank’s World Development Report, 2000/2001.

³⁷⁸ See for example Wyplosz, Charles, (2001), “How Risky is Financial Liberalization in the Developing Countries?” and Kono, Masamichi, (1997), “Opening Markets in Financial Services and the Role of the GATS”, WTO Special Studies, Geneva, 23.

³⁷⁹ Personal interview, November 2001.

and institutional infrastructure in financial services. It is well known around the world for this characteristic. Secondly, some developing countries are concerned that the commitments they make in the financial services trade negotiations will not be reciprocated in sufficient ways by developed countries. For many countries, this reciprocation would include trading concessions in agricultural and low-value added manufactures. These concerns are reduced in the case of Singapore because it does not have agricultural exports, but rather has an economy geared for services export and high-tech high-value added manufactures. Officials in Singapore are well aware of the need for their country to continue to adapt and liberalize according to the unique economic and financial environment of which they are a part.

Section II: Stages of Industrialization in Singapore

Singapore has become what it is today by a blending of history, geography, and economics. Economic development in the latter half of the 20th century was aided by Singapore's modern communications and transportation infrastructure, and skilled labour force. In addition, Singapore's time zone allows same day financial activities with North America, Europe, and the rest of Asia. According to the IMF, the rapid growth of Singapore can also be attributed to macroeconomic stability, an open trading system, and flexible labour markets.³⁸⁰ Singapore actively used market-leading policies in specified sectors which were thought to promise the highest growth potentials. These three factors made Singapore attractive to foreign firms looking to locate, and this set the stage for both investment and export-led growth. This section highlights how the domestic political history and initiatives in Singapore have conditioned its gradual orientation as an international financial center.

³⁸⁰ IMF, Occasional Paper #119, "Singapore: A Case Study in Rapid Development", 1.

1960-64 (Import Substitution).

In the late 1950s, Singapore's business community consisted largely of small merchants and financiers.³⁸¹ Manufacturing was small and fragmented, comprising just 12% of GDP in 1960.³⁸² As Singapore merged with Malaya and other close neighbors in 1960, it expected these much larger neighbors to provide a large enough domestic market. It had therefore embarked on an industrialization policy based on import substitution strategy. This plan was instituted by the People's Action Party (PAP) leadership based upon the work of the United Nations Industrial Survey Mission and the accompanying World Bank report.³⁸³ The report confirmed the government's fears that the way Singapore's economy had traditionally been running would be unable to provide long-term employment for the workforce. In addition to recommending an ISI development strategy, the report considered Singapore's late start at attracting industrial capital. Addressing this latter fact, the report recommended control over labour and the suppression of wage levels, the provision of industrial estates, the upgrading of technical training, and tax incentives. A state-developed economic plan covering the period of 1961-64 was released and closely resembled the

³⁸¹ The facts and time-line for Singapore's industrialization are drawn from personal interviews, WTO Trade Policy Reviews, and three academic sources: Hatch, Walter, Yamamura, Kozo, (1996), Asia in Japan's Embrace: Building a Regional Production Alliance, Rodan, Garry, (1989), The Political Economy of Singapore's Industrialization: National State and International Capital, Huff, W.G., (1994), The Economic Growth of Singapore: Trade and Development in the Twentieth Century.

³⁸² Ministry of Trade and Industry, Singapore.

³⁸³ Dr Albert Winsemius, a Dutch economist who led the United Nations Survey Mission to Singapore in late 1960, suggested an industrialization program to provide employment and raise individual income. See Ministry of Education (Singapore), "The Opening of the First Factory in Jurong, 2 Aug 1963.

original World Bank report. The fundamentals of the plan were that positive institutional and financial intervention by the state could form the basis of a fast-growing ISI program by increased private investment.

Around the same time, more political functions were being given to the bureaucrats in Singapore, a trend that increased their intervention in the economy.³⁸⁴ In these early years, party organization (i.e., the PAP) existed simply to assist in the enactment of policy, which would then be formulated by the government. However, the longer the PAP has remained in power, the harder it has become to distinguish the government and its agencies (including the PAP), from 'the state'. This is because, according to Mauzy and Milne, "The office holders have been, or will be pre-eminent party members, and also high in the pyramid of power, thus linking the government with the party."³⁸⁵ The reaction over the years from the PAP was to develop a more elitist, authoritarian ideology to justify the lack of separation of both Party and state from open public accountability.³⁸⁶

In 1963 during the height of this stage of Singapore's expansion, seven public enterprises in manufacturing were created. This represented the start of government orientation towards the idea that industrial structure should not be left solely to market forces.³⁸⁷ This was especially true considering Singapore's weak domestic industrial bourgeoisie. Hence, the merging of Party and state provided the government with the

³⁸⁴ Rodan, Garry, (1989), The Political Economy of Singapore's Industrialization, 70.

³⁸⁵ Mauzy, Diane, K., Milne, R.S., (2002), Singapore Politics Under the People's Action Party, 26.

³⁸⁶ Singaporeans for Democracy (SFD), "Chronology, Singapore's ruling People's Action Party".

³⁸⁷ Rodan, Garry, (1989), The Political Economy of Singapore's Industrialization, 77.

capacity to implement its industrial program with efficient coordination between production factors, and with minimal labour disruption. Its ideological notions about elitism and meritocracy became institutionalized, further rationalizing the structures of political control instituted by the PAP.

1965-79 (Export-led Industrialization).

When Singapore gained independence in 1965, and separated from Malaysia in the process, it faced daunting challenges of weak economic fundamentals: a low labour rate, high unemployment, and a poorly educated labour force. It was also around this time that the British announced their intent to completely withdraw from Singapore.³⁸⁸ This created a new sense of urgency about the economic orientation of Singapore and the role of labour in the economy. It was realized that firms producing primarily for the domestic market were unable to fully exploit the economies of scale in manufacturing. In addition, the ISI strategy, because of its negative effects on exports, contributed to increasingly severe balance of payments problems.³⁸⁹ As a result of this combination of factors, the government decided to abandon the import substitution strategy for export-led industrialization. Going against conventional wisdom at the time, it opened up its economy to foreign investments and leveraged on MNCs to gain access to technologies and markets, as well as the experience that accompanied them. It established a pro-business environment which included the

³⁸⁸ The main reason for the British leaving was economic. In the years after the Second World War II, the British poured in funds on military spending to contain the Communists during the Malayan Emergency, and the three-year Confrontation against Indonesia. See Sembawang Naval Base Nostalgia, (Website).

³⁸⁹ IMF, Occasional Paper #119, "Singapore: A Case Study in Rapid Development", 12.

development of industrial land and coordinating the expansion of related services like utilities, transport, and communications.³⁹⁰ Singapore also implemented a strong basic education for the population with emphasis on technical skills and engaged in constructive labour management policies and introduced a host of investment measures to attract MNCs.

Mostly British foreign banks dominated Singapore's banking system at independence. For three decades to follow, the government protected the existing family-owned local banks, especially in the retail sector, to enable them to expand their market shares. It was thought that strong local banks, with long-term interests aligned with the Singapore economy, would provide resiliency and stability for the financial system. The local family-owned banks merged and consolidated over time, but are today still run by their controlling shareholders. These banks were always subjected to strict supervision from the beginning which allowed them to grow into prudent, well-capitalized institutions.³⁹¹

The time around 1980 marked the beginning of an ambitious program of structural reforms aimed at diversifying the manufacturing base and moving Singapore up the value-added chain. Liberalizing and strengthening the financial sector was a key part of this plan. Because of the small size of Singapore's domestic market, external factors have always been the key determinant of its economic outlook.³⁹² Singapore's reform efforts were aided by the international environment at that time. Until the oil crisis of 1973, the US and Europe had

³⁹⁰ Huff, W.G., (1994), The Economic Growth of Singapore: Trade and Development in the Twentieth Century, 320.

³⁹¹ Deputy Prime Minister Lee Hsien Loong, "Post Crisis Asia - The Way Forward", Speech to the William Taylor Memorial Lecture, Basel, Switzerland, 21 September 2000.

³⁹² IMF Country Report No. 01/177, "Singapore: Selected Issues", October 2001, 4.

maintained economic growth. Singapore's accession to the GATT in 1973 also presented more market access opportunities for its exports. With its commitment to EOI the government was already well prepared to adopt the measures necessary to ensure the relatively low-wage, disciplined labour force required to carry out its plans. Suppressing labour is a strong example of how the PAP began to take a foothold with its extensive social control.³⁹³ The government passed the Trade Union (Amendment) Bill in August 1966. The bill declared strikes and other industrial action illegal unless approved through secret ballot by a majority of a union's membership and strikes were banned entirely in essential services. Aside from making sure to reduce the cost and militance of labour, the government changed in other ways to create an environment favourable to EOI. This included accelerated infra-structural development as well as institutional support and even direct government investment.

On the political front, the political system was, and still is, dominated by a single party and was an embarrassment for the PAP. Because it held quite a high international profile, and because of Singapore's aspiration to become a representative of, and a model for the Third World, an appearance of Parliamentary Democracy was important to the PAP. But at another level, the single party was not difficult to justify; ideologically, the PAP's mission was 'something above party politics'.³⁹⁴ In this respect, the PAP did no harm by instilling business confidence in Singapore as a site for export production. Even today, the PAP

³⁹³ Huff, W.G., (1994), The Economic Growth of Singapore: Trade and Development in the Twentieth Century, 358.

³⁹⁴ Rodan, Garry, (1989), The Political Economy of Singapore's Industrialization, 98.

completely dominates politics, most recently winning a sweeping majority under Prime Minister Goh Chok Tong in the November 2001 general election.

The PAP also made it clear that any objections to its policies were not to be mentioned. At the time, Prime Minister Lee Kuan Yew would not allow the local press to develop a critical approach to the government's policies. On May 2nd 1971, the government imprisoned four editors of the Chinese language paper Nanyang Siang Pau and forced two English-language papers to shut down - The Eastern Sun and the Singapore Herald. Lee emphasized that the media should have quite a different role to play in a developing country such as Singapore, than it did in developed Western democracies.³⁹⁵ In particular, the media should be expected to actively support the Party in the realization of the country's development objectives. As a result, critical examination of government policy was extinguished and created some temporary political instability and undermined investment and growth.

1979-80 (Industrial Restructuring).

By the late 1970s, rapid economic growth had created a labour shortage in Singapore that led to increased labour costs. There was also increased competition from the ASEAN region as lower cost countries renewed their labour policies to match Singapore's economic success. The government became concerned that it was coming close to losing its

³⁹⁵ See Seow, Francis, T., (1998), The Media Enthralled: Singapore Revisited, Seow writes: "Once a proud and independent institution, the Singapore press was brought to its knees by threats, arbitrary arrests and detentions, general harassment, and litigation during Prime Minister Lee Kuan Yew's administration. By the early 1980s, Singapore's entire press establishment had been restructured; with founding owners forced to divest their holdings of newspaper companies. The press become the mouthpiece of the state, using invidious self-censorship to distort the news."

‘developing country’ status under the World Bank classification, which would mean it would lose its General System of Preferences (GSP) trade advantages in its labour intensive products.³⁹⁶ The government saw GSPs as necessary for maintaining its export competitiveness.

Responding to these challenges, an incentive strategy was pursued which shifted the economy from labour-intensive, low value added activities to more capital driven and higher value added ones. Prime Minister Lee Kuan-Yew called this Singapore’s ‘Second Industrial Revolution’.³⁹⁷ Beginning in about 1980, a marked emphasis was placed on so called ‘brain services’ such as software and other services like financial services.³⁹⁸ As part of this plan, fiscal incentives were introduced by the government to encourage automation and mechanization, and new technology intensive industries such as the manufacture of computer components (disk drives) and other machinery. These areas were aggressively promoted because their higher productive capacities became the basis for industrial restructuring.

1980-86 (Coping with recession).

Amidst a growing economy and tight labour market, Singapore kept up its industrial

³⁹⁶ The Generalized System of Preferences (GSP) provides for the unilateral granting of tariff preferences by the advanced industrial countries on imports of manufactures and semi-manufactures from the developing world with the object of facilitating the industrialization of the latter. The bulk of GSP offers by industrial countries were in the early 1970s. (From Chen, Peter, S.J., (ed., 1983), Singapore: Development Policies and Trends, 305.

³⁹⁷ Singapore realized that protectionism was becoming ineffective in light of modern technological innovations. See also Hatch, Walter, Yamamura, Kozo, (1996), Asia in Japan’s Embrace: Building a Regional Production Alliance, 86.

³⁹⁸ Huff, W.G., (1994), The Economic Growth of Singapore: Trade and Development in the Twentieth Century, 305.

restructuring efforts. One example of this was how the Development Bank of Singapore (DBS), one of the government's various investment arms, was actively trying to shape industry.³⁹⁹ DBS was at the time just one of eight Singapore-based companies to have set up a venture capital company called Venture Investment in 1984. It invested \$14 Million of pooled capital into industries such as computer hardware & peripherals, software, and telecommunications services and equipment. This was part of a three-year wage correction policy aimed at upgrading industrial infrastructure. However, this policy was somewhat overzealous and wages ended up rising too rapidly. This coincided with an external environment that was sharply weakening. The US economy had slowed down considerably following the second oil crisis in the early 1980s. As a result, Singapore experienced its first post independence recession in 1985.

In response to the slowing economy, in March 1985 the government appointed a committee to report on Singapore's economic problems and prospects which released its report "The Singapore Economy: New Directions" early in 1986.⁴⁰⁰ The report emphasized a large shift in emphasis in regards to economic strategy. It was forecasted that the driving force of the economy was expected to be in the services sectors (e.g., banking, finance, transport, communications, and other international services). This essentially implied a greater future role for Singapore as a mediator and functionary for international companies

³⁹⁹ Rodan, Garry, (1989), The Political Economy of Singapore's Industrialization, 153.

⁴⁰⁰ The report outlines the causes of recession and policy changes recommended, future position and new directions, and highlights the fundamentals, strategies and key policies for Singapore. See Ministry of Trade and Industry, Singapore, "The Singapore Economy: New Directions".

investing in production facilities elsewhere in Southeast Asia.

Singapore's policies of diversification had greater implications for its place in the region. Singapore had now become a leader in the production of high-technology, high-wage goods in Southeast Asia, while foreign investment was naturally moving to lower-wage countries in the region. In order to encourage the allocation of new foreign capital that would correspond to each country's comparative advantage, Singapore, Indonesia, and Malaysia established the Johor-Batam-Singapore growth triangle in 1989.⁴⁰¹ Singapore gained from this cooperative production arrangement since multinational firms would retain their high skill-intensive headquarters in Singapore while shifting their labour-intensive manufacturing facilities to relatively low-wage regions. Why was Singapore's government so oriented toward open-market policies through the mid 1980's, when other developing countries had turned inward as a result of the global recession? This may be an important factor for Singapore's continued success. There are several possible explanations.⁴⁰² First, EOI had worked consistently well for Singapore since its embrace in the mid 1960s, so there was no interest to dismantle a 'proven' model for them. A critical analysis could interpret this as an example of how the authoritarian state's main goal is to further its own objectives. Hence, the maintenance of the PAP's export-oriented policy stance was simply directed at keeping the party in power.⁴⁰³ Second, a conservative mind-set in the government probably wished to preserve the established order as a solution to crisis through the 1985 recession. Third,

⁴⁰¹ IMF, Occasional Paper #119, "Singapore: A Case Study in Rapid Development", Edited by Kenneth Bercuson, February 1995, Washington, 14.

⁴⁰² Rodan, Garry, (1989), The Political Economy of Singapore's Industrialization, 196.

⁴⁰³ Personal correspondence, April 2003.

economic individualism was politically attractive to the PAP and the sustained crisis provided the opportunity for the Party to maintain its strong track record. Also, the Party has always been pragmatic and it realized the potentials of the market to fulfil its traditional functions at a time when the state faced fiscal crises from social welfare and infra-structural development costs. Finally, the local bourgeoisie became more vocal in playing a part in development. In the past, they were often passed over by the PAP's orientation toward foreign MNCs and the involvement of the public sector in the services and property sectors. In this case, it was felt they could play more helping roles in boosting employment and their continued capital accumulation depended on Singapore's open market policies. In general, these tended to be responses of a Party that was once again encountering new difficulties in ensuring its electoral dominance.

1986-98 (Developing a World-Class Manufacturing and Services Center).

The recession of 1985 had exposed structural weaknesses in Singapore's economy, which had been masked by previous strong economic growth. In 1986 and 1987 the government cracked down on dissenting opinion in reaction to its policies by seeking to prevent the regional and business press from reporting on their policies.⁴⁰⁴ Measures included essentially banning the *Far Eastern Economic Review*, while *Time*, *The Asian Wall Street Journal*, and *Asiaweek* were also affected by crackdown legislation. The government also stifled internal dissent by disciplining members of the Law Society who offered criticism, for example.

⁴⁰⁴ Rodan, Garry, (1989), The Political Economy of Singapore's Industrialization, 202-203.

The strategic focus during this fifth phase of economic development was to bring Singapore's capabilities up to world class levels.⁴⁰⁵ The first step was to enhance technological capabilities. The industrial strategy took on a 'cluster development' dimension whereby industries in manufacturing and services were mutually supporting. In manufacturing, this included electronics, petrochemicals, and precision engineering. Supporting services would include financial services, international trading and information technology. In banking, the government realized that in order to become strong players and to attract foreign firms, local banks (i.e., family run banks) would need to develop by competing with the best in the world. Singapore also took advantage of the regional boom and developed the 'external wing' of its economy, tapping the markets and resources of its regional neighbors and diversifying its dependence on developed nations. Despite the fact that the government has articulated their plan to build a greater local manufacturing base, Singapore continues to function mainly as an industrial service center providing services and backup to multinational companies operating in the region.⁴⁰⁶

In 1997 the Asian financial crisis struck, and it affected Singapore's financial sector in three important ways.⁴⁰⁷ First, regional economies entered into severe recessions, reducing capital inflows and intermediation by financial institutions in Singapore, as well as bank profitability. Second, the slowing of the domestic corporate sector, together with sizeable

⁴⁰⁵ Huff, W.G., (1994), The Economic Growth of Singapore: Trade and Development in the Twentieth Century, 35-36.

⁴⁰⁶ Hatch, Walter, Yamamura, Kozo, (1996), Asia in Japan's Embrace: Building a Regional Production Alliance, 87.

⁴⁰⁷ IMF, (April 1999), "Singapore: Selected Issues", IMF Staff Country Report No. 99/35., 6.

asset price declines, had impacted adversely on bank portfolios. Third, the imposition of exchange controls by Malaysia in September 1997 contributed to a sharp decline in activity in the over-the-counter market, where Malaysian shares dominate. Singapore did, however, emerge from the Asian Crisis of 1997 in relatively good condition. Even before the crisis, the absence of formal exchange controls, and key tax and other incentives, as well as Singapore's importance in the region as a financial center, resulted in a significant level of capital mobility into the country.⁴⁰⁸ The ability to channel this FDI into manufacturing and financial services was of benefit to Singapore. The Asian financial crisis is discussed in more detail below in the context of financial services reform.

1998 - present (Building the new economy & Globalization).

Many observers have also commented that there has recently been a general 'loosening up' in Singapore. Senior Minister Lee Kuan Yew has stated: "The loosening up is more in the economic sector; in the political sector a younger generation of ministers with different backgrounds is liberalizing to absorb into their ranks a younger generation of voters ... each generation undergoes certain trans-generation changes of values, ideas and expectations."⁴⁰⁹ Singapore's long-term economic goals from this point seek to move from regional to global market exports, strengthen its Small and Medium Enterprises (SMEs) as relevant partners of MNC's, and build human capital and promote lifelong learning for lifelong employability. Foreign talent is thought to be a key component in the plan to

⁴⁰⁸ IMF, Occasional Paper #119, "Singapore: A Case Study in Rapid Development", Edited by Kenneth Bercuson, February 1995, Washington, 3.

⁴⁰⁹ Far Eastern Economic Review, (1999), "Interview with Lee Kuan Yew 2", November 11.

augment the domestic workforce, as well as attracting investments in the high growth and high value added areas. The government hopes to help industries to upgrade and develop capabilities in the entire manufacturing value chain, such as R&D, design, logistics, and will develop life sciences as the fourth pillar of Singapore's manufacturing base alongside electronics, chemicals, and engineering.⁴¹⁰ Singapore intends to build up its competitiveness in service sectors and the government has been opening them up to greater foreign competition. The deregulation of financial services led the way. This was followed by the telecommunications industry, and the opening up of its electricity and gas utilities to full competition.

In 2001 the economic situation turned negative again as the worst recession in Singapore's history set in. GDP shrank by 2% after posting 10.3% growth in 2000.⁴¹¹ There was great uncertainty over how Singapore would escape this downturn because the economy had been so extensively restructured and streamlined to that point. The country relied on services for up to 60% of its GDP and only 26% on manufacturing.⁴¹² These were frustrating facts because it meant that spurring the manufacturing sector could offer only minimal relief from the recession. While the financial services sector was expected to remain a growth industry, further structural changes to the securities business and e-commerce were thought to be harmful for the economy. Economists argued that a more balanced growth strategy was needed which meant diversified exports and greater reliance on domestic sources of

⁴¹⁰ Personal interview, November 2001.

⁴¹¹ Saywell, Trish, "On the Mend", Far Eastern Economic Review, May 30, 2002.

⁴¹² Ong, Catherine, "Riding Out the Roughs", Business Times, Singapore, May 22, 2002.

growth.⁴¹³

Another problem may be the very thing that has been pushing the economy along over the last few decades. Singapore still functions primarily as an ‘industrial service center’.⁴¹⁴ Essentially, the country still provides service backup to the multinationals and it is basically a subcontractor of the rich countries. One interpretation of this trend is that Singapore has not been completely autonomous in the economic choices it has made because this role would lead it to primarily accommodate and be dependent on MNC’s. But services are essential to facilitate economic activities based on new production methods and they allow countries to direct technologies for their own production. In manufacturing, Singapore has managed significant growth in value added manufacturing capabilities in chemicals, pharmaceuticals, and electronics through the 1990s. This has diversified the economy in manufacturing and allowed for a further shift from low/medium value-added sectors to high tech and high value added manufacturing. During the same time period, sectors with low value added content such as textiles, apparel, and wood products declined substantially.⁴¹⁵

Section III: Singapore as a Trade and Financial Hub

Seeking to become a ‘fulcrum of Asian trade’

Singapore’s geopolitical location for manufacturing, shipping, telecommunications and financial services make it a special place in Asia. This can also have a downside, since if other countries in the region such as India, Japan, Hong Kong, and Malaysia are not doing

⁴¹³ Saywell, Trish, “On the Mend”, Far Eastern Economic Review, May 30, 2002.

⁴¹⁴ Hatch, Walter, and Yamamura, Kozo, (1996), Asia in Japan’s Embrace: Building a Regional Production Alliance, 87.

⁴¹⁵ IMF Country Report No. 01/177, “Singapore: Selected Issues”, October 2001, 12.

well economically, then Singapore will also not be performing at best. These economies did not fare well as a result of the 1997 Asian crisis, and dealing with the lingering stagnation of those economies is one of the major ongoing concerns of policymakers in Singapore.⁴¹⁶ The crisis had a limited effect on Singapore, mainly because of its well-developed regulatory and prudential standards in the financial services sector.⁴¹⁷ Emerging from the crisis in relatively good condition also left minimal protectionist sentiments with the Singaporean government.⁴¹⁸

As a smaller economy in Southeast Asia, the government of Singapore is well aware that it cannot compete in manufacturing with the larger economies.⁴¹⁹ The biggest challenge for the current generation of Singaporeans is thought to be dealing with the economic dominance of China and its entry into the WTO.⁴²⁰ As an export-dependent nation, Singapore is conscious of this fact, and constantly seeks out the best ‘niche’ markets at which it can excel.⁴²¹ While Singapore does face pressure to liberalize its trade arrangements because it is a small export-centered economy, it generally stands firm on what its preferred policies will be.⁴²²

⁴¹⁶ Ong, Catherine, “Riding Out the Roughs”, Business Times Online, May 22, 2002.

⁴¹⁷ Speech by Singapore Minister of Finance, Dr. Richard Hu at MAS dinner, “East Asian Opportunities After the Crisis”, 20 October 2000.

⁴¹⁸ APEC Monitoring Group, “Singapore Seeks Pivotal Trade Role”, September 16, 2000.

⁴¹⁹ Personal interview, November 2001.

⁴²⁰ Personal interview, November 2001.

⁴²¹ Finding ‘niches’ is a major development idea in Singapore. They currently include biotechnology, electronics (semiconductors), and telecommunications. By comparison, Finland has Nokia and Sweden has Volvo.

⁴²² Personal interview, November 2001.

After the WTO meeting in Seattle in 1999 collapsed, Singapore estimated that the world trading system had been weakened.⁴²³ Since Singapore is dependent on external trade, it now participates more extensively in regional trade agreements, but still places high value on new multilateral rounds.⁴²⁴ Over the last few years Singapore has been aggressively seeking to negotiate bilateral free trade agreements, which it now favours over the multilateral route, in order to develop and expand its export-centered economy. Beginning in 1998, Singapore has signed FTA's with Australia, Chile, Japan, Mexico, New Zealand, South Korea, and the US. Currently, FTA negotiations also are in the final stages with Canada. The negotiations with Canada were launched on October 21, 2001 and were in the latter stages of clarification of offers as of January 2003. Many of these agreements contain key financial services provisions. The viability of a bilateral agreement with the EU is also being discussed for the future. Signing bilateral FTA's is often a more efficient process for Singapore because agriculture is not a part of its economy, a sector where trade negotiations can often become snagged.

Singapore's agreement with the United States is seen to be of particular strategic importance. The negotiations, which began in 2001, are comprehensive and include market access, services (including financial services), e-commerce, investments, and rules of origin. The agreement is important for Singapore as part of its goal to become an integrated production area in Southeast Asia and to allow it to better compete with China.⁴²⁵ On the US

⁴²³ Ibid.

⁴²⁴ Personal interview, November 2001.

⁴²⁵ Inside US Trade, "Singapore Minister Sees FTA with US as way to Compete with China", March 20, 2002. Singapore's pragmatism and willingness to enter into free trade

side, Singapore is seen as a major strategic trading partner with one of the most open, well-regulated, safe and secure investment climates in the world. The agreement has been strongly driven by the US-Singapore FTA Business Coalition, a group of approximately 75 leading US companies and trade associations that support the conclusion and passage of a US-Singapore FTA.⁴²⁶ In June 2002, the US Ambassador to Singapore, Frank Lavin, indicated that the US had been seeking “very ambitious” market openings in Singapore and as a result, the negotiations had seemed to make more progress in sorting out the rules of trade than on actual market access concessions.⁴²⁷

In financial services, the US sought the removal of several important barriers in Singapore’s financial services legislation above and beyond the limitations indicated in its current WTO schedule. Because Singapore’s banks have not been seeking to expand abroad outside of Asia, they were offering to liberalize in financial services for concessions in other areas.⁴²⁸ In banking, the US sought the removal of quotas on new full-service bank licenses as well as related limitations on the number of locations banks could work from. The US was also seeking greater access for US banks to the local Singapore ATM network. Singapore conceded on most of these requests. In the insurance sector, Singapore offered full establishment rights to US firms as well as greater freedom to offer cross-border insurance services. Finally, in securities, US firms will be able to offer management services

arrangements is arguably a useful counter-balance to the influence of China.

⁴²⁶ See US-Singapore FTA Business Coalition,
<<http://www.us-asean.org/ussfta/index.asp>>.

⁴²⁷ Inside US Trade, (2002), “US Ambassador says Singapore FTA Talks Lag on Market Access”, June 28.

⁴²⁸ Personal Interview, November 2001.

locally and supply pension services under the CPF social security system. This example of bilateral liberalization which has reached beyond that achieved in the GATS FSA, indicated a reduced confidence in what can be achieved at the multilateral level.

In financial services, Singapore seeks to both attract foreign financial firms as well as wanting its own banks to expand and develop in other Asian markets. Singapore sees it as important to evaluate at what rate other countries are liberalizing and expanding because altering the regulatory regime is seen by the government of Singapore as a key source of competitive advantage for trade in financial services. Countries have differing standards and Singapore's are among the highest, a fact that has allowed Singapore to weather the financial crises and economic slowdowns in the region. In dealing with other countries, careful consideration is given to other countries' prudential policies, because what is considered 'prudential' in some countries may not be so in others.⁴²⁹ Financial services was but one of many services sectors earmarked for liberalization as part of the late 1990's economic reforms, and so the GATS Financial Services Agreement is seen by Singapore as only a small consideration in its overall liberalization program.⁴³⁰ While MAS officials stay alert to what develops at the WTO in financial services, making sure that their regulations match their commitments, Singapore has modest expectations from the GATS FSA and is also not

⁴²⁹ In addition to strict corporate governance standards, Singapore has higher capital ratio standards that initially instituted by the BIS standard (12% versus 8%).

⁴³⁰ The government thought manufacturing and services sectors would be Singapore's "twin engines of growth". In manufacturing, they focused on electronics, chemicals and pharmaceuticals. Services focused on "knowledge" industries like biotechnology and financial advising. See Speech by Singapore Minister of Finance, Dr. Richard Hu at MAS dinner, "East Asian Opportunities After the Crisis", 3.

an active participant in the negotiations.⁴³¹

Singapore as a “Financial Center” and Foreign Bank Operations

A financial center can be defined by a high concentration of financial institutions and underlying markets that allow transactions to take place more efficiently than elsewhere.⁴³² This aggregation of financial services providers is formed by numerous factors: market openness, low cost of funds, geographic location, a well-developed infrastructure, and an good supply of skilled labour. Financial activities tend to be drawn to locations that route high volumes of information in related commercial activities. Larger centers tend to be better at managing this because they have more ‘critical mass’, which speeds information flow.⁴³³ These are all elements that were well developed in the history of Singapore’s industrialization.

Singapore’s rival in the region for the last 30 years has been the Hong Kong SAR. What has defined these two centers has been their open and prudent financial systems, characterized by high credit ratings and capital adequacy ratios, high accounting standards, strong management and regulation, no deposit insurance, and a high number of foreign institutions. Hong Kong differs from Singapore in one major respect in that it maintained a laissez-faire approach to regulation with minimal governmental interference or control. Singapore, by contrast, introduced tight controls and strong government involvement following independence from Malaysia. Singapore also began with very high prudential

⁴³¹ Personal interview, November 2001.

⁴³² IMF, Staff Country Report No. 00/83, July 2000, 27.

⁴³³ IMF, Staff Country Report No. 00/83, July 2000, 27.

standards and chose to relax them over time, taking a gradual approach to liberalization. Hong Kong had always been more relaxed with regards to reserve requirements and the lack of a central bank for a long time. But numerous shocks from the 1980s and various financial scandals led Hong Kong to gradually introduce more prudential regulations and form the Hong Kong SAR Monetary Authority (HKMA).

The government's policy to promote Singapore as an international financial center included three main strategies.⁴³⁴ First, fiscal and regulatory incentives were used to attract financial business to Singapore and initiate the Asian currency market. Second, a clear separation was created between domestic financial intermediation and international banking activities. Third, it was important to develop the financial sector in a regulated and controlled manner. These are discussed in turn.

First, Singapore created the Asian currency market (Asian Dollar Market) in 1968 in an attempt to match the success London's Eurocurrency market.⁴³⁵ As an 'offshore' market, it allowed international banks to more profitably manage their assets under looser regulatory and fiscal treatment. The benefits for Singapore were the establishment of offices, the hiring of local labour, imported technology and information, and the increasing of the tax base. In the beginning, the government sought to develop the market faster with tax and regulatory incentives and a liberal employment policy for foreign skilled workers. These measures were intended to attract new business of foreign financial institutions and create an overall

⁴³⁴ Economic Review Committee (Government of Singapore), (2002), "Positioning Singapore as a Pre-eminent Financial Centre in Asia", 2.

⁴³⁵ The Asian Dollar Market allows Asian banks to collect deposits and make loans denominated in US dollars.

stronger financial system. The market was extremely successful through the 1970s and 1980s. It attracted large multinationals, many of which established their regional headquarters in Singapore for treasury and financing.⁴³⁶ The market's growth slowed in the mid 1980s and through the 1990's when Japan went into recession. Today, the Asian market still remains one of the largest offshore markets.⁴³⁷

Second, legislation was introduced which separated this offshore activity (the Asian currency market), from domestic banking activity. Banks were required to record their offshore transactions in Asian Currency Units (ACUs), and domestic transactions were recorded in domestic banking units (DBUs). The intentions behind this policy were threefold:⁴³⁸ first, the government had a policy of discouraging the internationalization of its currency, so it could not be speculated on, and it wanted to maintain greater control over domestic monetary policy. Second, the government wanted to protect the local banking industry. There were fears of over-banking as many new foreign firms began establishing in Singapore. Thus, in the 1970s a three tiered banking structure was introduced, which limited the retail activities of foreign banks. Finally, the government also wanted to keep control over where domestic savings were to be invested, and to insulate the savings from the less prudent regulations of international money markets.

⁴³⁶ According to the IMF, currently more than 5000 MNCs use Singapore for their regional headquarters for treasury and financing operations. IMF, Staff Country Report No. 00/83, July 2000, 32.

⁴³⁷ At the end of 1998, total assets were near US\$500 billion, composing around 600% of Singapore's GDP. IMF, Staff Country Report No. 00/83, July 2000, 32.

⁴³⁸ See MAS News Archive, "Credibility, Confidence, Dynamism: MAS in the New Economic and Financial Landscape", 20 July 2001.

The third way Singapore was promoted as a financial center was through its controlled regulatory approach of supervision of the financial services industry.⁴³⁹ The highest priority was protecting the soundness of the financial system, and protecting depositors. Market credibility was protected at all costs by minimizing risks, banking failures, and scandals. The prudential control by the Monetary Authority of Singapore (MAS) over foreign bank entry is the most contentious policy. Along with considerations of the strength of a bank's home country regulation, comfort letters are required stating that head offices will meet financial shortfalls of their branches. More importantly, there are strict consultative procedures with the MAS which must be followed. The MAS also regularly monitors bank loan files, accounts and transactions and internal controls. These procedures, in particular, raise questions about non-discriminatory regulation of foreign banks. Finally, the MAS does not allow unrestrained growth and competition in the financial sector. Its policies of monitoring and consultations were often criticized as being overly heavy-handed and burdensome for foreign banks, but recently this seems to have eased.⁴⁴⁰ In addition, the IMF has suggested that these highly prudential regulations have placed a hampering effect on the potential capital market development of Singapore.⁴⁴¹ Keeping in mind these three main promotional policies as a financial center, Singapore has had to proceed with caution managing its policies of safety and soundness on the one hand, and not discouraging market development on the other hand.

⁴³⁹ See MAS News Archive, "New Approach to Regulating & Developing Singapore's Financial Sector", 4 November 1997.

⁴⁴⁰ Personal correspondence, February 2002.

⁴⁴¹ IMF, Staff Country Report No. 00/83, July 2000, 35.

While foreign banks have been operating in Singapore for a long time, the banking sector has been gradually opened up to more foreign competitors.⁴⁴² Citibank is one of the largest foreign banks operating in Singapore and uses the island as its ‘laboratory and test bed for new ideas before going regional’, and the regional processing center for credit cards for the Asia Pacific, Latin America, the Middle East, and Europe.⁴⁴³ There are no major obstacles for foreign banks already established in Singapore as far as interbank and corporate business is concerned⁴⁴⁴. However, in the view of the government, the small banking market in Singapore means that not all banks can be granted full banking licenses. Therefore, key restrictions still apply to foreign banks wishing to engage in retail banking, including licensing restrictions on the number of foreign banks permitted to engage in fully domestic retail activities.⁴⁴⁵ It is important to note that these policies are also common to most other countries’ financial regulations. The main restrictions which still apply to foreign banks, and which do not apply to domestic banks, are limitations on the number of branches, standalone ATM machines, and debit & cash card services. The restrictions facing foreign banks were recently criticized by Andrew Liew: “I think for Singapore to become more competitive we really must remove all barriers to first world banking here. And this is not just propaganda on our part. The average Singaporean is more likely now to bank with a foreign bank, by

⁴⁴² For example, Citibank celebrated its 100th year of operation in Singapore in 2002. See Business Times Online (Singapore), Supplement on Domestic Retail Banking Reform, January 30, 2002., “Redrawing the Battle Lines”.

⁴⁴³ Business Times Online, (2002), “Eyes Wide Open”, Supplement on Domestic Retail Banking Reform, January 30.

⁴⁴⁴ Personal Correspondence, February, 2002.

⁴⁴⁵ These are seen as the most significant barriers to retail banking in Singapore. See WTO, Trade Policy Review (TPR), Singapore, 2000, 97, 101-103.

sheer numbers alone. But yet the foreign banks are not competing on an equal footing, and this represents ... some sort of dilemma.”⁴⁴⁶ Yet, foreign penetration of the banking system of Singapore is comparatively high. Foreign banks accept almost half of all deposits from residents, give more than half of all loans, account for 70 percent of total trade financing business in Singapore, and for 60 percent of banking profits.⁴⁴⁷

Singapore has taken a pro-active approach to building itself up as an international financial center, and has not relied passively on financial institutions to choose to set up there.⁴⁴⁸ Singapore has tried to accomplish this not by trying to shut out foreign players, nor by a totally laissez faire approach, but by a phased liberalization of the banking sector. Specifically this has involved opening the sector to greater foreign competition while simultaneously pushing the local banks to strengthen and upgrade themselves. Since the domestic market in Singapore is too small to sustain five local banks of adequate size to compete regionally, the stronger local banks have started to develop as strong regional players in order to diversify and grow. As a part of this strategy, the MAS has encouraged the local banks to consolidate among themselves.

The Monetary Authority of Singapore (MAS)

A competent and focused economic bureaucracy has been an important factor in

⁴⁴⁶ Business Times Online, (2002), “Small, Lean and Flexible” (ABN Amro), Supplement on Domestic Retail Banking Reform, January 30.

⁴⁴⁷ Economist Intelligence Unit (EIU), “Foreign Banks”, Country Finance Singapore, September 30, 2000.

⁴⁴⁸ Monetary Authority of Singapore, (2001), “Building One Financial World”, 42nd ACI World Congress Keynote Address, 25 May, 2001, by Deputy Prime Minister Lee Hsien Loong.

Singapore's success. The most important domestic institution fulfilling this role has been the MAS. Prior to 1970, the various monetary functions associated with a central bank were performed by several government departments and agencies. As Singapore progressed, the demands of an increasingly complex banking and monetary environment necessitated streamlining the functions to facilitate the development of a more dynamic and coherent policy on monetary matters.⁴⁴⁹ Therefore in 1970, Parliament passed the Monetary Authority of Singapore Act leading to the formation of MAS on 1 January 1971. The MAS Act gives the MAS the authority to regulate all elements of monetary, banking and financial aspects of Singapore. The MAS also has the important task of developing Singapore's financial industry. In April 1977, the Government decided to bring the regulation of the insurance industry under the wing of the MAS. The regulatory functions under the Securities Industry Act (1973) were also transferred to MAS in September 1984. The MAS is unique in that it is one of only a few institutions in the world that combines responsibility for monetary policy with supervisory oversight of the entire financial sector - banking, insurance, and securities. The encompassing powers of the MAS over all aspects of the economy surely materialized out of the intentions of the developmental-minded elite which created it.⁴⁵⁰

As a financial center, Singapore maintains an interest in the sound growth and development of the international monetary and financial system. The MAS works closely with international financial standard-setting bodies such as the BIS, IOSCO and IAIS to look

⁴⁴⁹ Monetary Authority of Singapore, "About MAS, History of MAS".

⁴⁵⁰ Referring to its omnipotence, one expert referred to the MAS as "Central Bank, big brother, Fort Knox and LKY (Lee Kuan Yew) all rolled into one." Personal Correspondence, October 2001.

into the establishment, strengthening, and implementation of international standards for the banking, securities and insurance industries, as well as the payment and settlement systems.⁴⁵¹ From its inception, the MAS approach to supervising the financial sector was built on strict admission policy, high prudential requirements, and rigorous enforcement. When the BCCI (discussed in Chapter 3) sought entry to Singapore and was refused, then later collapsed, Singapore was spared the fallout. The MAS' reputation as a thorough and uncompromising regulator went up.⁴⁵²

Other than the statutory requirements listed in the Banking Act, the MAS does not indicate the specific minimum standards applicants must meet to be granted a banking license. However, the MAS has always been concerned that prospective banks establish sound credit and risk management policies, adopt effective internal control systems, and employ personnel of the highest caliber.⁴⁵³ Foreign banks wishing to establish subsidiaries in Singapore are treated the same as local banks for regulatory purposes. That is, foreign banks are subject to the same level of scrutiny as domestic applicants for banking licenses. Specifically, this means that such banks must possess the same amount of capital as domestic banks.

⁴⁵¹ Personal interview, November 2001.

⁴⁵² Deputy Prime Minister Lee Hsien Loong, Chairman, MAS, "Credibility, Confidence, Dynamism: MAS in the New Economic and Financial Landscape", Keynote Address at the MAS 30th Anniversary Conference, Singapore, 20 July 2001. More recently, the Manulife Financial corruption case is discussed below.

⁴⁵³ Anandarajah, Kala, (2000), "Banking Regulation in Singapore and the Treatment of Foreign Banks", 708.

Section IV: Modern Financial Sector Reform in Singapore

In the mid 1990's, a number of joint government-industry committees were set up to study the refinement of the country's financial services sector and to recommend changes that would bring Singapore banks and financial institutions up to par with international best practices.⁴⁵⁴ The first was a Subcommittee on Finance and Banking that was formed in February 1997 as part of an earlier and broader government effort to consider the subject of Singapore's overall economic competitiveness. The majority of the 19 members of the Subcommittee (headed by the president of one of the local big four banks) were representatives of foreign banks and financial institutions based in Singapore. One of the main findings was that government had to better utilize and attract foreign talents in the field in order to become a global financial center.⁴⁵⁵

When the Asian financial crisis struck in 1997, Singapore was affected by the crisis reflecting its close linkages in the region, but was not hit as badly as other countries because its strong economic fundamentals served as a buffer.⁴⁵⁶ Singapore's main exposure to the crisis came through local bank operations in neighboring countries and exposure in local

⁴⁵⁴ US Embassy Document, "Reforming Singapore's Financial Services Sector: A Background & Progress Report", mimeo, May 1999.

⁴⁵⁵ MAS News Archive, (1999), "Growing the Singapore Financial Sector - Attracting and Nurturing Financial Sector Talent", 27 August.

⁴⁵⁶ The strong economic "fundamentals" were based on sound economic laws and standards, strong governmental financial position (i.e., low inflation, competitively advantaged investments), no bail-outs in response to the 1997 crisis, sound banks, and a previously deflated property bubble - See Deputy Prime Minister Lee Hsien Loong, "Post Crisis Asia - The Way Forward", Speech to the William Taylor Memorial Lecture, Basel, Switzerland, 21 September 2000.

property markets.⁴⁵⁷ The profits of the top four domestic banks fell by 28 - 50 per cent in early 1998, relative to 1997. The crisis also exposed weaknesses in supervision and transparency (especially in bank disclosures), and how competition could be improved in the banking sector. In the midst of the crisis, but before the full-fledged outbreak, Singapore launched a fundamental review of the financial sector by instituting a Financial Sector Review Group (FSRG) to seek a fresh approach to competition, regulation, and development of the financial sector.⁴⁵⁸ Cabinet also discussed the problem and approved an appropriate shift in regulatory approach and initiatives to liberalize the financial sector. Also in response to the developments of the Asian financial crisis, the MAS established an International Relations Department in April 1999.⁴⁵⁹ The Department sought to coordinate and shape MAS-wide perspectives on international monetary and financial issues, enabling the MAS to be more active in the international financial community. A process which began in 1998, the MAS now regularly reviews and updates its approach to regulating and supervising its financial sector. In May 1999, MAS announced a major five-year program to liberalize and consolidate the domestic banking sector.⁴⁶⁰ The program aimed to strengthen Singapore's banking system and the local banks, and also to enhance Singapore's position as an

⁴⁵⁷ WTO, Trade Policy Review (TPR), Singapore, 2000, 98-99.

⁴⁵⁸ In its investigation the FSRG's consulted with financial sector experts and external advisors. The FSRG did not publish a final report but reported regularly on conclusions it reached in individual areas and implemented them beginning in early 1998. See MAS News Archive, "New Approach to Regulating & Developing Singapore's Financial Sector", 4 November 1997.

⁴⁵⁹ Monetary Authority of Singapore, "Introduction to MAS, International Relations".

⁴⁶⁰ See MAS News Archive, (1999), "Liberalizing Commercial Banking and Upgrading Local Banks", 17 May.

international financial center. One of the most important policies was to gradually introduce greater foreign competition in the wholesale and retail banking sectors in part by removing foreign shareholding limits on local banks (previously limited to 40%). Since the 1970's in Singapore, aside from the “offshore” classification, no local or foreign bank had been granted a full or restricted bank license to this point.⁴⁶¹ The reasons for the significant change to the shareholding limit were driven not by pressure to make the domestic market more attractive, but because of perceived domestic market inefficiencies.⁴⁶²

The conditions on this removal are a tightening of existing safeguards on accumulation of ownership in a local bank that Nominating Committees must be set up to recommend competent board members, and a majority of residents with permanent resident status must be on the board. This was to ensure that control of the banks was to rest with individuals or groups who are assured to act in the ‘national interest.’ The reasons for retaining a significant local bank presence were expressed by the MAS: “In a major crisis, we must be able to count on major players with long term interests aligned with the Singapore economy, to act as stabilizers for our financial system. The Government’s policy is to maintain the local banks’ share at not less than 50 per cent of total resident deposits. The best way is for local banks to upgrade themselves and hold their own against stronger

⁴⁶¹ WTO, Trade Policy Review (TPR), Singapore, 1996, 92.

⁴⁶² The MAS identified four inefficiencies: a two-tier market for local bank shares and reduced liquidity, a distorted value for those shares, difficulties for local banks to implement competitive share option schemes for employees, and a reduced capability for local banks to forge strategic partnerships with foreign banks. See MAS, (1999), “Liberalizing Commercial Banking and Upgrading Local Banks”, Press Release, 17 May, 4.

competition. This in turn will most probably require consolidation within the industry.”⁴⁶³ Since 1997, domestic mergers have reduced the number of local banks. This trend is based on the belief consolidation would be more efficient, given the small size of the Singapore economy, and the increasing competition from foreign banks.⁴⁶⁴

In banking this was achieved by offering a total of six “Qualifying Full Bank” (QFB) as well as some “Qualifying Offshore Bank”(QOB) privileges. The QFB licensing policy is the main vehicle for the MAS’ gradual reform strategy, allowing foreign banks to gradually tap the banking market and the local banks for market share. Outside of liberalizing consumer banking, the QFB also has the objective of developing other parts of the banking sector at a time when Singapore is looking to negotiate Free Trade Agreements (FTA’s) with key economic partners, so the QFB also has strategic value as a bargaining chip.⁴⁶⁵ The QFB designation allows banks to establish no more than 2 new branches and 3 off-premise ATM’s each year, relocation of existing branches, and the freedom to share ATM’s with other QFB’s. Five new ‘restricted’ bank licences, for those banks more interested in wholesale business, were awarded to successful foreign banks.⁴⁶⁶ These reforms are discussed in greater detail below in the next sections.

In October 2001, the Singapore Parliament passed the Securities & Futures Act (SFA)

⁴⁶³ MAS News Archive, (1999), “Liberalizing Commercial Banking and Upgrading Local Banks”, Press Release, 17 May.

⁴⁶⁴ Personal Correspondence, February 2002.

⁴⁶⁵ Business Times Online, (2002), “The New Frontier”, Supplement on Domestic Retail Banking Reform, January 30.

⁴⁶⁶ Reforms discussed and confirmed in personal correspondences, January 2002 and February 2002.

and the Financial Advisors Act (FAA) which together represent a profound change in the regulation of financial products in Singapore.⁴⁶⁷ These policies reflect the MAS' move away from one-size-fits-all laws and regulations toward tailored supervision of individual institutions according to each institution's financial strength, risk management capability and profile.⁴⁶⁸ The shift of emphasis means in practical terms fewer rules and less prescriptive rules allowing institutions to set their own sensible rules based on good governance and management (with oversight from the MAS) and in line with overall business strategy. The old "restricted" bank licence was replaced with a "Wholesale Banking" licence to better reflect the range of activities permitted by this type of licence.

Foreign banks are still excluded from the main ATM network in Singapore but are developing their own. Standard Chartered Bank, Maybank, and HSBC Bank share an ATM network with just over 70 ATM's in over 50 locations. Citibank and ABN Amro, the other two QFB license holders are not part of the shared network and have ATM's concentrated mostly in their branches. Foreign banks are still therefore restricted by the ATM issue because by contrast the Development Bank of Singapore (DBS) network boasts 900 ATM's and the Oversea-Chinese Banking Corporation (OCBC) and United Overseas Bank (UOB) network have 800 ATM's, but it has not been a big issue in the over-banked Singapore

⁴⁶⁷ Changes dealt with dealer licensing, electronic trading, and other industry guidelines. See Lim, Eugene, and Loi, Kelry, (2002/2003), "Singapore: Onward with Consolidation", Euromoney, p178-179, in supplement "Global Banking & Financial Policy Review".

⁴⁶⁸ See Catherine Ong interviews MAS Deputy Managing Director, Mr. John Palmer, a Canadian formerly with the OSFI, (2002), "A Financial Report Card" May 22.

market.⁴⁶⁹ Local banks are subject to two restrictions which may give a slight advantage to foreign banks operating in Singapore. First, local banks are subject to observe the MAS's capital-ratio requirement of 12 per cent, while foreign banks do not.⁴⁷⁰ However, the MAS retains the discretion to impose a capital requirement on foreign banks based their risk profile, set anywhere between the BIS's Capital Adequacy Ratio (CAR) of 8 per cent, and the 12 per cent domestic standard. Second, local banks are required to perform community service roles such as serving small customers and less attractive or less profitable niches.⁴⁷¹

Singapore's financial services commitments in the WTO FSA are generally quite liberal, except for in Mode 1 (cross-border supply of services), where foreign firms remain at a disadvantage. However, this has been a choice made by almost all countries that have made commitments in financial services. There are important prudential and legal questions raised when firms operate without the legal assurances that are a part of Mode 3 commitments (Commercial Presence). Countries are therefore cautious to how they make commitments which affect cross-border market access, and usually schedule commitments as "unbound" - meaning no commitments are made. Though Singapore can offer foreign firms access to the market through cross-border supply, the government retains discretion in this regard.⁴⁷² In practical terms, these limitations restrict the cross-border provision of

⁴⁶⁹ DBS, UOB, and OCBC are the three remaining big local banks. See Business Times Online, (2002), "Shared ATM Services", Supplement on Domestic Retail Banking Reform, January 30.

⁴⁷⁰ Personal interview, November 2001.

⁴⁷¹ WTO, Trade Policy Review (TPR), Singapore, 1996, 92.

⁴⁷² In interview, one official agreed that Memorandum of Understandings (MOU's) would be a way to assure the integrity of foreign institutions, but noted the problem is that 'the man on the street does not know which banks are safe and which are not'. See also

financial information by providers such as Reuters and Bloomberg, and limits the cross-border transfer of sensitive banking data, all of which put foreign banks at a distinct disadvantage.⁴⁷³

Commercial Banking Institutions

As of February 5, 2003 there were 117 commercial banks in Singapore, 5 of which were locally incorporated.⁴⁷⁴ Around 95 per cent of banks operating in Singapore foreign owned.⁴⁷⁵ Commercial banks include local banks and foreign banks. The three remaining local banks in Singapore continue to seek market access and expand abroad within Asia but are generally limited by the differential rates of development of the other countries within the region.⁴⁷⁶ By far most banks operating in Singapore are Foreign banks and can be designated as foreign “full”, “qualifying”, “wholesale”, or “offshore”.

Full Banks

Full banks are allowed to undertake a full range of universal banking services. Until 1971, all commercial banks in Singapore were granted full licences which permitted them to carry out the whole range of banking business approved under the Banking Act. As of 5 February 2003 there were 27 full-licensed banks, five of which were locally incorporated, and the remainder branches of foreign banks.

Schedule of Specific Commitments, Singapore, GATS/SC/76/Suppl.3. for the actual commitments in Mode 1.

⁴⁷³ Coalition of Service Industries (CSI), “Request for Comments on the United States - Singapore Free Trade Agreement”, FR Doc. 00-109, 14.

⁴⁷⁴ Of the 5 locally-incorporated banks, three are the major bank groups DBS, UOB, and OCBC. The other two are smaller and include Bank of Singapore and Far Eastern Bank.

⁴⁷⁵ WTO, Trade Policy Review (TPR), Singapore, 1996, 90.

⁴⁷⁶ Personal interview, November 2001.

Qualified Full Banks

Introduced in mid-1999, this new category of banks was intended to distinguish them from the existing class of foreign full banks. The primary distinction between full and qualified full banks pertains to certain benefits such as restrictions on the number of off-premises locations that can be established. Current MAS objectives issued six qualified full bank licenses between 1999 and 2001. Banks with QFB privileges are allowed to have 15 branches and/or off-premise automated teller machines (ATMs), of which up to 10 can be branches. They are also permitted to relocate their existing branches and share ATMs among themselves. From 1 July 2002, QFBs will be allowed to provide debit services through an EFTPOS network (similar to Interac), offer Supplementary Retirement Scheme and CPF Investment Scheme accounts, and accept fixed deposits under the CPF Investment Scheme and Minimum Sum Scheme. The debit and cash card services are expected to be relaxed in July, 2003. With respect to market access, the MAS still controls the number of QFB licenses based on its assessment as to how much competition the local banks can handle.⁴⁷⁷ Given Singapore's small domestic banking market, not all banks can be granted full banking licences. Thus, two other categories of commercial banks evolved: wholesale banks and offshore banks.

Wholesale Banks

In 1971, a new category, restricted bank, was created to accommodate further entry of commercial banks into Singapore. As noted above, with the second phase of banking liberalization announced in June 2001, the restricted bank licence was replaced with the

⁴⁷⁷ Personal Correspondence, January 29, 2002.

wholesale bank licence. As of February 5, 2003 there were 31 wholesale banks in Singapore, all of which were branches of foreign banks. Wholesale banks may engage in the same range of banking business as full licence banks, except that they may not accept Singapore dollar fixed deposits of less than S\$250,000 per deposit from nonbank customers or pay interest on Singapore dollar current accounts operated by resident individuals.

Offshore Banks

As the entry of more foreign banks of good standing was seen to facilitate Singapore's goal of becoming an international financial center, another category of commercial banks, offshore banks, was created in 1973. Offshore banks have the same opportunities as full and wholesale banks in business transacted in their ACUs. The scope of business transacted in the DBU has however slightly more restrictions. As of February 5 2003, there were 59 offshore banks in Singapore, all of which were branches of foreign banks.⁴⁷⁸ In addition to the conditions imposed on wholesale banks, offshore banks also may not accept interest-bearing deposits from resident nonbank customers other than approved financial institutions or extend total credit facilities in Singapore dollars exceeding S\$500 million to nonbank customers who are residents of Singapore.

The above measures were intended to enhance competition and were equally matched by two main reforms in the regulatory regime.⁴⁷⁹ The first is the revision of the capital adequacy framework, which partially reduced the amount of cash reserves banks were

⁴⁷⁸ See Monetary Authority of Singapore (MAS), "Number of Financial Institutions and Relevant Organizations in Singapore", <<http://www.mas.gov.sg>>.

⁴⁷⁹ United States Embassy, Mimeo Document, (1999), "Reforming Singapore's Financial Services Sector: A Background & Progress Report", 4-9.

required to hold in relation to their loans and offered them a little more freedom. This was part of the movement away from a “one size fits all” approach to one that is risk-focused and institution specific. The second major change in the regulatory structure is the requirement that banks separate their financial and non-financial activities and to unwind cross-shareholdings. These changes are aimed at limiting the risks of contagion to banks from nonbanking activities, enhance market discipline, increase transparency and ensure that bank management focuses on the core business of banking and finance. Specifically, banks are required to group financial activities either under the bank itself or under a financial holding company. Nonfinancial activities must be segregated from the banking group and divested, and the management of financial entities and nonfinancial affiliates should be separated.

Foreign Insurance and Securities in Singapore

Insurance Companies

In other financial services, Singapore is more relaxed than in the direct banking sector. Banks, for example, are allowed to operate stockbroking and insurance businesses relatively unrestricted through separate subsidiaries.⁴⁸⁰ In addition, the insurance sector has been essentially opened wide to foreign firm participation. Before the reforms in insurance were introduced in 2000, Singapore had many restrictions in place, the most important of which were restrictions on the issuance of new insurance licenses based on a needs test, restrictions on the establishment of new representative offices, and restrictions on the foreign

⁴⁸⁰ WTO, Trade Policy Review (TPR), Singapore, 1996, 91.

ownership limit of domestic insurance companies (limited to 49%) was removed.⁴⁸¹ At the end of 1998, roughly 70 per cent of direct insurers were foreign-owned, representing about 54 per cent of total business.⁴⁸² As of February 2003 there were 153 insurance companies operating in Singapore and 57 insurance brokers. The local insurance market has been generally considered to be saturated and concentrated, so the government had not been issuing new licenses to foreign or domestic firms.⁴⁸³

In March 2000 the MAS announced the liberalization of entry into the direct insurance market.⁴⁸⁴ Previously, no direct life insurers had been allowed access to the domestic market since 1990, and no direct general insurers had been allowed since 1984.⁴⁸⁵ Allowing new entrants into the market was a way to increase competition, foster innovation, and raise the efficiency of incumbents. Direct insurers are now allowed access to the domestic market at a paced introduction in order to minimize unsound market practices in the event of an influx of a large number of companies. The MAS also abolished the 49% limit on foreign shareholdings of locally owned direct insurers, with the goal of enabling local insurers to merge and form strategic alliances with reputable foreign players. This would also create a way for foreign insurers to enter the market with an existing line of

⁴⁸¹ Coalition of Service Industries (CSI), "Request for Comments on the United States - Singapore Free Trade Agreement", FR Doc. 00-109, 11.

⁴⁸² Trade Policy Review (TPR), Singapore, 2000, 104. These numbers remained relatively constant from the previous WTO TPR in 1996 (See TPR 1996, 93).

⁴⁸³ WTO, Trade Policy Review (TPR), Singapore, 1996, 95. The market is concentrated with the four largest companies having up to 90% of premiums. See TPR 2000, 104.

⁴⁸⁴ Singapore's Financial Sector, Recent Market Developments (Insurance), undated.

⁴⁸⁵ Monetary Authority of Singapore (1999), "Recent Market Developments: Development and Liberalization of the Insurance Industry".

business.⁴⁸⁶ Aside from cross-border supply, foreign firms now face essentially no restrictions in the Singapore insurance market.

The insurance industry was liberalized in accordance with the understanding that a more competitive insurance market is necessary to raise industry standards to the international best practice and place Singapore as a leading regional center for insurance services.⁴⁸⁷ The MAS also examined strategies to improve the risk responsiveness of regulatory and supervisory regimes.⁴⁸⁸ For example, risk-based capital models may be used to determine the minimum capital that each life and general insurance company must maintain, as well as a risk-based supervisory approach in the inspection of insurance companies that will focus on areas of significant risk to each company.

Securities

Due to Singapore's open capital markets, the regional financial crisis had an impact on investor confidence and hurt stock prices.⁴⁸⁹ In line with its place in the region, the Singapore Exchange (SGX) aims at providing world-class capital markets infrastructure that mediates the free flow of capital across markets. Since domestic trading firms are notoriously inefficient and uncompetitive, the foreign firms in Singapore are the major

⁴⁸⁶ Monetary Authority of Singapore (1999), "Recent Market Developments: Development and Liberalization of the Insurance Industry".

⁴⁸⁷ Brostoff, Steven, (2001), "U.S. Insurers Push for Broad Access to Singapore", National Underwriter, 105, 3, 29.

⁴⁸⁸ Monetary Authority of Singapore, (2001), "Building One Financial World", Speech by Deputy Prime Minister Lee Hsien Loong, , 42nd ACI World Congress Keynote Address, 25 May.

⁴⁸⁹ WTO, Trade Policy Review (TPR), Singapore, 2000, 98.

players.⁴⁹⁰ In late 1999, the two major exchanges in Singapore - the Stock Exchange of Singapore (SES) and the Singapore International Monetary Exchange (SIMEX) were merged to form the SGX in late 1999.

With regards to market access, aside from cross-border supply restrictions, foreign companies generally have the same establishment rights as domestic firms but membership in the SGX is limited. Singapore also allows non-members of the SGX to apply to become Approved Foreign Brokers (AFB's), enabling them to trade directly in non-Singapore securities.⁴⁹¹ The largest remaining impediment to foreign companies is meeting the eligibility requirements set down by the Central Provident Fund (CPF).⁴⁹² One of the MAS's requirements is that companies have a substantial local presence, including having at least three qualified managers on staff. What this means is that a foreign mutual fund company cannot sell their funds by cross-border mode, but must set up and establish in Singapore.⁴⁹³ Once established, fund-management firms face another large obstacle in obtaining access to manage CPF savings. In 2001, eight new money management firms were awarded the status of 'CPF-included', a coveted status as it gives fund managers a fighting chance to amass large fund sizes in Singapore. As of January 30th, 2002, some \$63.8

⁴⁹⁰ Personal interview, November 2001.

⁴⁹¹ WTO, Trade Policy Review (TPR), Singapore, 2000, 97.

⁴⁹² The Central Provident Fund (CPF) was established in 1955 as a mandatory individual account system designed to provide a degree of financial security for workers in their old age. Both the employer and the employee contribute to the fund. CPF balances must by law be invested in government bonds.

⁴⁹³ Personal Correspondence, January 29, 2002.

billion of the CPF remained uninvested, so there is still room for more participation.⁴⁹⁴ As one asset manager said: “The Singapore market is concentrated on companies with big distribution. Until there is freeing up of that arrangement, it’s a hard slog for people without a tied distribution channel.”⁴⁹⁵ What this all means is that the Singapore money management market is going through a period of greater consolidation and as the number of funds expands. In addition, the level of competition has been raised because the CPF has begun to attach an expiry date to ‘CPF-included’ status. Firms that pass the investment consultant’s screening process must launch funds within three years. Those that fail are removed from the scheme.

Corporate Governance Reform

In June 2000, there were initiatives put in place to raise the standards for corporate governance and disclosure and a requirement for banks to separate their financial and non-financial businesses.⁴⁹⁶ The intention of these changes is was to limit the risk of “contagion” from nonbanking businesses to banks by improving the governance of banks. The code prescribes a set of corporate governance guidelines for listed companies in Singapore. The introduction of a civil penalty regime for insider trading to complement the existing criminal regime gives the MAS the power to undertake civil actions against insider trading. It also provides for investors to take civil claims against a person who has engaged in insider

⁴⁹⁴ Business Times Online, (2002), “The New Frontier”, Supplement on Domestic Retail Banking Reform, January 30.

⁴⁹⁵ Tony Morgan, JF Asset Management CEO. Quoted in Business Times Online, (2002), “Redrawing the Battle Lines”, January 30.

⁴⁹⁶ Monetary Authority of Singapore, (2000), “Measures to Separate Financial and Non-Financial Activities of Banking Groups”, 21 June.

trading. These new powers will be extended to other forms of market misconduct such as market manipulation, the dissemination of false or misleading information and the engagement of fraud or deceit. Singapore's high legal and governance standards have now improved and developed on a reputation that is helping to manage corruption in the region. One recent example of this was the case of a Canadian insurance company operating in Indonesia.

Manulife Financial Insurance (Canada) Case⁴⁹⁷

In June of 2000, the subsidiary of Canada's Manulife Financial Insurance company in Indonesia was handed down a bankruptcy charge by a lower Indonesian court. It was believed that the once powerful Gondokusumo family of Indonesia who owned a 40% stake in the Manulife subsidiary through its own Dharmala Group company before it went bankrupt in June 2000, bribed a corrupt Indonesian administrator and lower court judge to declare Manulife bankrupt. In July of 2002, after significant international pressure, the Indonesian Supreme Court overturned the original lower court decision and called for an investigation into bribery in the lower court. Manulife itself has brought lawsuits in Hong Kong, Indonesia, and Singapore based on where some of the defendants lived, and where some of the transactions in question took place. International pressure surrounding the matter came from three key directions. The International Monetary Fund (IMF) had been urging Indonesia to make critical improvements to the legal system to win investor

⁴⁹⁷ Facts gathered from McBeth, John, Webb, Sara, (2002), "Manulife appeals to Singapore", Far Eastern Economic Review, June 20, 42; Kagda, Sheob, (2002), "Manulife court ruling gets thrown out", Business Times Online, July 9th, 2002; and The Globe and Mail, (2002), "Probe set for Manulife allegations: Indonesian court looks for possible bribery", Tuesday June 25, B5.

confidence after the Asian crisis and waves of corruption. The Canadian government placed considerable pressure during the 18 month interim period and threatened to impose trade sanctions if the controversial ruling was not reviewed. Finally, the United Nations (UN) dispatched a task force to examine Indonesia's court processes. Internally, Indonesia's Supreme Court and Law Ministry have opened separate probes into alleged impropriety.

It is thought that this case has done serious harm to Indonesia's efforts to attract foreign investment and recover from decades of corrupt dictatorship. However the case demonstrates that controversial decisions can be overturned by the Supreme Court - a positive step for legal reforms. The case is relevant to Singapore because some of the transactions took place in Singapore and the family in question lived in and owned property in Singapore. In addition, Indonesians generally invest heavily in Singapore, while also using Singapore's banks, schools, and medical facilities and seeking shelter from the instability of their own country. Singapore froze the assets of the family in May 2002 after a court request by Manulife was granted, which sent a very strong outward message that it does not tolerate harboring criminals. Manulife is thought to have appealed to the impartiality of Singapore's courts, which are now known to offer hope to investors in Asia. The case highlights the importance of corporate governance and legal reforms in the financial framework, and how these must be measured against international best practices. In addition, the case illustrates the potential wrath of international discipline in financial matters and the extent of regional interconnectedness, both of which insist that corruption can no longer go unnoticed and will not be tolerated when financial stability is at stake.

Section V: Conclusions

Singapore's experience under the export-oriented industrialization model, including its recessions and substantial policy reassessment raises questions about its capacity to induce particular patterns of international investment. Whatever the assessment may be, Singapore has managed to attract investment which might otherwise not have taken place, or taken place at a later time. As a developmental state, Singapore concentrated considerable power, authority, autonomy and competence in the central political and bureaucratic institutions of the state, notably the economic bureaucracies. The history of industrialization indicates that Singapore has been essentially a mobilizing state in which political and bureaucratic components have been virtually fused. Domestic processes in Singapore have allowed this strategy to work effectively. A focused relationship between the PAP and the other components of the state facilitated export-led openness. The MAS played a key role from the beginning to regulate and supervise the financial services sector in line with these goals. Attracting regional and international investment has been managed by a capable economic bureaucracy that focused primarily on the prudential oversight of foreign firms.

As a financial center, Singapore is characterized by a high concentration of financial institutions, information flow, and high prudential standards. Over the course of its development, Singapore has attracted international funds by paying attention to fiscal and regulatory incentives and maintaining prudential standards. It has consciously maintained a separation of international and domestic banking activities to reduce speculations on its currency and insulate the domestic banking market. Finally, Singapore has controlled its financial development through enhanced market credibility and by maintaining controlled

growth in the financial sector. The MAS has been instrumental in making these policies effective through its encompassing power in line with the expectations of Singapore's developmental elite. The MAS has been responsible for disseminating sound credit and risk-management policies and keeping strong connections with other international standard-setting bodies.

Trade exports and services are the lifeblood of Singapore's economy and it has worked extensively and autonomously to advance its multilateral, and more recently, its bilateral trade opportunities. These efforts have the secondary purpose of boosting Singapore's economic and diplomatic profiles as a smaller state in the international system. One of the most important bilateral initiatives has been the completion of the US-Singapore Free Trade Agreement. In negotiating this agreement, Singapore realized the importance of the US market for its exports, and the concessions it can negotiate in exchange for access to its financial services market. As the US negotiators faced resistance to their ongoing requests for market access in the negotiations, Singapore demonstrated that it negotiates trade agreements with its own interests planted firmly at the table.

With respect to WTO liberalization and the liberalization of financial services under the GATS, Singapore's expectations of what could be gained in the negotiations have been modest.⁴⁹⁸ The country does not play a major role in the financial services discussions at the WTO, where the OECD countries are the major players. The GATS FSA is seen as being a constructive part of Singapore's overall economic strategy, one that has not interfered with pace of liberalization, or in the choices that have been made about prudential regulation.

⁴⁹⁸ Personal interview, November 2001.

Most of the liberalization that has happened in Singapore has been self-initiated. In being relatively open, the restrictions that Singapore maintains in its GATS schedule regarding financial services are common to most other advanced economies - they are directed at the maintenance of appropriate market size and safety.

The 1997 Asian financial crisis left Singapore in relatively good condition. This fact highlights how economic instability derives not from a market that is open to trade in financial services, but from inadequate domestic laws and regulations in the presence of high capital mobility. Singapore's response to the crisis of 1997 included more efforts to reform and liberalize its financial regulations, rather than taking a protectionist stance. The country had developed a competitive advantage in financial services before the GATS FSA, so protecting the domestic market was not an option. Specific measures included an overall shift from regulation to supervision (i.e., less interference), increased transparency and competition, and an overall promotion of the development of the financial sector. Another important and developing response after the crisis was enhanced corporate governance reform. The recent Manulife financial case is an example of the effectiveness of these policies, which are building on an already strong reputation of legal foundations and best practices.

Chapter 5

Economic and Financial Sector Reforms in India

“Despite all the talk, we are nowhere even close to being globalized in terms of any commonly used indicator of globalization. In fact, we are still one of the least globalized among major countries however we look at it...”⁴⁹⁹

“ Globalization is an unavoidable process which is taking place independent of us ... The truth is that if we do not reform rapidly, and position ourselves to compete, we will be marginalized. There is no divine dispensation that gives India alone the power to survive and prosper as an isolationist island in a globalized world. ...”⁵⁰⁰

Section I: Introduction and History

This chapter explores the modern economy of India with a particular focus on the financial services sector. It begins with an introduction to the history and nature of the economy and banking sector. India’s 1991 economic crisis is examined, along with explanations for the crisis that derived partly from fundamental flaws in the financial sector. As a response to the crisis, India needed to fundamentally re-evaluate how the government could better combine its need for growth and modernization, against its public and social obligations. Once these reforms were ongoing, the WTO financial services regime played an important role in helping India with the transition to an open system that could be more competitive and productive. This involved overcoming protectionist regulations in the financial services sector without creating any added instability in the economy. It also had

⁴⁹⁹ Dr. Bimal Jalan, Governor of the Reserve Bank of India (RBI), 2002.

⁵⁰⁰ Prime Minister’s Economic Advisory Council (EAC), Government of India, 2002.

to be done at a pace that was compatible with the domestic debates about reform that were ongoing. An important part of this debate tried to balance the competing demands of domestic regulatory reform, capital account liberalization, and the liberalization of trade in financial services.

These major financial sector reform efforts are discussed, which began shortly after 1991 with the Narasimham Committee recommendations, and which continued throughout the rest of that decade. This chapter demonstrates how pressures for reform in 1991 came from several directions, but also how external pressures for liberalization have been attenuated by domestic factors. These include union backlashes, public misunderstandings about the process of liberalization, and the quality and capability of India's bureaucrats. This filtering process has allowed India, as a developing country, to retain a high degree of self-determination in the prudential regulation of its financial sector. For example, India has made commitments to liberalize trade in financial services, but has also scheduled conditions on market access by foreign services providers. These conditions are those which arise out of existing prudential laws. The process has also allowed India to pace its liberalization as domestic circumstances have allowed. Over the last decade, several financial reform bills were placed before parliament. These reforms would have eventually been scheduled as commitments in the GATS, but rather were shelved due to their political sensitivity. The chapter next gives a detailed examination of India's banking, insurance, and securities sectors, and brings the discussion up to the present. The chapter finishes up with an examination of special developing country considerations in the WTO's GATS Agreement, India's interests to this point in financial services, and other service sectors that are of

interest for India's economic development.

The financial system in India is significantly different from that of other Asian nations because of the country's unique geographic, social, and economic characteristics. India is a lower-income developing country that has a large population and land size, a diverse culture, and extreme disparities in income, which are marked among its regions.⁵⁰¹ The country's economic policies are driven by a combination of socialistic and capitalistic features with a heavy bias toward public sector investment. This tends to blur the boundary between the public and private realms, based on the government's responsibility in serving the many competing economic and social needs. India's national financial system, then, is one that is dominated by government-administered rules that often have the effect of easing the political problems of gathering support for state-led industrialization.⁵⁰²

These features are reflected in the structure, size, and diversity of the country's banking and financial sector, which is closely associated with India's overall development efforts.⁵⁰³ The banking sector has had to serve the goals of economic policies that are laid out by successive five-year development plans. In particular, the plans focus on equitable income distribution, balanced regional economic growth, and the reduction and elimination of private sector monopolies in trade and industry. In practice, this has included maintaining controls and restrictions on the entry and operation of foreign financial institutions in India.

⁵⁰¹ World Bank, (2002), "Classification of Economies", 5.

⁵⁰² This "credit-based" system was described by Zysman, John, (1983), Governments, Markets, and Growth: Financial Systems and the Politics of Industrial Change, 71.

⁵⁰³ Chadha, B.L., (1995), "Changing Phases of Indian Banking Since 1969: Emerging Scenario", 213.

To serve India's needs, an extensive banking network has been established over the last 30 years, resulting in a banking system that is no longer confined just to the large cities and towns. In terms of the number of branches, India's banking system is one of the largest in the world today.⁵⁰⁴

In order for the banking industry to serve as an instrument of state policy, it was subjected to various nationalization schemes in different phases (1955, 1969, 1980), beginning shortly after India's independence in 1947. As a result of the nationalization initiatives, India's banking sector remained internationally isolated from foreign competition. This was in part due to strict branch licensing controls on foreign banks already operating in the country, as well as entry restrictions on new ones. In addition, the sector has been assigned the role of providing support to other economic sectors such as agriculture and small-scale industry. About 92 per cent of the country's banking segment is under State control while the balance comprises private sector and foreign banks.⁵⁰⁵ Services in general, including financial services, account for about half of India's GDP.⁵⁰⁶

India's development strategy since independence in 1947 until the mid-1980's followed an import-substitution industrialization (ISI) strategy. As part of India's 'planned economy' system, ISI policies kept the economy closed and inward-looking wherein domestic industries, including financial ones, were insulated from global competition through the use of high tariffs and extensive quantitative restrictions (QR's) on the import

⁵⁰⁴ IndiaMart, Finance & Investment Guide, "Investment in India - Banking - Banking System".

⁵⁰⁵ Deolalkar, G.H., (1999), "The Indian Banking Sector: On the Road to Progress", 60.

⁵⁰⁶ World Trade Organization (WTO), Trade Policy Review (TPR), India, 2003, 98.

of goods.⁵⁰⁷ It was assumed by the economic planners that exports could be diversified on the basis of domestic industrial growth. As one writer described it, India has arguably followed the path of growth-led exports rather than the “export-led growth” of other Asian economies, with emphasis on self-reliance through import substitution.⁵⁰⁸ Foreign trade was expected to play a small role in the ISI strategy because it was assumed that the domestic economy was large enough to generate economies of scale in a majority of industrial sectors.⁵⁰⁹ As Patel has noted, in India, “...the plethora of direct controls over investment, production prices, imports, foreign capital and even exports had played havoc with efficiency and, therefore, with growth”.⁵¹⁰

India had a relatively well developed commercial banking system at the time of independence in 1947.⁵¹¹ India’s regulator and supervisor in the banking sector, the Reserve Bank of India (RBI), was established in 1935 and became a state-owned institution in 1949. The Banking Regulation Act of 1949, on which the RBI operated, provided a framework for regulation and supervision of commercial banking. The first step towards nationalization of commercial banks was a report by the Committee of Direction of All India Rural Credit Survey under the direction of the RBI.⁵¹² The Committee recommended one strong and

⁵⁰⁷ International Monetary Fund (IMF), (2002), “India: Selected Issues and Statistical Appendix”, IMF Country Report No. 02/193, 52.

⁵⁰⁸ Deolalkar, G.H., (1999), “The Indian Banking Sector: On the Road to Progress”, 60.

⁵⁰⁹ Kumar, Rajiv, (1993), *The Walk Away From Leadership: India*, 160.

⁵¹⁰ Patel, I.G., (1995), “New Economic Policy: Historical Perspective”, 31.

⁵¹¹ Gilman, Tim, (1992), “India: Opportunities Rise as Barriers Fall”, 3.

⁵¹² Reddy, Y.V., (2002), “Public Sector Banks and the Governance Challenge: The Indian Experience”, 235.

integrated commercial banking institution, to be partnered with the state, and to stimulate the development of banking and rural credit. In 1955, the RBI took over the Imperial Bank and renamed it the State Bank of India (SBI). In addition, a number of other banks were made subsidiaries of the SBI in 1959, a time which marked the beginning of the planned economy in India often termed the 'Plan Era'.

By the mid-1960's, the Indian banking system had made considerable progress, but there was still widespread belief that the close links between commercial banks and big industry was crowding agriculture and small business out of the credit market.⁵¹³ In response to this, the government introduced the concept of 'social control' in the banking industry, which was intended to bring changes to the management and distribution of credit by commercial banks.⁵¹⁴ In part due to the eventual failings of this plan, the government moved to further nationalize more major commercial banks in 1969 and 1980. The objective was to better serve the development needs of the economy in conformity with national priorities and objectives.

The regulatory framework for the banking industry under the Banking Regulation Act was circumscribed by the special provisions of the Bank Nationalization Act of 1970.⁵¹⁵ While the latter Act technically provided for competition between banks and nonbanks and among banks themselves, competition in practice was conditioned by policy as well as the

⁵¹³ Nettimi, N., and Kuruba, G., (2001), "Reforming Banking and Financial Sector in the Context of Economic Restructuring", 43.

⁵¹⁴ Reddy, Y.V., (2002), "Public Sector Banks and the Governance Challenge: The Indian Experience", 236.

⁵¹⁵ Ministry of Finance (India), "Major Functions of the Banking Division", 2.

regulatory environment, common ownership by the government, and agreements between the government and its unionized employees.⁵¹⁶ Before the major reforms, almost all financial intermediation occurred through the public sector banks. Entry was restricted into banking, exit was impossible, and the government combined itself into the roles of owner, regulator, and sovereign.⁵¹⁷

Section II: History of Economic Crisis and Reform Initiatives

This section outlines the inherent problems with India's banks prior to 1991, and the economic conditions that led to the crisis. Most of India's major commercial banks were nationalized in 1969. With the nationalization came a gradual increase in restrictions on entry and expansion of private and foreign banks. This reduced competition either among the public banks, or between the public and private banks, and gradually eroded the spirit of competition from the banking sector.⁵¹⁸ One of the results of this process was the need for a large, inefficient bureaucracy to support the banks.⁵¹⁹ The competitiveness among banks was restricted by entry and exit controls and other restrictions imposed by the RBI in the form of license or branching restrictions. The foreign banks were mostly confined to metropolitan or port areas. They were not permitted to open branches beyond those areas, and were prevented from undertaking certain activities considered to be the privilege of the

⁵¹⁶ Reddy, Y.V., (2002), "Public Sector Banks and the Governance Challenge: The Indian Experience", 237.

⁵¹⁷ Misra, S.N., and Mishra, S., (2001), "Development of Commercial Banking under Financial and Banking Sector Reforms: Problems, Achievements and Prospects", 108.

⁵¹⁸ Nettimi, N., and Kuruba, G., (2001), "Reforming Banking and Financial Sector in the Context of Economic Restructuring", 43.

⁵¹⁹ Pura, Raphael, (1991), "For a Liberalizing India, Now Comes the Hard Part: Financial Deregulation", November 1.

public sector banks.⁵²⁰

Priority sector lending (often termed “priority credit” to “sick industrial units”) was another significant cost to the economy.⁵²¹ It was designed to increase the proportion of credit to those sectors important to the national economy in terms of their contribution to growth, employment generation, and which may not receive credit otherwise. Of the funds deposited in banks, 40 per cent had to be lent to priority sectors at discount rates. Other requirements forced banks to loan to exporting industries and food procurement programs, also at discount rates. This left about 25 per cent of bank deposits to meet the financial needs of all remaining sectors.⁵²² The political control of public sector banks and the lobbying associated with pressure groups resulted in some of the priority sector loans being given without adequate safeguards.⁵²³ Many were not protected against default, and some were used by those for whom they were never intended, or for purposes they were not intended. It was estimated that up to 21 per cent of the loans advanced by the public sector banks were non-performing.⁵²⁴ Non-performing assets (NPA’s) are those which the loan amount is not recovered from the borrower, or payment of either principal or interest are both overdue. In political terms, this issue created contentious debates between elected political officials and RBI technocrats about the extent of their responsibilities for policy-making in the public

⁵²⁰ Mistry, Percy, S., (1995), “Financial Sector Reform in India: Hesitant Pursuit of an Incomplete Agenda”, 180.

⁵²¹ Joshi, Vijay, Little, I.M.D., (1996), India’s Economic Reforms: 1991-2001, 113.

⁵²² Nettimi, N., Kuruba, G., (2001), “Reforming Banking and Financial Sector in the Context of Economic Restructuring”, 43.

⁵²³ Corporate Finance (London), “India”, Foreign Exchange Yearbook, 113.

⁵²⁴ Reserve Bank of India (RBI), (1999), “Towards a More Vibrant Banking System”, by Bimal Jalan, January 9.

sector.⁵²⁵ In the spring of 1990, India's Deputy Prime Minister Devi Lal, riding on popular support, insisted that the budget of his Finance Minister allow for \$ 592 million (USD) to finance rural debt relief. The move challenged the advice of RBI governor R.N. Malhotra, who argued that India's over-stretched banking system was already weighed-down by having to service an extensive branch network, poor quality loans, and an agricultural sector that was not showing the promise of future growth.⁵²⁶

The financial system in India has been a key avenue for government intervention in all sectors of the economy. An important consideration for reforming it has therefore focused on making it compatible with the other structural changes in the economy. In the fall of 1990, a World Bank report pointed to Indian banks' poor profitability, undercapitalization, and government financing as "striking shortcomings that signal danger for the future".⁵²⁷ One specific problem was regulatory oversight. Over the decades, the RBI emphasized its own developmental role at the expense of its regulatory and prudential obligations.⁵²⁸ The regulation of the financial sector for prudential reasons was therefore a secondary concern until most recently. The importance of effective financial regulation has now been recognized, but it remained fragmented and uncoordinated across different sectors in the financial sector. This has resulted in a pattern of development which has fallen behind

⁵²⁵ Personal interview, November 2002.

⁵²⁶ Clad, James, (1990), "Invisible Hand: Dandavate's Debt", 55.

⁵²⁷ Clad, James, (1990), "Don't Bank on It: Report Criticizes Indian Credit System", 59.

⁵²⁸ Mistry, Percy, S., (1995), "Financial Sector Reform in India: Hesitant Pursuit of an Incomplete Agenda", 171.

its international competitors in terms of the quality, cost, and range of its financial services.⁵²⁹

On the one hand, the domestic banking system has been successful at effectively mobilizing domestic resources. On the other hand, it has failed in many respects. It has generally failed to allocate funds efficiently, and it is restricted by government directives regarding systemic and institutional independence.⁵³⁰ The reasons for these failures can be blamed on the government's focus on institutional management and on whether banks were meeting prescribed social and operational targets for credit programs and interest rates.⁵³¹

Financial Sector Problems before 1991

This section outlines some of the specific economic causes leading up to the 1991 crisis, and India's position in the WTO Uruguay Round negotiations in services, which happened concurrently. The section ends with a discussion of how India's treatment of foreign financial institutions has been changing as a result of its commitments in the GATS FSA. Among the financial sector problems that contributed to the 1991 economic crisis in India were the regulatory environment in which the banks functioned, as well as other specific problems with internal organization. These included burdensome reserve ratios, misdirected credit, lax regulation, and the poor organization of the state financial institutions.⁵³² These problems are discussed in turn.

First, Indian banks faced crippling reserve requirements on their funds. Indian banks

⁵²⁹ International Monetary Fund (IMF), (2002), "India: Selected Issues and Statistical Appendix", IMF Country Report No. 02/193, 77.

⁵³⁰ McDonald, Hamish, (1991), "India: Under the Influence", 56.

⁵³¹ Personal Interview, February 2003.

⁵³² Joshi, Vijay, Little, I.M.D., (1996), India's Economic Reforms: 1991-2001, p112-115.

were obliged to satisfy two reserve ratios: the cash reserve ratio (CCR) and the statutory liquidity ratio (SLR).⁵³³ The CCR requires banks to hold part of their deposits in the form of cash balances with the RBI. There have been steep increases in the percentage required since the 1960's, up to around 15 per cent currently. The SLR stipulates the proportion of deposits that banks must hold in the form of government and other approved securities. This also increased over the years. Both of the balances carried considerably lower interest rates than were available on commercial terms. Thus, more than 50 per cent of deposits had to be invested in investments that barely covered the cost of funds, eroding bank profitability.⁵³⁴

Second, the banks are subjected to directed credit and administered interest rates. They are required to direct a sizeable part of their lending to 'priority sectors' at concessional rates of interest.⁵³⁵ After nationalization, the priority sector target was 33 per cent of advances, but it was later raised to 40 per cent. In addition, there were sub-targets for agriculture, small farmers, and the 'weaker sections of society'. Virtually all interest rates offered and charged by banks (and other financial institutions) were stipulated by the government, mainly due to the lack of a developed capital market.⁵³⁶ When the government determines who gets and gives credit and at what terms, the country can be described as operating under "financial repression".⁵³⁷ Until the recent reforms, India had all of the

⁵³³ Nettimi, N., Kuruba, G., (2001), "Reforming Banking and Financial Sector in the Context of Economic Restructuring", 47.

⁵³⁴ Narasimham, M., (1995), "Financial Sector Reforms", 353.

⁵³⁵ International Monetary Fund (IMF), (2002), "India: Selected Issues and Statistical Appendix", IMF Country Report No. 02/193, 76.

⁵³⁶ Corporate Finance (London), "India", Foreign Exchange Yearbook, 113.

⁵³⁷ Such repression was almost universal in developing countries until recently. See Srinivasan, T.N., (2000), "Economic Reforms in South Asia", 125.

characteristics of this. Most commercial banks and insurance companies were owned by the government, and interest rates were controlled. There were selective credit controls and directed lending to priority sectors. The government also required banks to invest more than 50 per cent of their deposits in government securities. Finally, the nationalized banks as well as the RBI had little autonomy in decision making, placing them at a competitive disadvantage by international standards.

Third, the banks were burdened generally by lax regulation and supervision and poor portfolio quality.⁵³⁸ The quality of the banks' loan portfolio since nationalization had deteriorated steadily due to a combination of factors.⁵³⁹ These included inadequate accounting and supervisory rules, as well as high interference in the supervision of banks.

Another problem was the focus on credit allocation targets, which diverted the focus of banks away from key businesses. These credit requirements were also subject to political influence, which contributed to a culture of non-repayment. The weak procedures of the legal system contributed to the problem by making loan recovery very difficult.

Finally, Indian banks faced low internal and organizational efficiency problems as well as a lack of competition.⁵⁴⁰ The low profitability of Indian banks was the result of not only the restrictions on their income-earning opportunities, but also of their high operating costs.⁵⁴¹ This included extreme over staffing, bad industrial relations, and inadequate

⁵³⁸ Nettimi, N., Kuruba, G., (2001), "Reforming Banking and Financial Sector in the Context of Economic Restructuring", 43.

⁵³⁹ Ahluwalia, Montek, S., (1999), "India's Economic Reforms: An Appraisal", 69.

⁵⁴⁰ Joshi, Vijay, Little, I.M.D., (1996), India's Economic Reforms: 1991-2001, 111.

⁵⁴¹ Personal interview, November 2002.

incentives for managerial competence. There is a large number of banks in India but there has been little competition between them. The public sector banks have had no incentive to compete. Furthermore, competition was inhibited by regulated interest rates and it was difficult for consumers to switch banks. All of these factors resulted in a banking system that was ill-suited to normal banking functions.

India's economic situation was characterized by high inflation, growing fiscal deficits, and widening balance of payments deficits.⁵⁴² The government had been engaging in excessive external borrowing to finance its deficits and low-return public-sector investments over the 1980's which led to the build-up of foreign debt and the balance of payments crisis of 1991.⁵⁴³ In addition, the open trade regime introduced by the Gandhi administration from the mid-1980's is thought to have had an adverse impact on the Indian economy.⁵⁴⁴ These problems needed to be corrected before the financial sector restructuring could begin. Financial liberalization was the prescription to cure these problems and involved a switch to market-determined interest rates and credit allocation, along with reforms of the financial system and banking sector.⁵⁴⁵ The political debate of the time focused around the way banking reform would be best accomplished. Rather than the full-privatization road, officials opted for improvements to the existing system based on the interest of the government which aimed to "serve social institutions" and its "commitments

⁵⁴² Gupta, Arjun Sen, (1995), "Sustainable Economic Reforms", 77-78.

⁵⁴³ Trade & Development Centre, Trade and Development Case Studies: India, part 3: Investment, Growth and Services, 1.

⁵⁴⁴ Aggarwal, S.K., (1998), "Indian Economy Comes of Age".

⁵⁴⁵ Werner, Richard, A., (1999), "Indian Macroeconomic Management: At the Crossroads Between Government and Markets", 3.

to the alleviation of poverty.”⁵⁴⁶

Most of the high growth during the 1980's was based on domestic demand and was generated by the consumer goods sector. The growing openness to the world market resulted in gains in the resource and labour-intensive sectors at the expense of the technology and capital-intensive sectors. Compounding the problem, the increasingly liberal trade regime left the Government with fewer policy tools to reign in the current account deficit.⁵⁴⁷ Until the 1980's, balance of payments crises were met mainly by the imposition of tariff and non-tariff barriers to imports. However, the policy of deregulation and tariff reduction that began in the mid-1980's blocked this traditional avenue.⁵⁴⁸ The approach to financial sector reform in India has been piecemeal and incoherent and the various efforts that have taken place have not fit logically into a framework for holistic financial sector reform.⁵⁴⁹ Moreover, there appears to have been no commitment either on the part of the government or of financial institutions to use the reform process as an opportunity to transform the financial sector into one that is internationally competitive and one that could be a significant source of growth.⁵⁵⁰

During this time, the Uruguay Round of multilateral trade negotiations was also taking place. In its role as a spokesperson for the developing countries and a key developing

⁵⁴⁶ Pura, Raphael, (1991), “For a Liberalizing India, Now Comes the Hard Part: Financial Deregulation”, November 1.

⁵⁴⁷ Wall Street Journal, “World Bank, IMF Continue to Support India’s Reform Effort”, Dec. 21, 1992, A5C

⁵⁴⁸ Werner, Richard, A., (1999), “Indian Macroeconomic Management: At the Crossroads Between Government and Markets”, 3.

⁵⁴⁹ Mistry, Percy, S., (1995), “Financial Sector Reform in India: Hesitant Pursuit of an Incomplete Agenda”, 175.

⁵⁵⁰ Ibid., 176.

country, India originally objected to the inclusion of services in the negotiations.⁵⁵¹ Initially India claimed there was no benefit from opening up the financial services sector, and feared that it might result in a linkage of trade-offs between the goods and services sectors, giving it a disadvantage. The Indian market was focused on agricultural and clothing exports, but had little interest opening its domestic market to foreign service providers. Moreover, India contended that the Uruguay Round had only served the interest of the developed countries by negotiating capital movement, whereas the area of labour movement was totally ignored. After strong persuasion and pressure from the US, based on a threat of a failed or weak agreement in financial services, India offered 'modest' commitments in services.⁵⁵² Specifically, this included an offer to open its banking sector to foreign countries, even to those without reciprocal deals in financial services, a condition previously applied by India.⁵⁵³ In the GATS, India took the view that commitments should be achieved through successive rounds of multilateral negotiations, with flexibility for its members. Hence, in its schedule of commitments, India states that its commitments are subject to entry requirements, domestic laws, rules and regulations and the terms and conditions of the RBI, SEBI, and any other competent authority.⁵⁵⁴

India's leadership role among developing countries was still somewhat effective

⁵⁵¹ Siddiqui, Jamshed, A., (1994), "GATT: The Indian Paradigm", 99.

⁵⁵² Adolf, Huala, (2000), "Financial Services Agreement of the GATS: The Developing Countries' Perspective", 210.

⁵⁵³ Wall Street Journal, "WTO Nears Pact on Financial Services as US Position Remains up in the Air", December 12, 1997.

⁵⁵⁴ World Trade Organization, Schedules of Specific Commitments, India, GATS/SC/42/Suppl.4.

despite the fact that India's role in this regard had been declining because of political and economic weaknesses leading up to the 1991 crisis. The Indian government also began to question the costs of sustaining its leadership role when it was realized that it was becoming a distraction from other more urgent domestic problems.⁵⁵⁵ Although it made no attempt to renegotiate the final draft of the GATS towards its own interests, government statements from the time offered support for it.⁵⁵⁶ This was part of a move by India to soften its traditional hostility towards the US, and move away from its path of socialist self-sufficiency.⁵⁵⁷ Among the developing countries, there was a growing lack of unity on common interests, which resulted in a weakened influence in the negotiations.⁵⁵⁸ A large number of them had begun to embrace trade liberalization as part of an outward-oriented development strategy, and were focusing their efforts on domestic unilateral reform.⁵⁵⁹

When the domestic economic reforms began in India in 1991, policymakers began to rethink the benefits of parallel liberalization between the domestic reforms and the liberalization in the Uruguay Round. The strategy also changed somewhat, based on the idea that opposition to the inclusion of services could be used as a bargaining chip, to ensure that issues of interest to developing countries remained on the table.⁵⁶⁰ This growing support among the policymakers for the Uruguay Round, and the potential impact the Agreement

⁵⁵⁵ Kumar, Rajiv, (1993), *The Walk Away From Leadership: India*, 167.

⁵⁵⁶ Dubey, Muchkund, (1996), *An Unequal Treaty*, 9.

⁵⁵⁷ Wall Street Journal, "India's Reforms Unleash Storm", February 25, 1992, A14.

⁵⁵⁸ Dubey, Muchkund, (1996), *An Unequal Treaty*, 5.

⁵⁵⁹ *Ibid.*, 11.

⁵⁶⁰ *Ibid.*, 10.

might have, however, was not well communicated to the people. The result was that the perceptions about what the Uruguay Round represented in the eyes of Indian society remained negative. Many Indians believed that the GATT would sacrifice the country's sovereignty in agricultural policies and raise the price of patent drugs.⁵⁶¹ Since a significant portion of India's economic reforms had been funded by the IMF, there was a belief that the government was bowing to foreign pressure and that the GATT was more generally a foreign conspiracy to exploit the third world.⁵⁶²

The 1991 Economic Reforms

This section details the measures that were implemented as part of the 1991 reform package, and some of the influences for reform. Economic reform in India began in the midst of a macro-economic crisis. The reform package, however, was exclusively the result of indigenous initiatives both within and outside the government, as reflected in the incremental nature of the reforms. The Narasimham Committee was appointed by the Government of India in 1991 to suggest reforms to improve the functioning of the financial sector.⁵⁶³ In India, financial sector reform is virtually the same as banking sector reform because more than 80 per cent of the funds flowing through the financial sector are accounted for by the banking system.⁵⁶⁴ In the early 1990's, banking reform proceeded in two phases. The first phase was launched in 1992 following closely on the recommendations of

⁵⁶¹ Economist, "Where India's Reforms Get Stuck", January 22, 1994, 2.

⁵⁶² Economist, "India: Seeds of Discord", April 2, 1994, 36.

⁵⁶³ Government of India (1991), "Report of the Committee on the Financial System", (Chairman Narasimham), Ministry of Finance, New Delhi.

⁵⁶⁴ Werner, Richard, A., (1999), "Indian Macroeconomic Management: At the Crossroads Between Government and Markets", 3.

the Committee on Financial System (CFS) in November 1991. The Committee suggested a greater role for market forces and more autonomy for the financial institutions in order to increase efficiency and productivity. Specifically it focused on interest rate liberalization, the strengthening of bank supervision and prudential supervision, increased competition in the banking sector, and a modification of the political environment through changes to the degree of government intervention in the banking system.⁵⁶⁵

Several measures were implemented in line with the CFS report. They focused on several specific areas: de-controlling interest rates; bringing accounting practices in line with international standards; easing the licensing of bank branches; introducing prudential norms for assets and non-performing loans in public sector banks; and phasing-in an 8 per cent capital/risk-weighted assets adequacy requirement based on the Basel Committee norm.⁵⁶⁶ In terms of organizational structure, the Board for Financial Supervision (BFS), which is part of the RBI, was created in 1992 to enhance the supervision of banking and to monitor and evaluate bank performance based on the new prudential standards. The reforms were intended to be taken sequentially and incrementally, rather than implemented as a full-blown package of liberalization and stabilization. The size of the country, the uneven nature of domestic development, and a political tradition of consensus was thought to have necessitated this approach.⁵⁶⁷ The reforms didn't reach full stride until the end of March 1995.⁵⁶⁸

⁵⁶⁵ Ahluwalia, Montek, S., (1999), "India's Economic Reforms: An Appraisal", 67.

⁵⁶⁶ Warner, Alison, (1993), "India: Private Passions", 52.

⁵⁶⁷ Kumar, Rajiv, (1993), *The Walk Away From Leadership: India*, 161.

⁵⁶⁸ Joshi, Vijay, Little, I.M.D., (1996), India's Economic Reforms: 1991-2001, 117.

In July 1993, the RBI announced guidelines for the entry of new banks. These guidelines were intended to ensure that the new entrants were well capitalized, technologically advanced, and met the 8 per cent capital adequacy norm. The business share of private sector banks and foreign banks increased from around 11 per cent in 1991-92 to 18 per cent in 1996-97.⁵⁶⁹ The government also wanted to be sure new banks were not involved with cross-holdings with other industrial groups. In general, however, the RBI continued to pursue a restrictive policy in regards to new banks opening additional branches. In India, the case for some level of privatization in banking is especially strong. This is because it is clear that public ownership has virtually paralyzed the efficiency of banks due to political and administrative interference in the allocation of credit.

On the basis of the recommendations of the Narasimham Committee, the government's response to these problems was threefold.⁵⁷⁰ First, with sensitive labour concerns in mind, it took steps to expand private sector equity in banks while maintaining state ownership. The Banking Acts were amended in 1994 to allow banks to raise private equity up to 49 per cent. Second, it gave money to banks out of budgetary funds and World Bank loans. This was done to give them more financial strength so they could participate in capital markets. Finally, it has tried to put in place new rules for the constitution of bank boards to give them a more professional orientation, and to allow representation for private shareholders. On the political front, many Indians argued that the pace of reform was

⁵⁶⁹ Ahluwalia, Montek, S., (1999), "India's Economic Reforms: An Appraisal", 69.

⁵⁷⁰ Narasimham, M., (1995), "Financial Sector Reforms", 362-365.

moving too fast and that it was effectively only helping 10 per cent of the population.⁵⁷¹ Much of this sentiment was based on concerns about corruption in India's Congress Party, named the "black-money party" by some, referring to millions of dollars in pay-offs for favours for members of the ruling party.⁵⁷²

There are three possible explanations for the initiation and consolidation of the reform process in India in 1990-1991. First is the operations and impact of international markets in goods and finance. During the 1980's, serious problems began to aggravate India's economic position.⁵⁷³ As the balance of trade worsened, the external debt continued to rise, and the servicing of that debt became an increasing burden. This overall deterioration in India's external economic relations provided the background for the crisis that emerged in 1990-91. In addition, as a result of the Gulf crisis, India's payments for imported oil rose dramatically. The economic crisis made a response from the Indian government an absolute necessity and it is an important explanation of the timing of new policy measures.

Second, it may be possible that some external influence for reform came through a direct exercise of power, or leverage, in negotiations between foreign actors and the Indian government. The most important international actors are the IMF and the World Bank, both of whom entered into negotiations with the Indian government because of the need for

⁵⁷¹ Wall Street Journal, "India Reforms: Damned with Faint Praise", Tuesday May 14, 1996, A17.

⁵⁷² Wall Street Journal, "India's Reforms Excite Growth, Not Voters", Friday April 26, 1996.

⁵⁷³ Brahmananda, P.R., (1995), "The New Economic Policy: Rationale, Progress, Effects and Required Change", 42-43.

financial resources that arose during the 1990-1992 economic crisis.⁵⁷⁴ The outcome of these talks was India's formal commitment to a plan for structural adjustment initiated in July 1991. However, historical evidence and the events following the introduction of the reforms indicate that while the external pressure had an influence on the timing of the reforms, it was far less important than is often stated.⁵⁷⁵ For example, the Indian government only accepted and implemented policies for which there was already willing acceptance. Furthermore, the events following the initial reforms show how India deviated from the IMF/World Bank prescriptions. For example, India privatized state enterprises, reduced the work force employed in public enterprises and public bureaucracies, and failed to press to reduce the public deficit. These were all measures of defiance from the IMF program.⁵⁷⁶

There is also another angle to this argument which deals with the international trade regime. Those who support the idea that external influence was a key factor explaining India's Uruguay Round commitments suggest that the developing countries, including India, were forced by the conditions of the negotiations to accept its generally far-reaching and one-sided commitments.⁵⁷⁷ However according to Winham, while India and other developing countries were apt to accept the terms of the Uruguay Round in order to maximize their potential benefits from it, it was not that case that pressures from outside India forced these

⁵⁷⁴ Wall Street Journal, "World Bank, IMF Continue to Support India's Reform Effort", Dec. 21, 1992, A5C

⁵⁷⁵ Pedersen, Jorgen, Dige, (2000), "Explaining Economic Liberalization in India: State and Society Perspectives", 274.

⁵⁷⁶ *Ibid.*, 274.

⁵⁷⁷ See for example, Muchkund, Dubey, (1996), An Unequal Treaty: World Trading Order After GATT, 133.

changes.⁵⁷⁸ He suggests that “Countries negotiate to create a favourable international policy environment, and they are influenced more by the nature of an agreement they can attain than by the structural nature of the situation they encounter. Above all, countries seek to establish an international regime compatible with the domestic regime.”⁵⁷⁹

Finally, and contrary to explanations that focus exclusively on the state elite or pressures from the international economy, it can be argued that the impetus for reform came from a new breed of Indian entrepreneur.⁵⁸⁰ There has been a gradual emergence of a more ‘modern’ and technologically advanced segment among all sizes of Indian industries. This included a gradual movement toward a system of professional managers in contrast to the traditional family-based system. In addition, many of the younger generation of industrial managers had traveled abroad for their management education. These changes amounted to a sort of ‘quiet revolution’ in the political organization in Indian industry, and happened in concert with the rise in prominence of the Confederation of Indian Industry (CII). The CII became representative of a new type of industrial establishment that was smaller, more professionally managed, and more oriented toward modern technologies than traditional Indian companies. This was in contrast to the other industrial bodies, The Associated Chambers of Commerce and Industry (Assocham) and The Federation of Indian Chambers of Industry and Commerce (FICCI). Both of these bodies were established long before

⁵⁷⁸ Winham, G.R., (1998), “Explanations of Developing Country Behaviour in the GATT Uruguay Round Negotiation”, 131.

⁵⁷⁹ *Ibid.*, 133.

⁵⁸⁰ Pedersen, Jorgen, Dige, (2000), “Explaining Economic Liberalization in India: State and Society Perspectives”, 266.

independence. Assocham represented British and other foreign-controlled industrial enterprises, but became less influential compared to FICCI, a body which mainly acted as the representative of traditional Indian-controlled large industries. The important point is that this emergence of new organized industrial interests coincides with, and may indeed have been decisive in the introduction and persistence of economic reform in the 1990's. In the years prior to the 1990-91 reforms, the CII had been prominent in the debates on the economic reforms and it strongly supported the liberalization measures of the reforms. The organization had been quite close to the Ministry of Finance and had been quite receptive to the CII's advice.

Section III: Approach to Modern Financial Sector Reform and Evaluation

Narasimham II

In 1997, the government appointed a second committee to review what had been accomplished since the first phase of reforms, and to chart an agenda for a second stage of banking sector reforms. The second phase was launched in October 1997 by RBI Governor C. Rangarajan, and is often referred to as Narasimham II. It was aimed at further improving financial soundness and credibility of banks, creating a competitive environment, and strengthening the institutional framework. Since the Asian financial crisis in 1997 and other emerging market crises that have occurred, the pace of reform in India has slowed.⁵⁸¹

The second phase of the Narasimham reforms were instituted in April 1998 on the basis of the report of the Committee on Banking Sector Reforms. It suggested further

⁵⁸¹ International Monetary Fund (IMF), (2002), "India: Selected Issues and Statistical Appendix", 55.

deregulation and liberalization of the banking system, together with further tightening of prudential requirements. The report asserted that recent developments in Asia had ‘served to reinforce the point that a strong and efficient financial system is necessary both to strengthen the domestic economy and make it more efficient and also enable it to meet the challenges posed by financial globalization’.⁵⁸² It directed criticism at the problem of non-performing assets (NPA’s), and blamed the policies of directed credit. When banks are required by directive to meet specific targets, for example, it risks the erosion of the quality of its loan portfolio.⁵⁸³ The Committee also recommended the continuation of licensing of new private banks and allowing foreign banks to set up subsidiaries or joint ventures in India. Finally, the Committee argued for increased RBI independence and that it should be made independent of government.

While the Indian financial sector seemed to have escaped relatively unharmed from the 1997 Asian financial crisis, it neglected to correct the problems of hidden losses, political meddling, and weak bankruptcy laws.⁵⁸⁴ One of the first solutions was drawn from the bank consolidation seen happening in other Asian countries like Singapore and Korea. This was also one of the reform recommendations of the Narasimham Committee.⁵⁸⁵ Larger institutions resulting from mergers arguably offer the benefits of more efficiency by reducing staff and other inefficiencies. In India, consolidation is thought to be an appropriate solution

⁵⁸² Reserve Bank of India (RBI), (1999), “Towards a More Vibrant Banking System”, by Bimal Jalan, January 9, 2.

⁵⁸³ Werner, Richard, A., (1999), “Indian Macroeconomic Management: At the Crossroads Between Government and Markets”, 6.

⁵⁸⁴ Slater, Joanna, (2001), “What India Could Learn From East Asia”, 51.

⁵⁸⁵ Reserve Bank of India, (1999), “March to the New Millennium by Indian Banks”.

due to the large number institutions - 27 different public institutions which could be reduced into six.⁵⁸⁶ In early 2001, some banks were testing the government's willingness to approve mergers. Major foreign banks such as Citigroup and ABN Amro have also shown interest in India's retail banking market, and hence the purchase of either private or state-owned banks.⁵⁸⁷

In December of 2000, the government tried to change the existing banking legislation in order to ease the way for mergers. It introduced a bill intended to cut the government's stake in public-sector banks from 51 per cent to 33 per cent.⁵⁸⁸ The bill sought to allow the free transfer of shares held by the government, so as to encourage acquisitions, mergers, and financial restructuring. If the bill passed, the government planned to set up a financial restructuring authority to take over the management of weak banks. These are strong measures by Indian standards and there is significant popular hostility to privatization. On December 21st 2000 the bank unions went on strike causing chaos. The bill was passed on to a standing committee, the Indian parliament's version of passing it into oblivion.⁵⁸⁹

An Evaluation of the Economic Reforms

Economic reforms in India since they were initiated in 1991 have not been pursued with due attention. In particular, measures that were aimed at encouraging entry by domestic

⁵⁸⁶ Slater, Joanna, (2001), "What India Could Learn From East Asia", 51

⁵⁸⁷ Economist, (2001), "India's Banks: Living Dead", 68.

⁵⁸⁸ Reserve Bank of India (RBI), (2001), "Financial Market Structure", in Report on Currency and Finance, RBI, January 29, 2.

⁵⁸⁹ Economist, (2001), "India's Banks: Living Dead", 68.

private banks and foreign banks seemed to be lacking in intent.⁵⁹⁰ Effective barriers to entry remain high. Until the public banks have had their finances restructured and augmented their equity base on capital markets, no serious competition is likely to be permitted.⁵⁹¹ Arguably, the authorities and the Narasimham Committee approached the 'leveling the playing field' idea not from the viewpoint of creating a competitive environment for healthy banks, but from that of debilitating new private entrants to prevent them from providing competition of the kind needed in the banking industry.⁵⁹² Rather than streamlining, restructuring, rationalizing and re-capitalizing the public banks, the authorities have imposed capital requirements and priority portfolio restrictions on new private entrants to level the handicap rather than level the playing field.

Relative to the new foreign bank entrants, the public banks in India have had the advantage of an established customer base, total market dominance, and an immense urban branch network. New entrants, provided they meet minimum standards, are burdened with the same priority lending targets or branch opening restrictions.⁵⁹³ In keeping with the recommendations of the Narasimham Committees and current international trends, domestic and foreign banks should be encouraged to expand as rapidly as their internal resources permit, applying the best technology and practices in the industry. Yet in governing the financial sector, the authorities seem to be overly ambivalent about the idea of permitting

⁵⁹⁰ Mistry, Percy, S., (1995), "Financial Sector Reform in India: Hesitant Pursuit of an Incomplete Agenda", 185.

⁵⁹¹ Personal interview, November 2002.

⁵⁹² Singh, Shrawan Kumar, (1995), "Banking Sector Reforms in India During 1990s", 209.

⁵⁹³ Personal interview, November 2002.

market forces to play a modest role in facilitating reforms through enhanced competition.⁵⁹⁴ This is especially true in the case of foreign banks. Their minimum capital requirement was raised to US\$25 million, but their rate of branch opening is still tightly restricted by the RBI. With other constraints applied to their operations such as priority lending, it was virtually impossible for a new entrant, confined to just one branch, to earn a viable return on investment and compete with entrenched foreign banks which have much wider branch networks.⁵⁹⁵ At the time, these entry requirements were much higher than in any other Asian country, and appeared to signal the government's intent to keep foreign banks out rather than ease them in.⁵⁹⁶

The reforms of 1991 and 1998 have changed some aspects of the way banks have been functioning in India. Higher prudential standards force banks to actively seek higher quality borrowers in order to improve their asset quality. Quality borrowers also are able to demand better terms because of the competition among banks, and also because the opening up of both domestic and foreign capital markets allows them to look for cheaper sources of funds outside the banking system.⁵⁹⁷ This should improve the overall efficiency of the system, but the reforms still have a long way to go. For example, existing prudential norms need to be further tightened and fully aligned with international practice. Also, a liberalized and more open economy with freer capital flows can place heavy demands on the banks and

⁵⁹⁴ Mistry, Percy, S., (1995), "Financial Sector Reform in India: Hesitant Pursuit of an Incomplete Agenda", 185.

⁵⁹⁵ Personal interview, February 2003.

⁵⁹⁶ Mistry, Percy, S., (1995), "Financial Sector Reform in India: Hesitant Pursuit of an Incomplete Agenda", 186.

⁵⁹⁷ Ahluwalia, Montek, S., (1999), "India's Economic Reforms: An Appraisal", 69.

the system in general. This will require banks to develop better risk appraisal skills.⁵⁹⁸ Improvements in India's legal system relating to debt recovery also needs further improvement. Efficient banking requires a credible threat of legal action to force recovery from borrowers.⁵⁹⁹ India's legal system in these areas needs massive improvement.

It is also seen as necessary to free the public-sector banks from government interference.⁶⁰⁰ In India, political interference is part of the explanation for the persistent problem of bad loans, many of those given to "priority" sectors. One director from a ratings agency in Singapore characterized this problem in India stating: "It's an open secret that many of these projects that used to be funded had compulsions other than commercial considerations."⁶⁰¹ The political leverage of Indian politicians, looking after their clients and patrons, has been harmful to the health of the banking system. This fact, along with their job protection protected by regulation, court judgements and judicial delays, gives the banks little in the way of legal recourse for loan recovery.⁶⁰² It also meant that banking reform, if it was to be initiated at all, would have to begin with the entrenched political appointees in the RBI, rather than the bureaucrats themselves. As one Indian finance official explained: "The problem is parliamentary control of the banking system."⁶⁰³

⁵⁹⁸ Ahluwalia, Montek, S., (1999), "India's Economic Reforms: An Appraisal", 70.

⁵⁹⁹ Personal interview, November 2002.

⁶⁰⁰ Slater, Joanna, (2001), "What India Could Learn From East Asia", 51.

⁶⁰¹ Ambreesh Srivastava, director at Fitch, Singapore, quoted in Slater, Joanna, (2001), "What India Could Learn From East Asia", 52.

⁶⁰² McDonald, Hamish, "India: Under the Influence", 56.

⁶⁰³ Pura, Raphael, (1991), "For a Liberalizing India, Now Comes the Hard Part: Financial Deregulation", November 1.

The government's efforts to reduce the amount of state ownership in commercial banks has been seen to be a positive move. However, it is still unclear to what extent private institutions will be willing to invest in the Indian banking sector, when the government hopes to retain the public sector character of banks.⁶⁰⁴ As the World Bank indicates, state control over financial institutions has led to their progressive deterioration everywhere.⁶⁰⁵ The reason for removing the public sector involvement in the financial sector is so the state can focus on safeguarding people's funds through good governance and regulation, not by running the banks itself. In this respect, the Indian government appears to be wrestling with the proper balance it wants to maintain between on the one hand, liberalizing the financial sector for all of the gains that can offer, and on the other hand keeping in place sufficient prudential regulation and control to achieve its social objectives.

Section IV: India's Banking, Insurance, and Securities Sectors and Modern Reforms

This section briefly describes India's banking and financial services regulators, supervisors, and administrations. It then gives a detailed description of the banking, insurance, and securities sectors in India, with a particular focus on how those sectors have been affected by the GATS FSA. The RBI is the main regulator and supervisor for banking operations in India. It also administers the government's monetary policy, and is responsible for granting licenses for new bank branches. The economics department of the RBI is large and is regarded as competent, with the top echelons of the RBI being more liberal and

⁶⁰⁴ Personal interview, November 2002.

⁶⁰⁵ Nishimizu, Mieko, (2002), "Adapting India's Financial Sector to a Globalizing World", 1.

realistic than the Indian government as a whole.⁶⁰⁶ As one banker noted: “The RBI has pretensions to be on par with other regulators around the world. I think they are embarrassed as hell by the state of the Indian banking system, which has become a talking point around the world. They are keen to develop a more stable system.”⁶⁰⁷ The Banking Division of the Ministry of Finance administers government policies having a bearing on the working of public sector banks and other financial institutions.⁶⁰⁸ Most of the financial services ‘policy’ is created by the Ministry of Commerce in New Delhi, where the small number of financial services negotiators are based. Think tanks and other related institutions in India tend to be excellent for related policy analysis and advice, and they actually make policy which is used by the government.⁶⁰⁹

Banking

The Indian banking system has three tiers. These are the commercial banks, the regional rural banks, and the cooperative and special purpose rural banks. There are approximately 80 commercial banks, Indian and foreign. There are almost 200 regional rural banks, and more than 350 central cooperative banks, 20 land development banks, and a number of primary agricultural credit societies. This chapter focuses on the commercial banks because in terms of business, they dominate the banking sector.⁶¹⁰ The commercial

⁶⁰⁶ McDonald, Hamish, “India: Under the Influence”, 56.

⁶⁰⁷ Quoted in McDonald, Hamish, “India: Under the Influence”, 56.

⁶⁰⁸ Ministry of Finance (India), “Major Functions of the Banking Division”, in “A Brief on Banking Sector Reforms in India”.

⁶⁰⁹ Personal interview, October 2002

⁶¹⁰ Reserve Bank of India (RBI), (2001), “Financial Market Structure”, in Report on Currency and Finance, RBI, January 29, 2.

banks include mostly the biggest Indian banks that were nationalized in 1969 (publicly-owned), but numerous foreign-owned and privately Indian-owned commercial banks also exist. Several of these public sector banks have been restructured, including a reduction in government ownership. This is mainly because the public sector banks have shown variable performance, with only a few being consistently profitable.⁶¹¹ The allowable limits of foreign participation in these nationalized banks has been slowly increasing, so they are effectively being privatized.

Most of India's public banks are well behind foreign banks in the areas of customer funds transfer and clearing systems.⁶¹² They are hugely over-staffed and are unable to compete with the new private banks that are now entering the market. While these new banks and foreign banks still face restrictions in their activities, they are well-capitalized and use modern equipment and attract high-caliber employees. The publicly-owned commercial banks face stiff restrictions on the use of both their assets and liabilities. Most notably, 40 per cent of loans must be directed to "priority sectors", and the high liquidity ratio and cash reserve requirements severely limit the availability of deposits for lending.⁶¹³ These sectors consist largely of agriculture, exporters, and small businesses. Foreign banks are required to make 32 per cent of their loans to these priority sectors.⁶¹⁴ Foreign banks, however, are not required to open branches in rural areas, or make loans to the agricultural sector.

⁶¹¹ Corporate Finance (London), "India", Foreign Exchange Yearbook, 113.

⁶¹² Personal interview, November 2002.

⁶¹³ Reserve Bank of India (RBI), (2001), "Financial Market Structure", in Report on Currency and Finance, RBI, January 29, 2.

⁶¹⁴ Ibid.

Foreign banks in India, once established, are subject to most of the same regulations as scheduled banks. There are some exceptions, and they are described in the following section. Most importantly, however, they are permitted to accept deposits and provide credit in accordance with the banking laws and RBI regulations.⁶¹⁵ The RBI holds the opinion that all banks in India, whether public or private, foreign or domestic, are subject to broadly the same set of rules and operate essentially on a level playing field. As of March 2002, twenty-five foreign banks had full banking licenses, operating more than 150 branches in India.⁶¹⁶

The systemic flaws which have been pointed out in India's banking sector may not forecast the same kinds of difficulties that occurred in the 1997 East Asian financial crisis. The Indians suggest that it was the financial sector that caused the sensational meltdown of some Asian nations, but note that their situation is somewhat different than Thailand, Indonesia, or Korea.⁶¹⁷ In India, for example, borrowed investment in property is relatively small, and property prices have already fallen, in a sense, letting out the steam gently.⁶¹⁸ Essentially, a micro-meltdown in India has already been happening. Other worries about the Indian banking sector deal with issues of ownership and control. India is now applying the norms of developed countries and as a result, many banks (including some of the biggest) are

⁶¹⁵ Economist Intelligence Unit (EIU), "Country Finance India, "Foreign Banks", 31 August, 2000.

⁶¹⁶ Reserve Bank of India (RBI), Branch Banking Statistics - Volume 3 : March 2002

⁶¹⁷ Slater, Joanna, (2001), "What India Could Learn From East Asia", Far Eastern Economic Review, 164, 36, p50.

⁶¹⁸ Nettimi, N., and Kuruba, G., (2001), "Reforming Banking and Financial Sector in the Context of Economic Restructuring", 49.

expected to show very poor return ratios and dozens of banks will be bankrupt.⁶¹⁹ When this happens, the two popular reasons to save defend bad banks will disappear. These are: first, to save face in the remote hope that fortunes will change, and second, some big banks are 'too big to fail', fearing social upheaval.

Another systemic flaw is thought to be the opacity of the RBI.⁶²⁰ The actual conditions of India's banks are less publicized because they are still largely owned, controlled, and directed by the Ministry of Finance (MoF). In reality, there is no reliable data about the non-performing assets of financial institutions and banks.⁶²¹ Some data, however, is now published, and this puts additional pressure for others to share information. Although efforts have been ongoing to introduce competition in the banking sector, the sector still needs further restructuring to bring regulation and supervision closer to international best practices.

India's national banks have been burdened by standards of public accountability which may be inconsistent with the degree of flexibility needed for reforms. The Committee on Banking Sector Reforms helped somewhat by recommending that the government's equity holding should be reduced to between 33 and 50 per cent, a change that would move toward freeing the banks from government ownership.⁶²² In the fall of 2000, government bank workers staged a one-day strike to express their discontent with the government's plans

⁶¹⁹ International Monetary Fund (IMF), (2002), "India: Selected Issues and Statistical Appendix", IMF Country Report No. 02/193, September, Washington, D.C. 76.

⁶²⁰ Personal interview, October 2002.

⁶²¹ Institute of International Bankers, (2002), "Global Survey 2002: Regulatory and Market Developments", 85.

⁶²² Ahluwalia, Montek, S., (1999), "India's Economic Reforms: An Appraisal", 70.

to privatize. While the government didn't change its plans, it limited the purchase of any single investor to 1 per cent and promised to maintain the "public character" of the banks.⁶²³ The decision to privatize and solve these problems needs to be made with caution. On the one hand, the financial and social dislocations that would occur with privatization would be beyond the ability of any government in the present political climate to manage.⁶²⁴ On the other hand, retaining the public ownership structure may mean that banks will be unable to free themselves of unwanted public and political control. It is believed that an important step in solving this dilemma is to make the RBI itself an independent institution with enhanced supervisory powers, and constitutionally protected from the government or political interference.⁶²⁵

Foreign Banks

The Reserve Bank of India (RBI) issued guidelines in January 1993 under which new private sector banks may be established.⁶²⁶ Approval has been granted for operation of 25 new foreign banks and bank branches since June 1993. Foreign bank branches and representative offices are permitted based upon reciprocity, economic and political bilateral relations, and India's estimated or perceived need for financial services.⁶²⁷ As a result, access

⁶²³ Wall Street Journal, "The Rigors of Cracking India's Markets — Reforms are Tantalizing, But Continued Debates Cool Investor Ardor", A25.

⁶²⁴ Mistry, Percy, S., (1995), "Financial Sector Reform in India: Hesitant Pursuit of an Incomplete Agenda", 181.

⁶²⁵ Reddy, Y.V., (2002), "Public Sector Banks and the Governance Challenge: The Indian Experience", 244.

⁶²⁶ Joshi, Vijay, Little, I.M.D., (1996), India's Economic Reforms: 1991-2001, 149.

⁶²⁷ IndiaMart, Finance & Investment Guide, "Investment in India - Banking - Banking System".

for foreign banks has traditionally been quite limited. They operated under restrictive conditions including tight limitation on their ability to add sub-branches or additional automated teller machines (ATM's), which were both granted on the basis of restrictive laws.⁶²⁸ Operating ratios were determined on the local capital of foreign branches, rather than on the global capital of the parent institution. In order to enhance competition, the RBI announced the entry of small-scale private banks outside metropolitan areas beginning in 1996. However, foreign banks receive better than national treatment with respect to priority-sector lending.⁶²⁹

On signing onto the Fifth Protocol to the GATS in 1998, India made a few liberalizing commitments in banking over its Uruguay Round schedule.⁶³⁰ This provided for a greater role for foreign banks starting in January 1999.⁶³¹ This was important because it reflected the fact that the government was now more decisive about allowing greater foreign participation in the domestic market. India also committed to Most Favoured Nation status in the GATS, effective January 1999, for all financial services sectors, dropping a previous MFN exemption. Previously, the entry criteria for foreign banks had been based on reciprocity, and economic and political bilateral relations.⁶³² India's WTO restrictions and commitments in banking are further discussed below in Section V.

⁶²⁸ See WTO, Schedules of Specific Commitments India, GATS/SC/42/Suppl.4.

⁶²⁹ WTO, Trade Policy Review (TPR), India, 1998, 156.

⁶³⁰ With minor improvements, these had already been scheduled as part of India's financial services commitments in the 1995 interim financial services agreement.

⁶³¹ World Trade Organization (WTO), Trade Policy Review (TPR), India, 2002, 121.

⁶³² India Finance & Investment Guide, "Investment in India - Banking - Banking System", India MART, January 2nd, 1999.

Entry requirements for banks were changed again in January 2001.⁶³³ Among the changes made, the RBI raised the minimum capital adequacy ratio requirement from 8 to 10 per cent. Foreign direct investment of up to 49 per cent of a bank's equity is now permitted. New banks are also required to open one-quarter of their branches in rural/semi-urban areas. To avoid some of these restrictions, foreign banks tend to use a consortium of banks, which includes at least one Indian bank. The traditional role for foreign banks operating in India has been to meet the needs of foreign companies operating in the country.⁶³⁴ However, most have broadened their operations to include services to the medium and large Indian companies as well. The most active foreign banks are those from the US and UK, though French, German, Japanese, and others are also represented. Citibank, ANZ Grindlays, Standard Chartered Bank and Bank of America dominate the foreign banking sector with 53 per cent of the total foreign bank assets, and 88 per cent of the profits in 1998/99.⁶³⁵ The competitive advantage of these foreign banks is based on their larger range of products and high standards of service, particularly in their ability to process local and international transactions quickly and reliably through their automated banking systems.⁶³⁶

Insurance

India's life insurance sector was nationalized into a full monopoly in 1956, with the

⁶³³ World Trade Organization (WTO), Trade Policy Review (TPR), India, 2002, 123.

⁶³⁴ Gilman, Tim, (1992), "India: Opportunities Rise as Barriers Fall", 5.

⁶³⁵ Economist Intelligence Unit (EIU), "Country Finance India, "Foreign Banks", 31 August, 2000.

⁶³⁶ Kono, Masamichi, et. al., (1997), "Opening Markets in Financial Services and the Role of the GATS", 17-20.

intention of reaching a broad geographical coverage.⁶³⁷ Following that, the general insurance industry was nationalized and consolidated into the government-owned General Insurance Corporation (GIC), and its four subsidiaries.⁶³⁸ At that time, more than 100 foreign companies were forced out of business.⁶³⁹ Currently, foreign insurance companies have no *direct* access to the domestic insurance market, except for some reinsurance and some marine cargo insurance.⁶⁴⁰ Although they have managed to mobilize a large amount of savings, India's national insurance companies have fallen short in many respects. Part of the problem, as with banks, had been the low profitability resulting from compulsory requirements that insurance funds be used for specified government activities.⁶⁴¹ Other problems have also stemmed from the lack of competition and general inefficiency that has plagued nationalized companies.

In late 1994, the Indian government moved to address these problems by appointing the Malhotra Committee, which recommended that the insurance sector be opened up cautiously to private sector competition, both domestic and foreign.⁶⁴² The Committee also recommended a restructuring of the dominant publically-owned Life Insurance Corporation (LIC) and General Insurance Company (GIC), and reducing the government's holding to 50

⁶³⁷ Adolf, Huala, (2000), "Financial Services Agreement of the GATS: The Developing Countries' Perspective", 209.

⁶³⁸ Joshi, Vijay, Little, I.M.D., (1996), India's Economic Reforms: 1991-2001, 164.

⁶³⁹ WTO, Trade Policy Review (TPR), India, 1998, 157.

⁶⁴⁰ WTO, Schedules of Specific Commitments India, GATS/SC/42/Suppl.4.

⁶⁴¹ Economist Intelligence Unit (EIU), "Reforms in India: Opening the Cover", 6.

⁶⁴² Sinha, S., Kumar, V., (2001), "India Deregulates Insurance, Defers Tax", 71.

per cent of equity.⁶⁴³ In addition, the mandated investments in government securities and socially-oriented activities should be reduced, with the hope of increasing profits and permitting more affordable premiums. Finally, the Committee recommended that a strong and effective regulatory agency be set up along the lines of the SEBI in the area of securities.

The Finance Minister introduced the Insurance Regulatory Authority (IRA) bill in parliament in December 1996. Pressure for increased foreign participation in the insurance sector had been building after US Commerce Secretary Ron Brown visited Bombay in January 1995. The purpose of his visit was to oversee a joint entry insurance arrangement, whereby American International Group (AIG) and Tata Group would enter India's financial services market, in partnership with existing Indian firms.⁶⁴⁴ The IRA bill was withdrawn by the government in August 1997 due to intense public reactions to privatization.⁶⁴⁵ In 1998, the government re-introduced legislation to allow insurance to be opened up to new private entrants, but with foreign equity capped at 26 per cent with an additional provision of 14 per cent for non-resident Indian investors.⁶⁴⁶ The earliest this legislation could have been passed was early 1999, but it was again not passed in the Winter session of India's Parliament.⁶⁴⁷ This made it more than five years after the Malhotra Committee first submitted its report. Critics of the entry of foreign insurance companies have been skeptical of their potential success. As one insurance expert noted: "... many a multinational has come

⁶⁴³ Joshi, Vijay, Little, I.M.D., (1996), India's Economic Reforms: 1991-2001, 164.

⁶⁴⁴ Holman, Richard, (1995), "World Wire", January 17.

⁶⁴⁵ WTO, Trade Policy Review (TPR), India, 1998, 158.

⁶⁴⁶ Ministry of Finance (India), "Major Functions of the Insurance Division".

⁶⁴⁷ Marathe, Kaumudi, (1999), "India market reform stalls again", 1.

to India with dreams of making a killing only to be defeated by its vast distances, its regional quirks and its sheer poverty.... The foreigners' Indian partners - finance and industrial companies - have little experience in insurance. And the former monopolists are not push-overs. They have matchless brand-names and country-wide sales networks..."⁶⁴⁸

In December 1999, about 200,000 insurance workers across India went on strike to protest against a government move to open the market to private Indian and foreign insurance companies.⁶⁴⁹ The unions representing the insurance corporations' staff received strong support from the Left parties, who also constituted a part of the ruling United Front Coalition government.⁶⁵⁰ The strike was in response to the government's introduction in parliament of the Insurance Regulatory and Development Bill of 1999, which was designed to open the insurance sector to greater competition and increase the foreign direct investment into the country.⁶⁵¹ The implications of the bill meant potential massive job cuts in the government-run firms. The main competition thrust of the bill was to allow foreign firms to hold up to a 26 per cent stake in private insurance firms. One insurance worker was quoted as saying "I don't understand the hurry on the part of the government to get the bill approved by parliament unless they have entered into a secret pact with some foreign powers."⁶⁵² The bill

⁶⁴⁸ Sam Gosh, manager of Allianz's Indian operation, quoted in Economist, (1998), "Premium Market", 80.

⁶⁴⁹ National Post, (1999), "Indian insurance workers strike against privatization", Financial Post, December 2, 1999, C15

⁶⁵⁰ Economist Intelligence Unit (EIU), "Reforms in India: Opening the Cover", February 24, 1997

⁶⁵¹ Watson Wyatt, (2002), Website, "Regulatory Update", 1.

⁶⁵² National Post, (1999), "Indian insurance workers strike against privatization", Financial Post, December 2, 1999, C15.

also faced split support within parliament itself with more nationalist politicians objecting to the bill along with the trade unions.⁶⁵³ There were suggestions that insurance reform could have died on the table, though foreign insurers were keeping their hopes high in anticipation of the potential of the Indian insurance market.

In March 2000, US President Bill Clinton visited India with a commercial agenda which included free trade in insurance. Although the proposed Indian legislation would allow foreign companies to own 26 per cent of equity in an Indian insurance company, the US insurance companies were arguing that this did not go far enough. The US visit also encouraged India to commit to a full opening in insurance (i.e., 100 per cent foreign equity) in its WTO insurance schedule.⁶⁵⁴ The legislation to allow greater foreign participation in the Indian insurance market was eventually passed and on October 23 2000, the Insurance Regulatory and Development Authority (IRDA) granted permission for three private insurance companies to undertake business.⁶⁵⁵ Since then, as of February 2001, the IRDA had issued licenses for 17 private Indian insurance companies, of which ten are in life insurance, six provide general insurance services, and one is a re-insurer.⁶⁵⁶ Under this year-2000 legislation, along with the 26 per cent foreign equity participation allowance, financial sector companies such as banks and non-banking financial companies were also granted greater freedom. They were permitted to invest in the insurance sector through joint-venture

⁶⁵³ Economist, (1998), "Premium Market", Finance and Economics, November 28, 80.

⁶⁵⁴ Brostoff, Steven, (2000), "Insurers hope Clinton visit will open up India's insurance market", 1.

⁶⁵⁵ Economist Intelligence Unit (EIU), Country Finance India, "First Private Insurers Gain Permission to Begin Operations", 30 November, 2000.

⁶⁵⁶ WTO, Trade Policy Review (TPR), India, 2002, 126.

companies, subject to certain credit and prudential criteria.⁶⁵⁷ The 26 per cent foreign equity limitation is again expected to be raised to 49 per cent some time in the future, a number to which foreign insurers would surely be attracted.⁶⁵⁸

Securities

India's securities regulator, the Securities and Exchange Board of India (SEBI), was set up in January 1992 after taking control from the government.⁶⁵⁹ The Capital Market Division of the Ministry of Finance deals with policy matters relating to the development and regulation of securities markets, investor protection, and most other non-banking investment vehicles.⁶⁶⁰ The government plays the largest role in the stock exchanges, issuing the most debt, and buying the most securities through the government banks.⁶⁶¹ Securities regulation in India is thought to suffer from three main weaknesses as a result of this government involvement. There tends to be relentless and extraordinarily detailed instructions, an environment that favours continuous direct bureaucratic intervention, rather than creating a climate for self-regulation, and the inability to enforce regulations effectively. The latter is explained by the sheer number of regulations, weak institutional capacity of the SEBI, weak information systems, and regulatory capture.⁶⁶² The government has been making efforts at

⁶⁵⁷ Kumari, Vaswati, (2001), "India Allowing Banks to Act as Ins. Agents", 43.

⁶⁵⁸ Personal interview, December 2002.

⁶⁵⁹ Awasthi, Prathana, (2001), "Capital Markets: Securities Regulations, Derivatives and Debt Markets", 13.

⁶⁶⁰ Ministry of Finance (India), "Major Functions of the Capital Market Division".

⁶⁶¹ Personal interview, November 2002.

⁶⁶² Reddy, Y.V., (2002), "Public Sector Banks and the Governance Challenge: The Indian Experience", 239.

reforming the sector, but as a confidential report notes: "...reforms are at best uncoordinated and at worst conflicting and hence potentially harmful... In the absence of a clearly articulated overall development strategy for the capital market, which is strongly supported by the government, the confusion which exists in the market will persist and vested interests may adopt increasingly entrenched positions, thus making it harder to introduce the required reforms."⁶⁶³ Many of these regulatory reform problems are shared by capital markets globally, however, largely because operators are invariably ahead of regulators knowledge and technologies.⁶⁶⁴

Although they participate in India's capital markets in various capacities, foreign securities firms have only been allowed to establish majority-owned joint ventures in India.⁶⁶⁵ Through registered brokers, foreign institutional investors (FII's), such as foreign pension funds, mutual funds, and investment trusts, are permitted to invest in Indian primary and secondary markets.⁶⁶⁶ However, holdings by a single FII are limited to 10 percent of issued capital, and total aggregate holdings of FII's cannot exceed 30 percent. FII's may also invest in corporate and government bonds within government rules. The Indian government also has a program that allows banks to deal in securities, called a "Primary Dealership", which allows banks to underwrite government of India debt. In general, foreign firms face no major

⁶⁶³ Quoted in Mistry, Percy, S., (1995), "Financial Sector Reform in India: Hesitant Pursuit of an Incomplete Agenda", 187.

⁶⁶⁴ Harris, Stephen, L., (1999), "The Globalization of Finance and the Regulation of the Canadian Financial Services Industry", 366.

⁶⁶⁵ World Trade Organization, Schedules of Specific Commitments, India, GATS/SC/42/Suppl.4 (3. Stockbroking).

⁶⁶⁶ Reserve Bank of India (RBI), (2001), "Financial Market Structure", in Report on Currency and Finance, RBI, January 29, p16-17.

functional restrictions in operating through a primary dealership.⁶⁶⁷

One of the most notable developments in the Indian securities market has been the emerging trend towards integration of the stock market with other financial markets.⁶⁶⁸ To facilitate this integration, the technology of trading in India has been gradually modernized.⁶⁶⁹ The National Stock Exchange introduced on-line electronic trading in 1994 and the system now links brokers across the country by computer, but securities trades are still done largely by paper. As the market for corporate financial products has been growing fast, reforms were necessary to put these transactions online. Competitive pressure also led the Bombay Stock Exchange to introduce an on-line trading system in 1995, with linkages to brokers all over the country. The settlement system has also seen major improvement. Previously, the completion of a trade involved the physical transfer of share certificates from seller to buyer, followed by submission of the certificates to company registrars to effect changes in the register of stockholders. The process was plagued by long delays, frequent loss of certificates, and the danger of forged certificates.⁶⁷⁰ In 1996, a National Depository began offering investors a more streamlined, dematerialized way to settle trades.⁶⁷¹ These changes have been slowly putting in place capital market institutions that offer investors more confidence and encourage financial intermediation. The Clearing Corporation of India is playing a greater role in this modernization, managing the government's securities

⁶⁶⁷ Personal interview, November 2002.

⁶⁶⁸ Awasthi, Prathana, (2001), "Capital Markets: Securities Regulations, Derivatives and Debt Markets", 13.

⁶⁶⁹ Personal interview, November 2002.

⁶⁷⁰ Personal interview, November 2002

⁶⁷¹ Ahluwalia, Montek, S., (1999), "India's Economic Reforms: An Appraisal", 71.

transactions through the banks which is done online and cleared through the Clearing Corp. The most current liberalization of India's securities market, the Securitization Bill, was awaiting bureaucratic intervention in 2001 and will bring in many new practices over the traditional basic loan transactions.⁶⁷²

Section V: The GATS and Barriers to Investment

This section outlines the changes that have been happening in India's laws and regulations affecting investments, including market access and establishment by foreign financial institutions. It then examines requests that have been placed on India in financial services and the other services sectors which are of key importance for India in negotiations. The new industrial policy announced in July 1991 marked a major shift for India. It represented in many cases a relaxation or elimination of many restrictions on investment, and simplified the investment approval process. This has been important to foreign developed countries because access to India's market has been important to them, and the large financial services firms based there. Many of these changes, however, are instituted by executive orders, and all have not yet received legislative sanction through parliament.⁶⁷³ Part of the problem is that financial services has not been a service sector in which India has had an interest to negotiate and make commitments.⁶⁷⁴ As such, India's schedule of specific financial services commitments has remained relatively restricted and indicates "unbound"

⁶⁷² Awasthi, Prathana, (2001), "Capital Markets: Securities Regulations, Derivatives and Debt Markets", 8.

⁶⁷³ Personal interview, October 2002.

⁶⁷⁴ Government of India, Ministry of Commerce & Industry/Department of Commerce, Trade Policy Division, (2002), "Consultation Document on the WTO Negotiations under GATS.

for modes 1 (cross-border supply) and mode 2 (consumption abroad) for all financial services.⁶⁷⁵

Indian governmental restrictions still face all banks, local and foreign alike, include excessive governmental interference, a slow courts system, and poorly developed contract law. For example, the mechanisms by which transactions are settled in India (i.e., the payments system) is quite rudimentary - an obstacle that slows all banking business.⁶⁷⁶ In the securities area, the quotes system is very slow, and there is no foreseeable movement on this in the next few years. It is difficult for money lenders in particular because non-performing assets have been growing by number, and collection has been slow.⁶⁷⁷ Additionally, investors cannot purchase securities in a speedy way. For these reasons, the GATS FSA is seen to be quite significant to the operations of foreign banks operating in India because the restrictions create great difficulties for banks trying to establish coherent business plans. Restrictions on the licensing of bank branches is one of the key issues.⁶⁷⁸

This restriction is not generally a problem for foreign banks that are already established in India. Scotiabank, for example, carries a full branch license and is therefore generally well-established to do business. They have also been issued new branch licenses which they have not yet been able to use.⁶⁷⁹ More recently, the RBI has been working to reverse the policy of limiting branch presence in India, and in the last 6-7 years this policy

⁶⁷⁵ WTO, Schedule of Specific Commitments, India, GATS/SC/42/Suppl.4.

⁶⁷⁶ Personal interview, November 2002.

⁶⁷⁷ Ibid.

⁶⁷⁸ Ibid.

⁶⁷⁹ Personal interview, December 2002.

has been very substantially relaxed. While 12 licenses may be issued per year under WTO rules, in practice this number can in reality be higher. In the past, the RBI would look at the whole banking business landscape and limit foreign participation to 10 to 15 per cent, on which basis it decides to grant or deny issuing licenses. This quota is still rigidly followed, so this relaxation of the number of licenses issued being liberalized means less.⁶⁸⁰ In addition to the GATS FSA, the RBI has also been pushing heavily the Basel Capital Adequacy Standards, accounting standards, and transparency rules on financial institutions in India. From the RBI's perspective, these are more important than the WTO commitments in terms of banking business and how the RBI sees the issues. The RBI is applying these standards across the board, so there is no discrimination between foreign and Indian institutions.⁶⁸¹

There are three WTO scheduled restrictions facing foreign banks wishing to operate, or already operating in India. The first major obstacles are commercial presence restrictions in banking. The operational language states: "Grant of license as permissible under existing laws."⁶⁸² In practice, domestic Indian laws require foreign banks to acquire special licenses for locations in particular cities. Essentially, foreign banks have no choice in the locations where the licenses may be granted. If the government doesn't like the location request for a branch, they will simply ignore the request, giving the bank the message they are trying to send.⁶⁸³ India also places a market access restriction on the establishment of ATM machines whereby off-site ATM's require specific approval. The reason for this is that ATM's are

⁶⁸⁰ Personal interview, December 2002.

⁶⁸¹ Ibid.

⁶⁸² WTO, Schedule of Specific Commitments, India, GATS/SC/42/Suppl.4.

⁶⁸³ Personal interview, November 2002.

considered separate bank “branches” and require their own license.⁶⁸⁴ Citibank tested these rules by having off-site ATM’s and posting security guards there who just happened to be able to open up bank accounts as well on the Internet (essentially a virtual branch).⁶⁸⁵ The rules still apply, however, and also means that the issuance of banking licenses could no longer be restricted for subjective reasons or based on political interference.

The second scheduled restriction facing foreign banks is listed under the subheading of “venture capital” in banking.⁶⁸⁶ It states that for foreign banks, “Funding has to be entirely out of equity”. This means that Indian banks are allowed to raise their capital from the local market (i.e., their shareholders), while foreign banks are required to rely on the capital financing of their home countries (i.e., they are not allowed to access the local debt market). This essentially makes the debt market inflexible and also brings greater risk to foreign banks because there is a greater risk associated with the currency exchanges.⁶⁸⁷

The last major restriction facing foreign banks states that “Foreign banks are subject to non-discriminatory resource allocation requirements.” In practice this means that foreign banks face a mandated lending requirement of 32 per cent that must be directed to priority sectors. Domestic Indian banks themselves must direct 40 per cent of their total loans to priority sectors. Priority sectors include certain exporters, small enterprises, housing, and certain developers. At first glance this appears to give an advantage to foreign banks, but the 32 per cent is a very rigid requirement. Combining this with the restrictions on the ability

⁶⁸⁴ WTO, “Schedules of Specific Commitments”, GATS/SC/42/Suppl.4.

⁶⁸⁵ Personal interview, November 2002.

⁶⁸⁶ WTO, “Schedules of Specific Commitments”, GATS/SC/42/Suppl.4.

⁶⁸⁷ Personal interview, November 2002.

to open branches and expand their coverage, and restricted ATM coverage, getting access to consumers is difficult. Local banks can open branches where they want (with easier licence approval) in small towns, which is a distinct disadvantage for foreign banks.

The Indian budget speech 2002/2003 announced that foreign banks will be allowed to now establish subsidiaries of their home banks in India.⁶⁸⁸ However this will require an amendment in parliament and this will be a very slow process. It may take until the next budget speech to get this passed. It has already been 8 months since the budget speech and this is still not law. This subsidiary idea was initiated probably because of the sheer momentum of Indian financial reforms. The second issue in the Indian budget was the 10% cap on voting rights for bank shareholders (i.e., foreign ownership rules). Government-owned banks in India place a 20 per cent cap on foreign ownership, while private banks (non-government owned) and foreign banks have a 49 per cent cap on foreign ownership (recently raised from 20 per cent). In a developing market, a 49% ownership cap is highly restrictive because when combined with the 10% voter cap, authoritative control is again lost.⁶⁸⁹ For example, ING Bank holds 49% of Vyasya Bank (an Indian bank), but is limited to 10% voting control. Citibank and HSBC have indicated that they want to invest in Indian banks but are being withheld by the 10% voting cap. The next step in reform should be lifting of the 10% cap on voting rights to come into line with the 49% equity holding. But this has been buried in the old Banking Regulations Act and would be quite difficult to

⁶⁸⁸ Government of India, India Budget Speech, 2002/2003, "Follow-up Action", Amendments to the Banking Regulation Act of 1949, Recommended in April 1998 by the Committee on Banking Reforms (RBI).

⁶⁸⁹ Personal interview, November 2002.

change.⁶⁹⁰

This is compounded with the lack of domestic capital needed to support local bank growth. The banks see this restriction based on prudential concerns to be unfounded because foreign banks subsidiaries are already 100% owned. They do not need to issue public shares because they are already private local corporations based on limited liability.⁶⁹¹ The other issue of contention is whether the government of India will allow foreign institutions access to local capital. Local banks don't need foreign capital to grow and expand, but the voting rights issue is key. These restrictions facing both foreign banks and Indian banks to differing degrees, while they do not effectively prevent entry into the Indian market, act as significant barriers to business once they become established and operational.

As for other restrictions, India's GATS schedule in financial services indicates that it has taken no commitments with respect to mode 4, the movement of natural persons (e.g., banking professionals). However, as one banker indicated, this is not really a concern to foreigners because not very many people are interested in traveling and working in India.⁶⁹² This is primarily because it is an insecure place in the world surrounded by Pakistan and Afghanistan. Local Indians are seen to be very qualified to do the jobs, and there are also top-skilled Indian financial people working in the US, for example. Requests that have been made to the government for additional foreign banking professionals have never been refused.⁶⁹³

⁶⁹⁰ Personal interview, December 2002.

⁶⁹¹ Ibid.

⁶⁹² Personal interview, November 2002.

⁶⁹³ Personal interview, November 2002.

India also indicates that it has taken no commitments in banking services for mode 1, cross-border supply of banking services. In general, transactions from foreign countries into India have faced no problems in this regard. Although capital is needed for growth and development, India has not been a major exporter of financial services. Because of this, and for prudential reasons, outward transactions from India to foreign countries face currency restrictions. Considering its social responsibilities and its previous role as a leader for the developing countries in the trade regime, the Government of India had been taking a gradual approach to liberalization in financial services. Many financial services sectors remained protected while the government strengthened the legal and financial structures, and it is thought that this is one of the factors that helped India emerge relatively unscathed from the Asian crisis.⁶⁹⁴

Current requests made to India in banking include taking full market access and national treatment commitments in modes 1 and 2 for all sub-categories, the removal of limitations on preferred form of commercial presence, the reduction of numerical quotas, monopolies, exclusive service suppliers, and discrimination between domestic and foreign service suppliers in the application of laws and regulations.⁶⁹⁵ In addition, India received requests to remove restrictions on the use of foreign capital and the ceiling on equity, tax rates between local and foreign banks, removal of lending requirements for priority sectors, and overall greater non-discriminatory transparency.

⁶⁹⁴ Personal interview, November 2002.

⁶⁹⁵ Government of India, Ministry of Commerce & Industry/Department of Commerce, Trade Policy Division, (2002), "Consultation Document on the WTO Negotiations under the General Agreement on Trade in Services (GATS)".

With respect to the insurance sector, India's insurance commitments in the WTO Financial Services Agreement remain almost entirely "unbound" (i.e., no commitments have been taken). As such, the latest stage of WTO services negotiations in the spring of 2003 have requested India to taking full market access and national treatment in specific classes of insurance (marine, aviation, transport, and re-insurance) services for modes 1, 2, and 3, as well as horizontal commitments in mode 4.⁶⁹⁶ In addition, India has been requested to allow insurance companies to allow the form of commercial presence and partner they choose, remove limitations on the level of equity participation, ensure that acquired rights are protected (grandfathering), and ensure transparency in the development and application of regulations.

Requests to India in Insurance have also focused on removing restrictions on the ability of service providers to choose their preferred form of commercial presence and partner, removal of limitations on level of equity participation, and ensuring transparency in the development and application of regulations.⁶⁹⁷ However, this is a very sensitive issue because the government fully nationalized the insurance companies so it is expected that there will be no major changes soon unless there happens to be major problems in attracting FDI or problems with the budget deficits, for example. As part of the integration of financial services, new opportunities have emerged for banks to enter into the area of insurance. Banks may now act as insurance agents and brokers, but only through the establishment of

⁶⁹⁶ Government of India, Ministry of Commerce & Industry/Department of Commerce, Trade Policy Division, (2002), "Consultation Document on the WTO Negotiations under the General Agreement on Trade in Services (GATS)".

⁶⁹⁷ Ibid.

a separate subsidiary. The government made this change when it was unable to get an amendment to the Insurance Act passed which would have allowed the creation of private insurance corporations and brokerages.⁶⁹⁸

India has also made general requests in financial services in which it has a competitive advantage. They include market access and national treatment for mode 2 (consumption abroad) for data processing of financial services, removal of restrictions on the form of commercial presence, requirement of incorporation of a bank subsidiary at the sub-federal level, removal of domestic regulations restricting the expansion of bank branching and provision of other financial services, and finally, the removal of discriminatory limitations on foreign equity, and remove QR's on the number of licenses for foreign banks.⁶⁹⁹

Section VI: Conclusions

The satisfactory achievements of India's reform program achieved after 1991 indicate that perhaps the limits of what is feasible under prevailing political and social constraints had been achieved. Liberalization requires developing countries to change long-standing administrative and institutional arrangements in order to improve effective governance. Making progress in the WTO financial services agreement could only be achieved once the domestic financial sector was reformed. This difficult task has involved moderating domestic political debates about the value of liberalization over protectionism in banking and

⁶⁹⁸ Kumari, Vaswati, (2001), "India Allowing Banks to Act as Ins. Agents", 21.

⁶⁹⁹ Government of India, Ministry of Commerce & Industry/Department of Commerce, Trade Policy Division, (2002), "Consultation Document on the WTO Negotiations under the General Agreement on Trade in Services (GATS)".

insurance. Although limitations on the outward flow of capital protected India to some extent from the 1997 Asian financial crisis, many reforms had still not materialized to that point, so some protection was still necessary. Many trade-distorting policies still needed to be replaced with trade-oriented measures and transparency in administration of policies. These changes are extremely difficult in a country that has been dependent on policies of economic and social re-distribution for the entirety of its modern history. The more recent improvements in India's banking commitments in the GATS indicate that the process has been advancing better. Thus, financial services liberalization in the GATS can still be recommended as an important way for India to consolidate its financial reforms.

The Indian financial system, and the banking system in particular, has been dominated by public sector institutions and banks. An important question at the center of the domestic economic debate in India is whether the public sector character of Indian banks and other institutions is consistent with their being able to play a role as a global competitor in financial services. There are perceived advantages and disadvantages to this existing structure. An advantage is a reduced vulnerability of the system as a whole because it is owned largely by Indians. Another important advantage is the wide reach and the established infrastructure that has been built up over the last 30 years. The disadvantages are the heavy costs paid to maintain this structure, the inability to respond quickly to market trends, and the lack of freedom in decisions because of the non-commercial considerations in banking. Either way, India remains a long way from being able to shed off total state intervention in its economy. Mass poverty, lack of entrepreneurial initiative in the private sector, and the

reliance of the private sector on the government cannot be quickly changed.⁷⁰⁰ According to M.R. Madhavan, vice-president at Bank of America in Mumbai, “This is definitely not a government in reform mode, it’s a government on the defensive.”⁷⁰¹ In the shorter term, therefore, the removal of political motivations from economic decisions and unnecessary governmental intervention are more realistic goals.

In practice, however, it is hard to point to outright discrimination between foreign and local banks in India. Foreign banks can operate in most businesses they choose without effective restrictions, and aside from minor limitations, have not wanted for more liberal conditions in any major ways.⁷⁰² The insurance sector in India continues to be a state-run monopoly, but this is not contrary to the GATS because India remains largely “unbound” in its insurance schedules. The government has been, however slowly, increasing the allowable foreign equity participation in the publicly-owned insurance companies. The securities sector has not been a major issue for foreign institutions because they already have effective access through joint-participation. The major concerns in the securities area are thought to be improving regulatory oversight and institutional capacity, such as the weak information systems. India has been taking a gradual approach to liberalization by keeping the insurance sector, and until recently, the securities sector closed to foreign competition. This protectionism may be initially useful in a developing country as the government focuses on strengthening legal and financial regulations.

⁷⁰⁰ Sen, Raj Kumar, (1995), “New Problem Areas of Indian Banking and the Narasimham Report”, 378.

⁷⁰¹ Slater, Joanna, (2002), “India: On Autopilot”, 48.

⁷⁰² Personal interview, November 2002.

In negotiations, India has liberalized its laws in many cases, but has not yet bound this in its schedules. This can be used as a bargaining chip in upcoming negotiations, because binding is a significant concession (i.e., there is a value in binding). In broader negotiations, countries must be willing to make commitments in their total offers (considering the whole services scheme), so India should come under more pressure to open up its financial services sectors in the future. Progress to increase the participation of developing countries as laid out in Article IV of the GATS has been inadequate thus far. The three main areas of promised increased participation was to strengthen their domestic services capacity, to improve access to distribution channels and information networks, and to liberalize market access in modes of supply of interest to developing countries. These are major issues of concern for the developing countries in the current Doha Round of multilateral trade negotiations.

Although the developing countries are accorded limited special and differential treatment under GATS⁷⁰³, this agreement contains no provisions similar to Part IV of the GATT on more favourable treatment of developing countries. GATS Article XIX allows developing countries to make fewer specific commitments than industrialized nations. 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 based on the argument that if the national governments have concern for economic efficiency, the optimal policies

⁷⁰³ Refer to WTO GATS Annex 1B, preamble paragraphs.

would be the same both for developed as well as developing countries.⁷⁰⁴

Today India is becoming a significant exporter of services, mainly through ‘outsourcing’ services for multinational companies in high value-added services such as software, information technology, and business services, all of which are fully complementary to the knowledge-based business of financial services.⁷⁰⁵ India recorded 5.4% GDP growth in 2001, but the problem is that while this may be quite respectable growth in other economies, it is not so in a country of one billion people.⁷⁰⁶ The services sectors, including computer software to consumer finance, insurance, and tourism continue to power India’s economic performance. Only now is India beginning to understand how financial services liberalization can complement these services and help it to develop a stronger economic infrastructure.

⁷⁰⁴ Matoo, Aaditya, (1998), “Financial Services and the WTO: Liberalization in the Developing and Transition Economies”, 19.

⁷⁰⁵ Personal interview, November 2002.

⁷⁰⁶ Slater, Joanna, (2002), “India: On Autopilot”, 48.

Chapter 6

The Process of Financial Services Liberalization and Developing Countries

“We don’t deal directly with national governments ... we did not want to make this a political organization ... [We] felt if there was a governmental international organization, then we would get involved in all the politics of the government instead of dealing with the issues ... “

So you want to keep the governments at bay?

“They want to keep their governments at bay, most members.”

Paul Guy, Secretary General of IOSCO

December 10, 1991.⁷⁰⁷

Section I: Concerns with the Process

The previous chapters were designed to outline in detail the subject of trade in financial services, in part by reviewing the histories of three countries that have liberalized their financial services regimes. Chapter One suggested that the substance of domestic policy and the timing of domestic policy reform are key to understanding what can be accomplished at the international level. This has been consistent with a ‘political economy’ approach, which sees a defined role for the state in managing and reforming policies in the financial arena. This also means that allowing foreign establishment in the financial sector has not been based solely on economic factors, but is also affected by a wider range of domestic political, social, and regulatory concerns. This chapter reviews the strengths and weaknesses of this process of liberalizing trade in financial services, which began with the conclusion of the Uruguay Round in 1993. The argument of the dissertation is advanced by showing that the process is a useful one, and based on the three case studies presented here,

⁷⁰⁷ Taken from Underhill, Geoffrey, R.D., (1995), “Keeping Governments out of Politics: Transnational Securities Markets, Regulatory Cooperation, and Political Legitimacy”, 251.

it has generally been moving along well in these countries. However, there have been problems along the way. Several important issues are still being worked out, including the structural weaknesses of the GATS, concerns about domestic regulation, and the overall question of whether the agreement can be beneficial for countries.

One of the key problems surrounding liberalization lies in the varying attitudes toward foreign direct investment, and the prospect of foreign ownership and control in financial services.⁷⁰⁸ Difficulties also stem from the task of making accommodations between economies which are regulated very differently, regardless of how closely interlinked they may be in political or economic terms. An important question for developing countries is why they should undertake market access and national treatment commitments in the GATS when there exists an uncertain promise of long-term growth, during and after opening financial services markets. For example, opening up to foreign financial services providers may hurt domestic firms in the short run, because the development of domestic firms has been hindered by domestic regulations, and they have not been accustomed to competition. There is also the issue of whether developing countries are allowed a sufficient amount of self-determination in making their choices about liberalization. The specific criticism has been that while the GATS claims to achieve liberalization without compromising the right of governments to regulate their economies, this may actually work better in theory than it does in practice.

This dissertation has attempted to show that the process of liberalization in the GATS

⁷⁰⁸ Mattoo, Aaditya, (1998), "Financial Services and the WTO: Liberalization in the Developing and Transition Economies", 26.

FSA is valuable, one that has allowed a liberalization of commitments in financial services at a desirable level. In part, this is because a country's orientation becomes more compatible with international standards and expectations. One sign of this is how protectionist attitudes in financial services have been slowly changing in the three case studies presented here, as countries realize the potential benefits of a more liberalized financial services regime. This has extended benefits by demonstrating diplomatic initiative, in addition to helping to develop stronger domestic financial intermediation. For the advanced economies, the WTO FSA has provided a framework within which the concepts of domestic and prudential regulation can be strengthened. It has provided a mechanism for removing discriminatory measures between domestic and foreign services providers in the fairest way possible.

In the rest of this chapter, Section II lists the potential problems and challenges surrounding the process of liberalization, and Sections III, IV, and V respond with some lessons and solutions to those challenges. Specifically, Section III responds to those criticisms of liberalization with an analysis of the benefits that can be gained when an economy liberalizes their trade regime in financial services. Section IV examines the challenge of fitting GATS FSA liberalization into the overall pace and sequencing of financial liberalization. This includes the modes of services commitments that have been taken most frequently in the GATS, as well as the constraints that have limited commitments, such as the issue of domestic regulation. Section V first draws from the Singapore case study and contrasts the liberalization of trade in financial services against the events of the 1997 Asian financial crisis. That crisis exposed many weaknesses in the Asian economies, and the GATS FSA was one way those weaknesses could be addressed. Section V also considers

the perspective of the developing countries in general. It examines the concerns that they have had with the process of making commitments in the GATS, and the benefits that could be realized by opening financial markets to greater competition. For example, in India, a protectionist stance over the financial sector was the initial reaction after the Uruguay Round, a perspective that has changed after realizing the benefits of greater competition in the financial sector.

Section II: Potential Drawbacks of Liberalizing Trade in Financial Services in Developing Countries.

This section outlines the main concerns that have been expressed about the potential downside of liberalizing trade in financial services. Most of these problems can be understood more clearly after appreciating why developing countries may be reluctant to make commitments in the WTO GATS FSA, despite the promise of long-term growth. This includes their differing interests relating to those of the advanced economies, in relation to what they have to gain from making commitments, and other factors. The financial sector is often seen to be special, and opening it up to foreign participation can be politically difficult, especially when other countries have shown mixed performance after liberalization. This has resulted in protectionism in some areas, while a consensus can be reached about how fast and far the financial sector should be opened. These concerns have highlighted the structural and technical problems with the GATS, including the way commitments are made in the agreement, and the required amount of technical capacity - a capacity that many developing countries are lacking. All of these concerns have also been inserted into the broader debate about the positive rule-making nature of the GATS, and the political

challenges to trade liberalization more generally.

The biggest challenge for developing countries stems from the unclear relationships between market opening and capital account liberalization,⁷⁰⁹ on the one hand, and how these processes are linked to the domestic economy, on the other. These processes are related because they both require domestic liberalization, such as removing government intervention, freeing restrictions on financial services mergers, or strengthening domestic institutions. However, the fact that liberalizing commitments in the FSA focuses primarily on removing discriminatory barriers, and does not directly subject the economy to unstable capital flows, has not been clearly understood. One reaction to this misunderstanding can be the attempt to protect the domestic market from foreign competition because it is thought that domestic interests stand to lose. Another reason for the reluctance to liberalize in the GATS, which is also discussed in this section, relates to the structural challenges the agreement proposes. Specifically this involves the process of making commitments under a highly legalized regime, and how commitments are negotiated between developed and developing economies, and then scheduled. These latter challenges are discussed first.

At the outset, one should note that international trade has indeed become more legalized. As a result, governments need to have sufficient bureaucratic resources (i.e., staffing and expertise) to make and monitor the necessary changes. However, the benefits of these changes often do not reflect back on the government, but are usually absorbed by the industry itself. An additional concern has been voiced by financial regulators about the fact

⁷⁰⁹ Dobson, Wendy, (2002), "Further Financial Services Liberalization in the Doha Round?", 2.

that only regulations that are 'necessary' are allowed to be scheduled. Regulators in protected markets have argued that viewing domestic regulation through this necessity framework could undermine sound public policy objectives.⁷¹⁰ In a market-based economy, this can place regulators and the regulated at odds. On the other hand, rules that are overly confining, as well as binding, can have negative effects in the uncertain environment of international trade, so that increased legalization may not result in an appropriate balance.⁷¹¹ As Robert Wolfe has noted, "Since WTO law at best creates guidelines rather than commands for participants in the trading system, and since it is not really 'enforceable', new rules that participants do not understand may not be worth the time spent on negotiations. Many developing countries have difficulty making effective policy, however, which limits their integration into the world economy more than rules emanating from the WTO."⁷¹² These concerns are related to the GATS itself.

The weaknesses of the structure of the GATS were outlined in Chapter Two. First, commitments in the GATS are made by the positive list approach method, which requires substantial efforts by countries to identify the laws and regulations they seek to liberalize, and those they want to protect. Many developing countries do not have the technical expertise or staffing to manage this process. In India, for example, the few specialists that are dedicated to negotiations in financial services at the Ministry of Commerce are often

⁷¹⁰ Sauve, Pierre, Steinfatt, Karsten, (2001), "Financial Services and the WTO: What Next?", 358.

⁷¹¹ Goldstein, Judith, Martin, Lisa, L., (2000), "Legalization, Trade Liberalization, and Domestic Politics: A Cautionary Note", 604.

⁷¹² Wolfe, Robert, (2003), "Regulatory Transparency, Developing Countries, and the Fate of the WTO", 12.

over-taxed with the amount of work placed on them.⁷¹³ This means that the GATS can allow for too much discretion in making liberalization commitments, whether by lack of input from experts, or because of initial protectionist intentions. Second, the issue of reciprocity and the asymmetry between developing and industrial countries highlights the differing interests of these countries. Sorsa argues that the bulk of the commitments made in financial services were the result of self-interested bargaining, whereby developed countries made narrow openings, while the developing countries made very liberal openings.⁷¹⁴ This issue is discussed further below. The significance of completing an agreement in financial services at the end of the Uruguay Round was, therefore, less substantive, and mainly systemic and political, given the goal of forming a strong basis for future liberalization in financial services. This relates back to the issue of domestic regulation and having sufficient autonomy in policy-making, and is referred to throughout the rest of this chapter.

It is important to consider the differing interests of the participants, which set emerging and developing countries against the industrial OECD economies.⁷¹⁵ Emerging economies are concerned about how quickly they need to integrate with the rest of the world, and how best to capture foreign capital inflows (FDI) to accelerate growth. OECD economies largely seek openings in foreign markets for their large financial services firms. In the GATS negotiations, developing countries often give in to pressure from trading

⁷¹³ Personal interview, October 2002.

⁷¹⁴ Sorsa, Piritta, (1997), "The GATS Agreement on Financial Services - A Modest Start to Multilateral Liberalization", 4.

⁷¹⁵ Dobson, Wendy, (2002), "Further Financial Services Liberalization in the Doha Round?", 3.

partners and offer increased market access in the form of increased ownership of existing domestic firms, rather than allow new entries to the market. Considerable negotiating energy was devoted by the OECD countries to relaxing these restrictions on new entry and to maintaining existing foreign ownership.⁷¹⁶ In financial services, this is seen in the struggle over “grandfather provisions” which guaranteed the ownership and branching rights of incumbent firms while more limited rights were extended to new or potential entrants. This placed the latter at an obvious competitive disadvantage.

The pressure in the negotiations, and the positive rule-making orientation of the GATS, have been used to illustrate how the process can potentially constrain the exercise of regulatory authority by governments. It is argued that governments often give in to powerful corporate lobbies, which methodically push inappropriate domestic reforms and seek to diminish governmental regulatory authority and empower themselves through the WTO. Critics argue that this abuse is further encouraged by granting powers to less than transparent, secretive panels in the case of a dispute settlement claim. This, in turn, has the ability to destroy the compromises set up by domestic stakeholders, and leads in the end to a serious diminution of democratic accountability.⁷¹⁷ For example, the most important international financial agreements are reached after limited discussions among a few important nations, which are then extended to a wider international community. Industrial countries often negotiate agreements, then seek to expand their reach by bringing in developing countries

⁷¹⁶ Mattoo, Aaditya, (1999), “Developing Countries in the New Round of GATS Negotiations: Towards a Pro-Active Role”, 2.

⁷¹⁷ Sinclair, Scott, (2000), GATS: How the World Trade Organization’s new “services” negotiations threaten democracy, 29, 80.

effectively to endorse the agreement, presenting them with a *fait accompli*.⁷¹⁸

Partly reflecting these arguments, international trade is being subjected to increased political challenges. Compounding the problem, as the WTO's director general has noted, is the fact that governments themselves in industrial countries have, among other things, lost the 'popular appetite' to continue to liberalize trade.⁷¹⁹ Issues of ambivalent will and purposes were present even after the Uruguay Round, but the failure of the 1999 WTO meeting in Seattle was an event that made economists and regulators more aware of the potential political implications of their decisions. Part of this has been attributed to the fact that services are now under more scrutiny in the OECD countries than they were in the Uruguay Round negotiations.⁷²⁰ Opponents to liberalization argue that services, which are ordinarily essential and publicly provided, will be forced into privatization and be left open to predatory MNCs. These arguments can have significant political influence, even though they tend to be false and misconstrued.

Developing countries and emerging markets have been reluctant to fully deregulate for three other reasons.⁷²¹ First, countries that have deregulated their financial markets have varied experiences. In most developing countries, services have not yet made a valuable contribution to trade, but their dependence on labour services could render these countries

⁷¹⁸ Porter, Tony, in Armijo, Leslie, E., (ed., 1999), Financial Globalization and Democracy in Emerging Markets, 104.

⁷¹⁹ World Trade Organization (WTO), "Reflections on the Global Trading System", Mike Moore speech, August 25th, 2000.

⁷²⁰ Sauve, Pierre, Steinfatt, Karsten, (2001), "Financial Services and the WTO: What Next?", 352.

⁷²¹ Dobson, Wendy, (2002), "Further Financial Services Liberalization in the Doha Round?", 3-4.

vulnerable.⁷²² One negative consequence of this is that it may encourage liberalization at a rate that may be faster than is prudent in a liberal sequencing plan. The East Asian economic crisis was a vivid example, to many, of the potential down-sides of more economic integration. It highlighted a number of financial and structural weaknesses in the region: mis-allocated lending, political favouritism, nonperforming loans, herding behaviour, and moral hazard.⁷²³ It also showed in hindsight how sound and well-functioning financial systems can help to avoid a repetition of such a crisis in the future.⁷²⁴

Developing countries that want to engage this process must determine if their domestic financial sectors should be opened up to foreign competition, and if so, exactly how. Governments are interested in the questions of how fast to open up, how to implement the policies so as to minimize risks and the costs of transition, and the other measures that will be necessary to implement and complement those policies. They must also consider the pursuit of public policy objectives, distributional concerns, and equity. This is an area in which the WTO has recently been under pressure. As Hoekman and Mattoo note: “One of the ironies of the GATS is that the provisions dealing with domestic regulations are among the weakest. This is largely a reflection of the difficulty of developing effective multilateral disciplines without seeming to encroach upon national sovereignty and unduly limiting

⁷²² Mashayekhi, Mina, (2000), “GATS 2000 Negotiations: Options for Developing Countries”, 5.

⁷²³ Sauve, Pierre, (1998), “The Benefits of Trade and Investment Liberalization: Financial Services”, 2.

⁷²⁴ Kampf, Roger, (1998), “Financial Services in the WTO: Third Time Lucky”, 113.

regulatory freedom.”⁷²⁵ Given the sensitivities of achieving a balance of these objectives, trade negotiators would need to work more closely with regulators in order to agree on workable results.⁷²⁶ Developing countries especially need this flexibility to undertake policy and regulatory reforms which meet public policy objectives, and which lead to more harmonized relations with the developed economies.

Potential problems may arise in the pacing and sequencing of financial liberalization in the multilateral and national contexts. This may be particularly an issue with respect to prudential regulation, monetary and balance of payments management, and capital account liberalization. As a trade agreement, the GATS tends to focus on market opening, leaving the responsibility for an appropriate sequencing of financial sector reforms to national authorities. The concern, however, is that the process of developing commitments under the FSA may not always give proper considerations to broader prudential issues. This can include making sure that the proper pacing and sequencing of domestic financial reforms is taking place before commitments are made. Although, in principle, national governments are expected to agree to undertake only commitments that are consistent with their programs of reform, this may be harder to achieve because the commitments are part of a bargaining package negotiated with many countries. For example, stronger trading partners may press a smaller country to open market access for foreign financial institutions in their own

⁷²⁵ Hoekman, Bernard, Mattoo, Aaditya, (2000b), “Services, Economic Development and the Next Round of Negotiations on Services”, 292.

⁷²⁶ Mashayekhi, Mina, (2000), “GATS 2000 Negotiations: Options for Developing Countries”, 35.

interests without regard for the adequacy of the prudential framework in this country.⁷²⁷

In the Uruguay Round, governments agreed to allow limited, temporary MFN exemptions under the GATS. In financial services, reserving the right to apply reciprocity as a basis for granting market access to other countries, was one example. The US in fact took the MFN exemption, allowing it to discriminate between its trading partners in financial services tradeoffs.⁷²⁸ These exemptions were gradually negotiated out of the schedules of commitments after the 1995 interim agreement on financial services as countries began to understand that the GATS was only potentially limiting if their domestic laws constituted limitations on market access and national treatment.

A second reason why developing countries have been reluctant to liberalize is because some believe finance is of special concern to the economy and must be controlled by domestic interests. Developing countries may be hesitant to commit to future liberalization because the government has a stake in the continued operation of those firms and/or because the government may be affected by pressure groups. One financial concept that supports this argument is the concept of 'window guidance'.⁷²⁹ It assumes, for example, that domestic banks are generally more sensitive than foreign banks to subtle forms of influence by the central bank. Foreign banks are arguably far less likely to be responsive to these influences, and the related needs of underfinanced small and medium-sized industries. Hence, if domestic banks are more closely tuned in to the domestic economy, then this places

⁷²⁷ Tamirisa, Natalia, et. al., (2000), "Trade Policy in Financial Services", 22.

⁷²⁸ Mattoo, Aaditya, (1998), "Financial Services and the WTO: Liberalization in the Developing and Transition Economies", 3.

⁷²⁹ Stiglitz, Joseph, E., (2002), Globalization and Its Discontents, 70.

their activities more in line with the broader national interest. In the case of India, economic redistribution to rural populations and agriculture has taken precedence in the debate about more liberalization.

The question can be asked why governments, which are primarily interested in maintaining their political authority, would willingly implement liberalization programs that could potentially reduce their control. The answer is that many developing countries are reluctant to impose restrictions that may deter foreign investment, despite its potential drawbacks. They often respond to their unsuccessful restrictive policies and initiate pro-market interventions and international regulatory cooperation.⁷³⁰ The liberalization of financial systems can play a major role in this respect, but needs to be carefully sequenced and managed.⁷³¹ This includes strengthening the supporting institutional framework, including the regulation and supervision of financial firms. It also involves developing better disciplinary standards for financial institutions (i.e., disclosure & governance), promoting competition and efficiency, and diversifying domestic financial system. These benefits were seen in Singapore's response to the Asian financial crisis, as it strengthened financial disclosure rules, and corporate governance standards. India has been changing its rules regarding the allocation of bank credit, and overall allowable participation in the financial sector.

A third reason why developing countries are reluctant to liberalize is that opening can

⁷³⁰ Joyce, Joseph, (2000), "The IMF and Global Financial Crises", 94.

⁷³¹ Dobson, Wendy, Jacquet, Pierre, (1998), Financial Services Liberalization in the WTO, 12-13. See also Claessens, Stijn, Glaessner, Tom, (1999), "Internationalization of Financial Services in Asia", 7.

be politically difficult. While the users stand to gain, powerful domestic interests can stand to lose. Restrictions on services are generally engineered to protect infant industry, or to allow the 'orderly exit' of firms in times of crisis. In the past, infant industry arguments failed because governments could not commit themselves to liberalize at some future date. For example, one expects infant industries, by definition, to eventually become successful. Thus, at some future date, competing firms should be allowed market access through liberalization. Because developing countries can rarely compete with the developed financial markets, they do not take an aggressive stance in negotiations. Developing countries can be excluded from the give-and-take negotiating process because of this. As a result, they lean toward a defensive, protective posture in negotiations. This has not been a major problem, however, because many of these countries have also realized that opening their financial services markets can be beneficial beyond the concessions made to foreign service providers.⁷³²

In sum, governments are primarily concerned with four main factors when opening their financial services markets to competition. First, how fast to open up, second, which policies will minimize transition costs and potential risks and maximize the benefits of increased openness, third, which complementary policies are required, and finally, which foreign competitors should be introduced? A key challenge for the developing countries is to strengthen domestic standards and prudential supervision, because ultimately governments retain the roles of supervisor, regulator, and are responsible for objectives like protecting

⁷³² Dobson, Wendy, Jacquet, Pierre, (1998), Financial Services Liberalization in the WTO, 78.

consumers.⁷³³ With greater liberalization in mode four, many more developing countries could ‘export’ at least the significant labour component of services.⁷³⁴ For the developing countries, the GATS provides an opportunity for them to achieve meaningful market access commitments in sectors and modes of interest to them, especially in financial services which are an integral part of a national development strategy.⁷³⁵ Many Asian countries, India included, have not had well-developed financial systems because of their histories with state ownership. Many have required improvements to their payments systems and to develop money markets and central bank operations, and to reduce the numbers of nonperforming loans. Unless their domestic financial systems are freed of restrictive regulations and competition policies, the Asian countries will not benefit from liberalization in financial services.⁷³⁶

Section III: Potential Benefits of Liberalizing Trade in Financial Services

In the financial services negotiations before 1994, not much progress was achieved until an international effort persuaded many governments of the domestic financial and economic benefits of the agreement’s potential.⁷³⁷ The GATS has had an indirect impact of this kind by encouraging debates at the domestic level about the adequacy of existing

⁷³³ Sauve, Pierre, Steinfatt, Karsten, (2001), “Financial Services and the WTO: What Next?”, 365.

⁷³⁴ Mattoo, Aaditya, (1999), “Developing Countries in the New Round of GATS Negotiations: Towards a Pro-Active Role”, 3.

⁷³⁵ Mashayekhi, Mina, (2000), “GATS 2000 Negotiations: Options for Developing Countries”, 4.

⁷³⁶ Claessens, Stijn, and Glaessner, Tom, (1999), “Internationalization of Financial Services in Asia”, 65.

⁷³⁷ Feketekuty, Geza, (2000), “Assessing and Improving the Architecture of the GATS”, Chapter 4 in Sauve & Stern, (2000), GATS 2000, 88.

regulatory systems. As a result, many countries have taken liberalization initiatives aside from, and in addition to, those in the international agreement. The protection of certain emerging banking sectors does make some sense in the few cases where there is no natural comparative advantage in providing domestic consumer services. However, protectionism under such conditions must be weighed by the developing countries against the urgent need to obtain efficient intermediation services to aid economic development.

In order to begin a discussion of the benefits of the process of liberalization in financial services, it is useful to recall three concepts which were described as distinct but interrelated in Chapter one: domestic regulatory reform, capital account liberalization, and the liberalization of trade in financial services. These processes are closely related because they all depend on domestic financial deregulation. This is primarily why the issue of domestic regulation in services at the WTO is the most contentious at present. The GATS essentially works toward the elimination of discrimination of treatment between foreign and domestic financial services providers. This especially includes measures which discriminate between financial services providers operating through commercial presence and cross-border trade. A certain degree of capital movement is necessary for effective and efficient liberalization, because some types of financial institutions like securities firms, for example, need to be able to move capital freely in order to conduct their normal business. Another example is when foreign banks are allowed to branch and draw on the world-wide resources of their parent bank. On the other hand, non-life insurers (e.g., motor insurance), and many other consumer financial services, for example, have mostly non-financial services characteristics. They involve, for example, few investable funds. In these cases there are

fewer linkages with capital account liberalization, and liberalizing these services can proceed separately from other reform processes. As stated in chapter two, the GATS provides the safety mechanisms for countries to take control in situations where unforeseen capital mobility issues arise. It also does not require governments to make commitments, including in areas they might perceive to be a threat to their economic stability, or that might carry higher risks. The optimal degree and speed of opening should be based more on influencing the quality of the financial system, one of the results of reducing the amount of discrimination.

The criticisms of liberalization, outlined in Chapter One, suggest that the GATS processes are basically mandating change to countries that are reluctant to liberalize, and forcing their economic decisions. In fact, it is unrealistic to think they are. In many cases, liberalization in financial services policy is being initiated at the domestic level by democratically elected governments that are the members of the WTO, and that participate in the other international regulatory bodies. This, however, is as democratic as the process can get. To go further, or bring the details of each step of the politics and economics surrounding the management of financial services, into public account, would lead to disorder and immobility. This is one of the main reasons why central banks are independent in many countries and why complex negotiations are handled by experienced regulators in *de facto* departments of finance - distanced from more political agencies.⁷³⁸

It can be argued that these domestic policy objectives are based on a country's historical, cultural, and legal background. These domestic circumstances influence a country's international relations, so the decision to liberalize in financial services is usually

⁷³⁸ Personal interview, September 2001.

a sovereign one. The important question is whether sufficient self-determination is actually exercised in this process. The GATS accounts for this, and was important from the beginning of the Uruguay Round in 1986 at Punta del Este. The trade ministers agreed to limited ambitions of future negotiations for trade in financial services, recognizing the importance of respecting national laws and regulations in services. As Kampf notes: “The Annex on financial services makes no reference to the establishment and adoption of common international standards and criteria as the basis for the recognition of prudential measures, despite the potentially positive impact on trade in financial services which such internationally agreed standards would be likely to further.”⁷³⁹ Article IV of the GATS aimed to ensure the reasonable, objective, and impartial application of regulatory measures, but did not make any attempt to set multilateral rules concerning the substance of domestic regulations. Essentially, it aims for ‘equally competitive’ opportunities, whereby discriminatory practices are eliminated. Achieving a significant level of liberalization will require governments to identify where domestic liberalization and policy reform would be desirable for economic development. As Hoekman has noted: “The challenge, therefore, is to develop negotiation modalities that will encourage governments to use the GATS as a mechanism through which to pursue desired domestic reforms.”⁷⁴⁰

Economic Arguments for Liberalization

The relationship between financial market liberalization and economic development

⁷³⁹ Kampf, Roger, (1997), “Liberalization of Financial Services in the GATS and Domestic Regulation”, 162.

⁷⁴⁰ Hoekman, Bernard, (2000a), “The Next Round of Services Negotiations: Identifying Priorities and Options”, 31.

has been extensively studied. The literature indicates that the liberalization of financial systems is a major factor in economic development, but needs to be carefully sequenced and managed.⁷⁴¹ In particular, it is important to strengthen the institutional framework of the state, including the regulatory and supervisory functions (the screening of new foreign entrants), and the use of the market in disciplining financial institutions (including better information, and better corporate governance).

The benefits from liberalization arise primarily from more competition and better financial intermediation obtained through comparative advantage.⁷⁴² The GATS FSA is one way developing countries can develop such an advantage. It is obtained in the same way as in other sectors - specialization on the basis of comparative advantage, dissemination of know-how and new technologies, and the realization of economies of scale and scope.⁷⁴³ Many economists argue that the liberalization of trade in financial services is also thought to have strong positive effects on economic stability, income and growth.⁷⁴⁴ It does so by

⁷⁴¹ Caprio et al., (1994), Levine, (1997), and Claessens, Stijn, Glaessner, Tom, “Internationalization of Financial Services in Asia”, 7.

⁷⁴² See Hindley, Brian, Smith, Alasdair, (1984), “Comparative Advantage and Trade in Services”. See also Francois, Joseph, Schuknecht, Ludger, (1999), “Trade in Financial Services: Procompetitive Effects and Growth Performance”.

⁷⁴³ This encourages resources to move into the most productive activities, and improves productivity and the investment climate. Economies of *scale* allow lower average costs through the production of greater quantities of goods and services of the same type. Economies of *scope* allow cost reductions through the production of related goods or services.

⁷⁴⁴ See for example Hoekman, Bernard, Mattoo, Aaditya, (2000), “Services, Economic Development and the Next Round of Negotiations on Services” or Kono, Masamichi, Schuknecht, Ludger, (1998), “Financial Services Trade, Capital Flows, and Financial Stability”.

See Chapter 2, page 5 for a discussion of “Liberalization”.

improving the national distribution of resources and promoting technical improvements, as domestic service providers are required to adopt new technologies in order to compete with foreign providers. Limiting the openness of the financial services sector is costly, it is argued, resulting in higher costs of financial services, slower institutional development, and more fragile financial systems.⁷⁴⁵ The crucial question then becomes how liberalization and the accompanying reforms should be carried out so as to maximize the benefits. One important way is by making financial services commitments in the GATS, a system based on the principles of nondiscrimination and predictable and transparent conditions for international trade. Essentially this means rules-based as opposed to power-based relations.⁷⁴⁶

The trend toward increased legalization (i.e., making international commitments more precise and explicit) in international trade arguably has both negative and positive effects on trade liberalization. On the positive side it can produce better availability and more precise information about the implications of trade policies.⁷⁴⁷ This makes for more effective monitoring and enforcement of rule-breaking as well as reducing transaction costs. Through the establishment of sets of rules (right and obligations), greater predictability is added to

⁷⁴⁵ Based on cross-country empirical evidence in a study by Claessens, S., Glaessner, T., "Internationalization of Financial Services in Asia", Background Paper to the conference "Liberalization and Internationalization of Financial Services", World Bank and WTO Secretariat, April 1999. See also Levine, Ross, (1997), "Financial Development and Economic Growth: Views and Agenda", 720.

⁷⁴⁶ Kono, et. al., (1997), "Opening Markets in Financial Services and the Role of the GATS", 1.

⁷⁴⁷ Goldstein, Judith, and Martin, Lisa, L., (2000), "Legalization, Trade Liberalization, and Domestic Politics: A Cautionary Note", 604.

trade relations. To the extent that there is a reduction in absolute sovereignty, it is to some extent complemented by the relative influence gained by national governments in international organizations, and the establishment of international rules. Legalization also binds liberalization, making national policies more predictable, and weakening the power of protectionism. For developing economies, these rules are particularly important, as they could otherwise be subjected to discriminatory trade policy actions from larger economies.

Evidence also suggests that robust legal and supervisory frameworks, low levels of corruption, high degrees of transparency, and good corporate governance are key for managing financial globalization.⁷⁴⁸ The GATS helps to underpin macroeconomic and regulatory reforms when they are combined with appropriate macroeconomic policies and adequate regulation. When a country makes commitments, it signals policy stability and intent to foreign investors. As Wendy Dobson has noted, a country's reputation rather than market share drives the decision of whether or not to enter a foreign market.⁷⁴⁹ Participation in the GATS shows initiative, and may induce other countries to do likewise. It must also be recognized that the potential economic gains from unilateral (autonomous) liberalization are also significant. Not only can countries improve their relative standing through competitive liberalization, but services are an input into the production of most industries (i.e., intermediaries). Hence, an inefficient service sector can be very costly to the economy

⁷⁴⁸ Prasad, Eswar, Rogoff, K., et. al., (2003), "Effects of Financial Globalization on Developing Countries: Some Empirical Evidence", 6.

⁷⁴⁹ Dobson, Wendy, (2002), "Further Financial Services Liberalization in the Doha Round?", 7.

as a whole.⁷⁵⁰

Enhanced competition can also promote efficiency, help to recapitalize troubled institutions, and transfer technology and know-how.⁷⁵¹ Corporations are primarily the center of activity, those with the expertise in these highly knowledge-intensive services industries. While protectionists forward the infant industry argument, the playing field can be leveled simply by requiring foreign firms to observe the same regulations as domestic firms (i.e., by committing to national treatment).⁷⁵² Successful domestic liberalization means more emphasis on competition, rather than on a change of ownership from public to privately held.⁷⁵³ This is because restricting commercial presence in service provision, and thus excluding competition from the market, will cause prices to be set based strictly on the domestic market.

Section IV: Strategies for Opening

It should now be clear that a case is not being made for hasty liberalization. Rather, financial sector reform requires pacing, sequencing, and other specific components.⁷⁵⁴ Pacing involves either a gradual or rapid approach, either total reform or that coexisting with governmental controls intact. Sequencing must account for the general macroeconomic

⁷⁵⁰ Bhagwati, Jagdish, (1997), Writings on International Economics, 463.

⁷⁵¹ Mattoo, Aaditya, (1998), "Financial Services and the WTO: Liberalization in the Developing and Transition Economies", 26.

⁷⁵² Claessens, Stijn, Glaessner, Tom, (1999), "Internationalization of Financial Services in Asia", 18.

⁷⁵³ Mattoo, Aaditya, (1999), "Developing Countries in the New Round of GATS Negotiations: Toward a Pro-Active Role", 1.

⁷⁵⁴ Reserve Bank of India (RBI), (1999), "Banking Soundness, Monetary Policy and Macro-Economic Management: Random Thoughts", Speech by Y.V. Reddy, 1.

condition of the economy, ownership and privatization issues, and the regulatory and supervisory framework. Generally, the circumstances in each individual economy determine how much macroeconomic stability and prudential regulation are needed before opening.⁷⁵⁵ Economies that do not have systemic weaknesses can launch more comprehensive reforms. This has been the case in India, where certain components have been necessary, such as dismantling the credit programs, reducing barriers to entry, and privatization.

There are two main ways in which a country can approach financial liberalization. The first is the “Big-Bang” approach that introduces all market-opening measures at the same time. This strategy can prevent the reform process from being interrupted before it is complete. In India, for example, market reforms and opening were initiated rapidly in 1991, but with the passage of time, they had slowed. By mid 1998, the whole exercise was still incomplete.⁷⁵⁶ Interest groups who could lose from greater competition are generally against this approach because it offers them no time to organize a resistance. The second is the “Gradualist” approach, which provides time to adjust to new conditions and can raise the credibility of the opening process. All of the case studies in this dissertation have reflected the latter approach. The premise of Chapter Three was that the impetus for these activities has come from government’s responsibility to achieve economic growth and stability, and the need to update regulations in line with international standards.

Canada’s efforts in this regard can be characterized more as ‘restructuring’ than as

⁷⁵⁵ Das, Dilip, K., (1998), “Trade in Financial Services and the Role of the GATS: Against the Backdrop of the Asian Financial Crises”, 93.

⁷⁵⁶ Das, Dilip, K., (1998), “Trade in Financial Services and the Role of the GATS: Against the Backdrop of the Asian Financial Crises”, 93.

'revolution'. It has been based on the need for an updated domestic regulatory framework in financial services, conditioned by several domestic political issues. When considering changes to the legislation affecting foreign financial institutions, the government has had to balance the interests of the large domestic banks as well as the interests of the public good. This included periodic reviews that established the Bank Act of 1980, and continued up to the most current legislative changes announced by Bill C-8. Canada had also participated in the financial services provisions offered in the FTA and the NAFTA, both of which offered considerable experience for the WTO process. All of these agreements have represented efforts to reduce or eliminate obstacles to trade in financial services between Canada and its trading partners. Largely on its own terms, Canada has managed to achieve conservative levels of liberalization while balancing both social and private interests at the domestic level.

Other considerations are also important. It is generally argued that the 'sequencing' of FS opening should be preceded by macroeconomic stabilization and supported by evolving prudential measures.⁷⁵⁷ In particular, national reform programs need to be coordinated with liberalization, considering macroeconomic conditions and policies, level of development of prudential regulation and supervision, the need for financial sector restructuring, regulatory structure of interest rates and credit markets, and finally, the depth of financial markets more generally.⁷⁵⁸ In developing countries with underdeveloped financial sectors, domestic regulatory reforms are first essential. Linking this to the level of

⁷⁵⁷ Sorsa, Piritta, (1997), "The GATS Agreement on Financial Services - A Modest Start to Multilateral Liberalization", 20.

⁷⁵⁸ Tamirisa, Natalia, et. al., (2000), "Trade Policy in Financial Services", 23.

commitment to the state of development is also key. The GATS FSA accommodates this by gradualism - the progressive liberalization of financial services markets. It focuses on market opening, leaving the appropriate sequencing to national authorities, though this can be difficult in international trade bargaining situations, especially when developing countries are dealing with more powerful partners.

The GATS Negotiations

The outcome of the Uruguay Round was unbalanced with regards to services. The so called “tradeoffs” between modes of supply that can satisfy different countries’ interests did not occur. In addition, an overall unwillingness on the part of developing countries to open up their domestic services markets made demands for the liberalization of labour mobility hard to accomplish. For example, there was resistance from developing countries to liberalize labour mobility in exchange for a greater commercial presence of foreign banks. This is because in many cases, the commitments made by the developed countries only covered a small proportion of the various visa categories for temporary entry.⁷⁵⁹ These issues have been complicated by the nature of the differences in modes of supply.

Cross-border trade and commercial presence are the two most relevant modes of trade in financial services. The policy implications of each of these modes of supply for a country often results in contentious debate. Opening to cross-border trade, for example, increases the flow of capital more than liberalizing commercial presence. It therefore needs to be coordinated closely with capital account liberalization in the context of prudent

⁷⁵⁹ Mashayekhi, Mina, (2000), “GATS 2000 Negotiations: Options for Developing Countries”, 21.

macroeconomic and financial sector policies. More commitments have been made in mode three (commercial presence), because of the greater legal predictability and regulatory control it offers. Mode one, on the other hand, has been left mostly 'unbound' in country service schedules due to the difficulties with legal control that comes with cross-border control and accountability.

Allowing foreign service providers to access domestic markets via commercial presence has its own concerns. It requires removing barriers to direct investment and thus can raise strategic and cultural concerns about foreign ownership in the financial sector. It brings about sectoral concerns about the quality and soundness of foreign entrants, and questions whether they would only engage in providing services to the most profitable sectors of the market (i.e., "creaming" or "cherry-picking"). Thus, the liberalization of commercial presence needs to be designed in the context of a consistent macroeconomic framework, supported by appropriate supervision and regulation.⁷⁶⁰ In the FSA, Canada essentially 'locked-in' the existing levels of access it had been offering to foreign institutions. While it can be argued that Canada (along with most other countries), continues to be restrictive in market access by limiting the ownership of its major banks, the case can also be made that the Canadian market has in fact remained accessible in the areas in which foreign financial firms wish to operate. The requirement that Canada's biggest banks remain closely-held ensures that these institutions remain focused on the interests of Canadians. Specifically, this reflects Canada's unique social and economic concerns, and allows the government to effectively govern the financial system through the exercise of regulatory

⁷⁶⁰ Tamirisa, Natalia, et al., (2000), "Trade Policy in Financial Services", 4

authority.

In developing financial markets, commercial presence is thought to benefit the financial sector in several ways.⁷⁶¹ First, it improves the institutional environment by enhancing transparency. Foreign service providers will find it easier to gain information on creditworthiness if they are physically present in the foreign market. Secondly, commercial presence can increase the pressure to strengthen the regulatory and supervisory framework. This includes making available information on best practices and transparency, so that unnecessary interventions are reduced, and regulation and supervision are improved. Finally, commercial presence helps market development. The development of new services is easier when service providers have clear information about local market needs. Markets that then become more developed are less volatile, as investors are more willing to engage in long-term commitments. Also, the presence of foreigners can help to spread risk more broadly, resulting in better risk management and diversification.

A WTO study in 1997 found that members made more commitments in financial services than any other service sector except for tourism.⁷⁶² However in financial services the number of limitations maintained on market access or NT was higher than in other sectors, and the levels of commitments varied considerably across countries. Where commitments were made, as noted earlier, it was found that governments generally preferred to liberalize commercial presence (Mode 3) rather than cross-border trade (Mode 1). A later

⁷⁶¹ Kono, Masamichi, "Financial Services Trade, Capital Flows, and Financial Stability", WTO, 1998, 11

⁷⁶² See Kono, Masamichi, (1997), "Opening Markets in Financial Services and the Role of the GATS", WTO Special Studies, Geneva.

WTO study showed that the GATS led to less emphasis being placed on the introduction of competition through new foreign entry and greater emphasis on equity participation (which protects incumbents).⁷⁶³ Developing countries can, however, be more open than commitments suggest. Countries can be extremely open with respect to commercial presence, but extremely closed with respect to cross-border supply. An IMF study by Sorsa on the 1995 interim agreement in financial services, found that in most countries, the actual level of liberalization differed from that undertaken in the GATS.⁷⁶⁴ Many members with relatively developed sectors made narrow openings, while some lesser developed countries made very liberal openings. The conclusion from this data was that the bulk of GATS liberalization was the result of a process of self-centered bargaining.

The Issue of Domestic Regulation

This dissertation has shown how trade in services is affected by barriers that are deeply rooted in the domestic regulatory system. Many aspects of services regulation, unlike the regulatory regime applying to goods (e.g., import duties, quantitative restrictions), are essentially flexible and discretionary. Before the GATS, for example, governments relied on public monopolies to achieve universal service objectives, either by cross-subsidization across different segments of the market, or through transfers from the government or

⁷⁶³ See Mattoo, Aaditya, (1998), "Financial Services and the WTO: Liberalization in the Developing and Transition Economies", World Trade Organization, Staff Working Paper TISD9803.WPF.

⁷⁶⁴ Sorsa, Piritta, (1997), "The GATS Agreement on Financial Services - A Modest Start to Multilateral Liberalization".

government controlled banks.⁷⁶⁵ These monopolistic market structures are now a major impediment to liberalization. This is because in financial services, regulations which aim to uphold prudential supervision, can also be manipulated to serve protectionist ends by legitimizing barriers to trade.⁷⁶⁶ In many countries, for example, domestic banks are saddled with debt because of past directed-lending programs, and are not well-equipped to deal with foreign competition. This is where negotiations reach difficulties because they require a listing of many sensitive aspects of domestic regulation. At the same time, regulators hesitated in limiting their existing regulatory capacities under such a novel international agreement.

Another problem is that regulations are often in need of reform in order to deal with the increased complexities in modern financial services sectors. In this respect, governments are often more reactive to such changes as the “real world”, pressures such as those caused by industry innovations, that are forced on their agendas.⁷⁶⁷ This was seen in two events that pushed the agenda and eventually helped the progress of the WTO financial services negotiations up to 1999.⁷⁶⁸ First, private firms in the US and the EU created the Financial Leaders’ Group in 1996, which was organized to provide unified European-North American financial sector support to liberalize trade in financial services in the 1997 WTO financial

⁷⁶⁵ Mattoo, Aaditya, (1999), “Developing Countries in the New Round of GATS Negotiations: Towards a Pro-Active Role”, 8.

⁷⁶⁶ Hindley, Brian, (1999), “Internationalization of Financial Services: A Trade Policy Perspective”, 2-3.

⁷⁶⁷ Personal interview, September 2001.

⁷⁶⁸ Dobson, Wendy, Jacquet, Pierre, (1998), Financial Services Liberalization in the WTO, 84-85.

services negotiations. Second, the fallout from the 1997 Asian financial crisis showed a need to restore confidence to the international financial system.

In the Uruguay Round services negotiations, two sets of compromises were reached that have significant implications for domestic regulation and dispute settlement in services. For services in general, some requirements were introduced in GATS Articles VI and VII. GATS Article VI has several requirements. Domestic regulation, for example, needs to be “reasonable, objective and impartial”, with information on procedures to be followed. Additionally, regulation should be non-burdensome, not restrict service supply, and should reference international standards. GATS article VII provides for mutual recognition for countries’ respective regulatory regimes, on the basis of multilaterally agreed criteria, where possible. In financial services, the compromise was written in the Annex on Financial Services in the form of the “prudential carve-out”. This is intended to be used by members for issues of safety and soundness, and in reality it is not closely restricted by GATS provisions. Taken together, these measures represented a compromise aimed at resolving the tension between making more services commitments and maintaining domestic regulatory authority.

Agreeing to remove these barriers is delicate work for regulators, who may be potentially subjecting their sovereign spheres to WTO dispute settlement and necessity tests.⁷⁶⁹ Domestic stakeholders, NGOs and civil society generally circle around this unknown with calls to stop the liberalization process. Yet if liberalization is to proceed further and

⁷⁶⁹ Recall that the “necessity test” is a GATS requirement that regulations not be more burdensome than necessary to ensure the quality of the service. See GATS Article VI, 4(b).

benefit from the next rounds of services negotiations, more substantial regulatory change will be required at the domestic level. The previous negotiations in services essentially achieved only a locking-in of the commitments which already existed up to that point. The discussion in chapter two showed how the GATS can achieve liberalization without compromising the right of governments to regulate their economies. The question that should be asked is whether this has been working better in theory than in practice. The answer is yes, as seen in the numerous public domestic backlashes unleashed by those who stand to lose from liberalization, and the messages that are voiced by the anti-liberalization activists. This, however, is a problem that needs to be addressed by governments at the domestic level. In the GATS, domestic deregulation in financial services does not imply the elimination of prudential regulation. Rather, it aims for the withdrawal of government intervention through, for example, privatizing state-owned banks, easing restrictions on cross-sectoral activities to allow banks, insurance companies, finance companies, and securities firms to enter each other's sub-sectors. One way this can be better enhanced is to initiate broad consultations with potential stakeholders. This route is more likely to gain legitimacy and solve complex regulatory necessity problems.

The WTO's current work in this area is being done by the WTO Working Party on Domestic Regulation. Its agenda includes examining key aspects of regulation identified in GATS Article VI. Since 1999 it has focused on the development of general disciplines for professional services, and on concepts related to the development of regulatory disciplines generally. For the latter issue, the Working Party has been focusing on issues surrounding

the necessity and transparency of domestic regulation.⁷⁷⁰ This has focused on the “necessity test” of Article VI which seeks to determine that domestic regulations are not ‘more burdensome than necessary.’ Feketekuty states the function of Article VI clearly: “Article VI of the GATS provides a basic framework for minimizing the distortions of trade created by domestic regulation.”⁷⁷¹ One of the main objectives for improving transparency has been aimed at ensuring that those who are affected by regulatory changes are sufficiently consulted, a process that would garner greater overall legitimacy.⁷⁷²

Since the process of liberalization is largely driven by market access negotiations, policymakers face the challenge of linking the sequence and pace of multilateral trade liberalization to what is happening in the context of national financial sector reforms and specific domestic circumstances.⁷⁷³ For example, the processes of domestic deregulation of the financial sector in Canada and the liberalization through trade agreements have often taken place in concert. While both have allowed for a gradual reevaluation and modernization of Canada’s policies in this regard, the concerns at the domestic level may have been a real and continuing distraction from making progress with respect to less restricted foreign entry. As Woodrow has noted: “The crux of the matter is that domestic regulation/supervision is no longer purely domestic in conception or implementation but

⁷⁷⁰ World Trade Organization, (2001), “Report on the Meeting Held on 2 October 2001”, Working Party on Domestic Regulation (WPDR), November 2001.

⁷⁷¹ Feketekuty, Geza, (1998), “Setting the Agenda for the Next Round of Negotiations on Trade in Services”, 4th page.

⁷⁷² Sauve, Pierre, and Steinfatt, Karsten, (2001), “Financial Services and the WTO: What Next?”, 358.

⁷⁷³ Tamirisa, Natalia, et. al., (2000), “Trade Policy in Financial Services”, 3.

must be closely calibrated to international trade and regulatory agreements affecting the field.”⁷⁷⁴

It has also been suggested that the WTO Working Party may now need to broaden its focus and examine the relationship between general guiding principles affecting domestic regulation and specific issues of regulation in individual sectors.⁷⁷⁵ In financial services, this would involve the relationship between the WTO and other international bodies concerned with sectoral regulation (in the case of insurance, the International Association of Insurance Supervisors (IAIS)). Other issues might consider if such external associations should play a role in providing consultation or experts for a Dispute Settlement Panel.⁷⁷⁶ The adoption of such standards across countries is also more likely to reduce the scope for commercial conflict by reducing incentives for regulatory arbitrage.⁷⁷⁷

Section V: Lessons from the Case Studies

The 1997 Asian Financial Crisis

Many economies had significant structural weaknesses leading up to the Asian financial crisis of 1997. For example, the regulation and supervision of financial institutions were often weak, overall transparency was lacking, and there were serious shortcomings in governance and public administration. In many cases, this included tangled laws, corrupt

⁷⁷⁴ Woodrow, R. Brian, (2001), “Domestic/International Regulation and Trade in Insurance Services: Implications for the Services 2000 Negotiations”, 380.

⁷⁷⁵ Cooke, John, A., (2000), “The Emergence of Domestic Regulation as a Focal Issue in the GATS 2000 Services Negotiations”, 141.

⁷⁷⁶ *Ibid.*, 143.

⁷⁷⁷ Sauve, Pierre, Steinfatt, Karsten, (2001), “Financial Services and the WTO: What Next?”, 358.

courts, deeply biased credit systems, and elaborate business registration requirements.⁷⁷⁸ These weaknesses contributed to the severity of the crisis because they allowed weak investments to flourish. While capital can provide a country with much needed economic development funds, freeing its movement has to be done in tune with the strengthening of domestic institutions. If countries open up before their corporate sectors and financial systems are ready, they run the risk of being swamped by volatile capital flows, both inwards and outwards. The World Bank's chief economist for East Asia and the Pacific, Homi Kharas recently said: "The best safeguard against future downturns is to have such reforms (legal and financial) well underway; the best way to take advantage of an upturn is to have all systems in place which encourage and properly utilize investment capital. We are encouraging all countries in the region to stick with their reform programs."⁷⁷⁹ When opening can be accompanied by greater transparency, predictability, and market-competition, downturns should in fact be less severe and better handled.⁷⁸⁰

Some economists have been suggesting that a slower and more thoughtful approach to opening be used, in order to ensure that appropriate domestic reforms could first be made to regulations and to the economies. In many cases such caution stems from uncertainty about opening markets, whether by changes in the international economy, or due to the condition of the domestic economy. Through the WTO FSA, however, countries can play

⁷⁷⁸ World Bank, (2000), "Better Institutions Key to Poverty Reduction in East Asia and Around the World", 1.

⁷⁷⁹ World Bank, (2001), "Prolonged Economic Downturn will hurt East Asia's poor, Reforms more vital than ever", 2.

⁷⁸⁰ Sauve, Pierre, (1998), "The Benefits of Trade and Investment Liberalization: Financial Services", 2.

a significant role in their own financial services liberalization, based on unique economic and political circumstances. For Singapore, the WTO FSA has been more of a benchmark and guideline against which the MAS has been able to measure its standards. This is mostly because the country is not a big player in the financial services negotiations. Singapore has undergone mostly self-initiated liberalization, with the goal of attracting investment which otherwise might not have been harnessed. A big part of this capability has been having fiscal, regulatory, and prudential incentives in place. This reinforces the argument that the significance of the WTO agreement in financial services has been thus far to create a framework for negotiating trade in services and to lock-in commitments, rather than to achieve significant levels of liberalization. Essentially, the WTO FSA has not been a pressure on Singapore's financial sector opening, because Singapore intends to keep foreign financial firms closely regulated.

The 1997 Asian financial crisis had a relatively limited direct effect on the Singapore economy. However, the problems in the neighboring countries did have the effect of decreasing the potential investment entering the country, as well as lowering overall corporate revenue. One of the realizations from the crisis in Singapore was the need to strengthen corporate governance standards, disclosure, and transparency policies. These market-supporting changes help by easing the flow of information, defining and enforcing property rights and contracts, and increasing competition. After the September 11 terrorist attacks in New York, there was concern in East Asia about a prolonged economic slump.⁷⁸¹ Since the crisis, Singapore has been looking outward with the goal of negotiating bilateral

⁷⁸¹ Personal interview, November 2001.

free trade agreements. One of the most important aspects of this direction has been to develop as an international financial center, with the MAS in consolidated control.

The Developing Country Perspective

The case of India demonstrated a history of planned economics, a heavy reliance on public sector investment, and public control of the banking system since 1969. This has placed public-sector objectives at loggerheads with international competitiveness. In the banking system, this is most visibly reflected in legislated reserve requirements, directed credit, and overall lax regulation and supervision. In the wake of India's major economic reform initiative of 1991, new guidelines for foreign banks, including increased equity participation and the re-capitalization of the public banks, began to appear. While the impact of external relations such as the international trade and financial institutions seem to have played a role, there is also an indication that changes were happening from within, the new spirit of entrepreneurship being one example. Reforms have not been followed through with due attention, and current regulatory changes have been carried through very slowly.

With respect to the WTO FSA, India's long-standing administrative and institutional arrangements need to be changed and aligned with WTO guidelines. This, however, is difficult in a country dependent on economic and social redistribution. While curing the problems with the state-owned banks appears to be an onerous task in the short-term, the removal of political interference is a realistic short-term goal. Despite all of the potential benefits to be realized by financial services liberalization, developing countries like India still *initially* want to avoid regulatory reform, and to maintain some significant market management and intervention capability. One reason for this may be that the WTO financial

services negotiations have generally been less attractive to developing countries because they have not been significant financial services exporters (i.e., unable to compete), and hence have had relatively little to gain from them.⁷⁸² The financial services negotiations were a single-sector negotiation (i.e., separate from the Uruguay Round) and tended to divide countries into the developed countries that sought greater market access, and the developing countries who focused on the extent of competition in their domestic market.⁷⁸³ The “reciprocity” nature of the services negotiations made the developing countries feel they were at a disadvantage.⁷⁸⁴ This is because the governments of developing countries are primarily interested in harnessing foreign capital flows to accelerate growth and are less interested in gaining access to developed country financial markets. In addition, developing countries fear regulatory regimes that are not yet entirely standardized across countries. Therefore they feel it important that the state initially play a greater role in services trade and that local firms receive some benefit.⁷⁸⁵ Their different goals along with the reciprocity problem have led to protectionism in their financial services markets.

While developed countries argue that the liberalization of trade in services can be highly beneficial for developing countries, particularly through FDI and access to the import of services, many developing countries are skeptical about the benefits of market access and

⁷⁸² Kampf, Roger, (1998), “Financial Services in the WTO: Third Time Lucky”, 3. See also Dobson, Wendy, Jacquet, Pierre, (1998), Financial Services Liberalization in the WTO, 78.

⁷⁸³ Mattoo, Aaditya, (1998), “Financial Services and the WTO: Liberalization in the Developing and Transition Economies”, 18.

⁷⁸⁴ Dobson, Wendy, Jacquet, Pierre, (1998), Financial Services Liberalization in the WTO, 96.

⁷⁸⁵ Bhagwati, Jagdish, (ed., 1997), Writings on International Economics, 456-457.

their supply capacities. The process of progressive liberalization needs to be properly sequenced so as to maximize the benefits. The key concern for developing countries is not only the increased flow of trade, but also the overall contribution to a competitive services sector and to the level of development at the national level.⁷⁸⁶ Since it recently acceded to the WTO, for example, China will soon be allowing foreign banks access to its domestic market. It is now working hard to make its big four state banks profitable by upgrading technologies and clarifying the ownership and oversight responsibilities in its banking sector. This latter issue is a difficult challenge for the competing domestic agencies, as they debate about what is best for the state banks and the national economy.⁷⁸⁷ For many other developing countries, the development of the services export business is the only way that they can get away from their dependence on the export of basic commodities. Liberalization is thought to strengthen developing country financial systems through capacity-building, attracting good capital, and improving efficiency.⁷⁸⁸ Capacity-building refers to improvements in the infrastructure (payments systems, etc.), market development, as well as prudential regulation, supervision, and transparency.⁷⁸⁹

There are differing reasons for protectionism in developing countries, and one of the

⁷⁸⁶ Mashayekhi, Mina, (2000), "GATS 2000 Negotiations: Options for Developing Countries", South Centre Working Paper # 9, 3.

⁷⁸⁷ The agencies are China's central bank, the Ministry of Finance, and a financial task force under the Communist Party. Leggett, Karby, (2003), "Chinese Banks Ponder Change", *Globe and Mail*, Monday July 28, 2003, B7.

⁷⁸⁸ Dobson, Wendy, Jacquet, Pierre, (1998), Financial Services Liberalization in the WTO, 12-13.

⁷⁸⁹ Kono, Masamichi, and Schuknecht, Ludger, (2000), "How Does Financial Services Trade Affect Capital Flows and Financial Stability?", 147.

goals set out in this dissertation was to examine the appropriateness of protectionism under differing circumstances. Huala Adolf draws several conclusions about the developing country perspective in the GATS Financial Services Negotiations.⁷⁹⁰ The developing countries share similarities in wanting liberalization in the financial services sector to proceed at a pace with their economic capacity. Liberalization should also reflect the level of development of each country. In India, the objective has been to ensure that economic benefits reach the rural areas. These factors go to influence the expectations of these countries in the FSA. The ultimate goal is that the beneficiaries of liberalization should be the 'small' people, not the state or the companies. Developing countries face the challenges with respect to simply having the resources (funds or bureaucratic staffing) and the necessary technical assistance to manage the changes to their financial services regulations.

During the Uruguay Round's services negotiations, for example, India was a pivotal developing country member.⁷⁹¹ Initially, it took a hard line opposition to the negotiations and strongly opposed it. India initially claimed that there was no benefit from opening up financial services. It also contended that the Uruguay Round had only served the interests of the developed countries by negotiating the capital movement, whereas the interests of the developing countries (e.g., labour movement), was totally ignored. As the Uruguay Round negotiations proceeded, the developing countries realized that they could no longer resist having services included in the Uruguay Round and were successful at having two safeguards

⁷⁹⁰ Adolf, Huala, (2000), "Financial Services Agreement of the GATS: The Developing Countries' Perspective", 212.

⁷⁹¹ Ibid., 210.

put in place. At the substantive level, they got the ‘development of the developing countries’ clause inserted, consistent with their development priorities and national laws and regulations.⁷⁹² Second, they succeeded in establishing a distinctly separate negotiating process for services.⁷⁹³ In part due to strong persuasion from the United States, India eventually gave in, though commitments were considered modest. In the GATS, India took the view that commitments should be achieved through successive rounds of multilateral negotiations, with flexibility for its members. As a result of the negotiations, India made limited commitments to opening in its banking sector but is almost completely closed in insurance services. In its schedule of commitments, India makes them subject to entry requirements, domestic laws and regulations, and the terms and conditions of the RBI, the Securities and Exchange Board, and other competent authorities.

Several developing countries have been more willing to make commitments in banking. This is due to the higher priority placed on opening of the banking sector for foreign investors. In line with this, more commitments have generally been made in the more ‘internationalized’ financial services (like reinsurance, or services to the corporate sector) compared to specialized domestically-oriented financial services.⁷⁹⁴ Regulators may have objections to liberalization of cross-border trade (mode 1), as it is much more difficult to control industries that are located in foreign jurisdictions. Indeed, regulators may prefer

⁷⁹² WTO GATS Annex 1B (*Desiring..., Taking...*).

⁷⁹³ Muchkund, Dubey, (1996), An Unequal Treaty: World Trading Order After GATT, 48.

⁷⁹⁴ Das, Dilip, K., (1998), “Trade in Financial Services and the Role of the GATS: Against the Backdrop of the Asian Financial Crises”, 99.

that establishment by foreign firms is required, as this ensures that they will maintain their control of the activity involved (e.g., insurance). In addition, there is the legal issue of which jurisdiction the FSP is accountable to in the case of problems. Host countries are also concerned about situations where unsophisticated consumers and investors trust their funds with an FSP. Limiting cross-border supply ensures a host regulator's maximum direct involvement with regulating the activity. In addition, liberalizing commercial presence is thought to be safer in underdeveloped financial systems because it requires only limited liberalization of capital flows. Hence, in developing countries, 'modal neutrality' (equal liberalization commitments in both Modes 1 & 3) is not desirable.⁷⁹⁵

Finding a solution to the problem of protectionism will take time. In insurance and other financial services, the liberalization initiatives of the FSA may need to be slowed down in order to focus more on transparency and appropriate regulation, and the details of a 'necessity test' be worked out before expecting developing countries to accept international standards in line with the industrial countries. In insurance, as in all services, a necessity test would need to account for the particular functions of regulation as well as the specific objectives of relevant government policy.⁷⁹⁶

Section VI: Conclusions

Strengthening multilateral disciplines on domestic regulation can have a significant role in initiating regulatory reform at the domestic level. Since there are limits to what can

⁷⁹⁵ Kono, Masamichi, Schuknecht, Ludger, (2000), "How Does Financial Services Trade Affect Capital Flows and Financial Stability?", 168.

⁷⁹⁶ Woodrow, R. Brian, (2001), "Domestic/International Regulation and Trade in Insurance Services: Implications for the Services 2000 Negotiations", 386.

be achieved at the multilateral level, some of the key challenges need to be dealt with primarily at the national level. This is because multilateral trade rules are designed to ensure market access, but not to directly promote economic efficiency or social welfare.⁷⁹⁷ Considering the challenge of forming a strong basis for liberalization in financial services, the significance of the GATS FSA was mainly systemic and political. Because of the close linkage between international trade liberalization and domestic regulation, the financial services measures in of the GATS may bring about a certain level of convergence of regulatory and supervisory practices.⁷⁹⁸ However it does not seek to harmonize or administer financial 'deregulation', or force countries to adopt specific regulations which could alter the foundations of its cultural, legal, or historical makeup. The GATS aims to reduce regulatory differences through basic principles and disciplines over time.

The argument here has been that the costs and benefits of internationalization will depend on the efficiency and competitiveness of the domestic financial system, which is influenced by the nature of domestic regulation. The GATS FSA can facilitate this process without sacrificing the self-determination of countries in the prudential regulation of their economies, or in how fast they choose to liberalize. Countries engage the world economy largely on their own terms, not on the terms set by the global market or multilateral institutions. In fact, countries with underdeveloped financial systems may benefit the most in the long run because opening up can accelerate financial sector development. In some

⁷⁹⁷ Mattoo, Aaditya, (1999), "Developing Countries in the New Round of GATS Negotiations: Towards a Pro-Active Role", 6.

⁷⁹⁸ Kampf, Roger, (1997), "Liberalization of Financial Services in the GATS and Domestic Regulation", 155.

cases, protection of the banking sector in lesser developed countries may be temporarily helpful where the country has no comparative advantage whatsoever. Such protection needs to be checked against the need for developing adequate financial intermediation, especially the development of banks, through which the country needs to develop economically. Opening markets in financial services can ignite a crisis if monetary policies are lax, leading to imprudent lending. Also, if corporate governance problems exist, as they did in the Asian financial crisis, financial institutions will be undermined because weakened banks cannot survive in an environment that is more competitive.⁷⁹⁹ Essentially then, opening the financial services market is not responsible for crises (because it does not focus on opening the capital account), but policy and management errors will.

The GATS FSA itself is unique in the degree of support and political legitimacy it gathers from the financial services industry.⁸⁰⁰ Industry support in the European Union and the United States is seen to have been a key factor in the eventual success of the agreement. However, multilateral principles and industry support alone will not be sufficient to move further ahead in financial services. Since nondiscriminatory practices are nearly always embedded in domestic regulations, a wide variety of initiatives will be necessary to enhance and formalize regulation and supervision at the domestic level in line with international standards. Industry recognizes that the WTO represents a significant attempt to pave the way to equally competitive opportunities for countries trading in financial services. However,

⁷⁹⁹ Das, Dilip, K., (1998), "Trade in Financial Services and the Role of the GATS: Against the Backdrop of the Asian Financial Crises", 91.

⁸⁰⁰ Sauve, Pierre, Steinfatt, Karsten, (2001), "Financial Services and the WTO: What Next?", 353.

there are other problems which arise from the significance of stock markets and capital mobility that point to the need for mechanisms which also account for 'systemic risk' across differing domestic approaches to financial regulation and supervision. This is important because a government's position in financial negotiations with other governments is affected as much by domestic factors as it is by external relations.⁸⁰¹

Compared with other sectors of the economy, the financial services sector is unusual in having an elaborate and intensively used network of international fora both for continuing consultations on policy issues and for informal, but widely accepted, standard setting.⁸⁰² The networks of rules and standards that now exist at the international level include a variety of actors including national agencies, international bodies, and Self-Regulated Organizations (SROs). Regional agreements, like the European Economic Community (EEC) and the North American Free Trade Agreement (NAFTA), combine both the political and technical aspects of liberalization. The Financial Stability Forum (FSF), International Monetary Fund (IMF), and the International Accounting Standards Board (IASB) are just three of an array of international regulatory arrangements that monitor international financial health. These technical arrangements function to expand markets, while acting as supplemental guidelines which attempt to reduce risks and improve information. They are not designed to affect the legal framework within which financial services providers operate in particular countries, but

⁸⁰¹ Pauly, Louis, W., "National Financial Structures, Capital Mobility, and International Economic Rules: The Normative Consequences of East Asian, European, and American distinctiveness", 355.

⁸⁰² Key, Sydney, J., (1999), "Trade Liberalization and Prudential Regulation: The International Framework for Financial Services", 73

rather seek to harmonize conditions and standards. By contrast, the GATS focuses more on the political and legal commitment to liberalization, a task the WTO is working hard to sustain.

Chapter 7

Conclusion

Services are now among the most important economic activities in countries at virtually every stage of development. This is because services are essential economic “intermediaries” that provide essential infrastructure roles in transportation, finance, communications, and information. This has made trade liberalization in services a more vital process for the integration of the world economy, a fact that was addressed by the creation of the GATS. The GATS was one of the major innovations to come out of the Uruguay Round, and it represented an international effort to establish rules governing trade in services. The agreement in financial services (FSA), along with its associated provisions in the GATS, represents a significant effort toward increased multilateral economic cooperation. One of the unique features of trade in financial services is the strong interdependence that exists between the regulation and supervision of the domestic financial sector and the international trade and financial regimes.

Three main conclusions can be drawn from this dissertation regarding the nature of liberalizing trade in financial services. The first refers back to the three distinct processes that were discussed in Chapter One. They are domestic regulatory reform, capital account liberalization, and the liberalization of trade in financial services. Although these processes are interlinked in some respects, this dissertation has argued that the GATS FSA focuses almost exclusively on the last. The second main conclusion, which comes out of the case studies and Chapter Six, is that the benefits that can result from liberalizing trade in financial services outweigh any potential drawbacks. The focus here has been on the economic and

structural benefits of the FSA, and these are especially important for developing countries undergoing economic reforms. The third important conclusion is that the GATS FSA has not been of primary importance to, or a significant pressure on, countries liberalizing their financial services sectors. The agreement has had value mainly in political and structural terms, by initializing the process of liberalization among countries with many different approaches to regulation, and providing a mechanism to continue it into the future. These three main conclusions are discussed in turn.

This dissertation has dealt with three processes that are distinct, but interdependent, and which occur at the domestic and international levels. Domestic regulatory reform involves deregulation, including the reduction or elimination of government intervention in the economy. One example that was used in Chapter One was the repeal of the Glass-Steagall Act in the US, which had been separating banking and securities businesses. It also involves re-regulation, whereby updated and more effective regulations are introduced. One example used in Chapter One was the raising of the capital adequacy ratio standard for banks to bring them in line with, or higher than, the Basel Capital Accord. The case studies have illustrated that it is important for domestic reforms to precede, or at least to accompany commitments that are made in the FSA.

The FSA is significant for domestic regulations because it requires countries to make binding commitments in financial services. This is an objective that was not possible to achieve as part of the larger initial WTO undertaking, and the FSA was negotiated separately and more slowly. Since it is associated with the GATS, trade in financial services has been subjected to multilateral standards, including binding dispute settlement, and a mechanism

for future liberalization. It is also subject to the more specific WTO principles of nondiscrimination, market access, most-favoured nation treatment (MFN), and national treatment (NT). In financial services, these principles help countries to identify restrictive measures that are intentionally protectionist, and those that are legitimately prudential. This is a task that is complicated further because countries use many different approaches to financial regulation.

The liberalization of trade in financial services also mirrors some of the most important debates surrounding liberalization and the international financial order. They include, inter-state relations, and in particular, the political and economic relations between the advanced economies and the developing countries. It also has implications for domestic politics through the increased legalization of international trade relations. In this respect, the WTO now incorporates legally enforceable rules to monitor and supervise Member actions and regulations. In this respect, domestic politics can be deeply affected and in a way have become inseparable from international economic transactions. In this respect, the GATS FSA should complement the domestic reform agendas of the developing countries. The argument here has stressed the importance of domestic institutional reforms, and that the FSA is a useful process that doesn't affect Member's self determination for prudential or economic regulation at the domestic level.

The second process that was discussed in Chapter One was capital account liberalization. This involves easing or removal of regulations that control the flow of hot money in and out of a country. A country's decision to introduce or discourage controls on capital is based on the need to either insulate the economy from the potentially destabilizing

effects of unrestricted capital flow, or a contrasting desire to capitalize on market developments which can enhance growth. While all countries regulate their financial markets to different degrees, deregulating too much has brought major problems, especially for the developing countries. On the other hand, countries with well-developed regulatory infrastructures in place are aware of the competitive advantage it can bring. Chapter Six showed that it is important to pace and sequence changes to domestic regulations that affect the flow of capital so that opening markets to foreign financial service providers can be accomplished safely. Capital account liberalization, and what it aims to accomplish, has often been misunderstood by critics of liberalization for being one in the same with the third process, although it is wholly distinct.

The third process discussed in Chapter One was the liberalization of trade in financial services, the central focus of this dissertation. It focuses exclusively on improving the terms and conditions of market access and nondiscriminatory treatment for foreign suppliers of financial services. Liberalizing trade in financial services can cause problems if it happens in the presence of inadequate macroeconomic and regulatory policies or inappropriate government interventions. However, Chapter Two outlined how the FSA achieves a balance in these matters in a few important ways. First, it aims to maintain the domestic regulatory autonomy of its Members. This is in part because of the built-in safeguards of the GATS, but also because the WTO is a voluntary Membership organization. In addition, the GATS Annex on Financial Services is a key part of the agreement that restricts the agreement from applying to services supplied in the exercise of governmental authority. It also provided the 'prudential carve-out' for the protection of investors and consumers. The Understanding on

Commitments in Financial Services is also important because it provides for a way to make more in-depth commitments in market access and national treatment. This has been done by most advanced economies, and should be gradually accepted more by the developing countries. Using this framework, the FSA can help to consolidate financial sector reform, strengthen financial systems, and provide an additional institutional framework in financial services.

The second main conclusion of this dissertation is that the benefits of the process of liberalizing trade in financial services outweigh the drawbacks. Several potential criticisms have been leveled against the GATS and the FSA, particularly against several alleged obstacles that prevented countries from completing the agreement. Many of these are addressed by the safeguards in the GATS and the FSA that were mentioned in the previous section, and some that are described below. One obstacle was the structure of the GATS itself. While it provided for prudential protection, there were still misunderstandings about how this could potentially play out in real situations. There was also uncertainty about the relationship of the GATS' cross-border supply and commercial presence guidelines, and how commitments in them would affect the flow of volatile capital. There were also related concerns raised about the need for the liberalization of trade in financial services, especially when many developing and emerging economies were still working through basic economic and financial sector reforms at the domestic level.

Other alleged obstacles are related to the fact that the GATS requires countries to identify the domestic laws and regulations that discriminate between domestic and foreign services providers. This is a requirement of the positive-list approach to scheduling trade

commitments. In some cases, this can go to the heart of government-provided services, or be entrenched in regulations that serve protectionist ends. In addressing this, the GATS places an emphasis on the transparency of domestic regulation. GATS Article VI requires domestic regulation to be “reasonable, objective and impartial”. It also requires it to be not more burdensome than necessary to achieve the desired effect. The process of identifying and liberalizing these regulations has been sensitive work, even though the GATS only focuses on removing those interventions that lead to discriminatory practices. In the long term, this may require a broader focus, including more technical assistance from the WTO, and the participation of other international bodies to help with specific sectoral regulations and standards.

Liberalization in financial services can also be politically difficult for countries that have strongly entrenched interests that stand to lose. This is because the financial sector is seen to be ‘special’, or strategic for development in many countries. This highlights the asymmetry of interests between developing countries and the advanced economies, especially regarding the resources each has to expend in the process, as well as the power they possess. Certainly a challenging feature of the post-Uruguay Round negotiations is that they have involved countries at different levels of development, alternative modes of supply (cross-border supply and commercial presence), and many specific sectors (banking, insurance, and securities).

In order to address this imbalance between the developing and the industrialized countries, the FSA instituted a more legalized approach to trade relations in financial services. This has the benefit of reducing the effects of power-based relations, especially

between countries that have differing levels of influence in the trading system. It also aims to eliminate discrimination between domestic and foreign financial services providers by making these trade relations more predictable. Legalization brings better and more precise information, a critical resource upon which financial services is based.

There are several additional economic benefits that can come from liberalizing trade in financial services. It can help to strengthen financial systems by increasing efficiency and competition. It does so in a legal and transparent fashion, primarily by removing protectionist regulations and allowing the entry of foreign competitors. The FSA does so based on a country's decision to liberalize only where it deems necessary. This has the added benefit of increasing the quality of foreign direct investment. This develops more efficient intermediation for the rest of the economy's industries. Commitments in these areas show policy intent and certainty to foreign investors and other governments.

The GATS can also be used as a mechanism through which governments can pursue their domestic reforms. Making commitments in the GATS can be used as a signaling opportunity by governments that have decided that regulatory reforms are in the national interest. Pressing forward with services liberalization is important, but should not be done merely to maintain a forward momentum in multilateral trade negotiations. It should not displace traditional goods issues and unfinished business (agriculture, textiles, safeguards), because domestic support for the resulting agreements may be narrow.

The fundamental objective of the GATT, the predecessor to the WTO, was to expand world trade by reducing tariffs and other barriers to trade, and to reduce discriminatory treatment between trading partners. Without imposing standards other than those supported

by consensus, it required countries to avoid applying their policies in ways that opposed GATT objectives. The creation of the WTO shifted this negative approach to international trade rules, giving them a positive rule-making stance.⁸⁰³ In particular, the WTO focuses on the principle of market access, which has resulted in an agreement that tells governments which measures they shall take, rather than those they should not. This has led critics of trade liberalization, especially in services, to argue that the process intervenes too heavily in domestic regulation and makes the domestic economy vulnerable to international market forces.

This interpretation of positive rule-making has been challenged here. Another way to interpret the switch to positive rule-making, is to view it as the rule-oriented ‘contract’ character of the GATT, that was improved and consolidated in the WTO.⁸⁰⁴ To the point of questioning the WTO itself as an outside ‘pressure’ on countries, it must be recalled that the WTO is a membership organization to which countries choose to accede. The WTO is as democratically accountable as an international organization can get. While secrecy and opacity have been a running concern for the WTO, norms about public access and standards are improving. In cases where established rules and regulations are no longer desirable, the WTO does not require that they be removed for the sake of deregulation

Free trade agreements by their nature constrain the independence of countries. Though this does foreclose policy options that were previously available to countries, the

⁸⁰³ Dymond, William, A., Hart, Michael, M., (2000), “Post-Modern Trade Policy - Reflections on the Challenges to Multilateral Trade Negotiations after Seattle”, 22.

⁸⁰⁴ Winham, G., R., (1998), “The World Trade Organisation: Institution-Building in the Multilateral Trade System”, p.365.

interpretation of how this happens is important. The whole point of an agreement is to eliminate those policy options that can be used purposely for protectionism against other countries. In Canada, trade policy considerations must be constantly aware of what is happening in the United States. The fact that we have signed onto commitments largely based on our relationship with that country does not equate to a redistribution of political power, though some would argue it does.⁸⁰⁵ In fact, powerful pressures and interdependence have and will always exist between Canada and the US and it is difficult for policies to get too far out of line with those in the US.⁸⁰⁶

The GATS provides mechanisms to ensure the maintenance of latitude in policymaking. Actions taken by private individuals or corporations are, with few exceptions, left entirely unrestricted by it. Economies cannot afford to do only as they wish, but in reality must play by the rules of the game, as participants in the international system. Countries like Singapore, for example, have conditioned their opening to the system at a comfortable pace which satisfies both its domestic demands and international obligations. Essentially, there are many pressures to which countries are exposed, and countries must decide what is best for them domestically.

While there has been inequality between the developing and advanced economies in the negotiations in services, this has always been a feature of the system. Both the GATS

⁸⁰⁵ See Stairs, Denis, (1988), "The Impact on Public Policy: A Leap of Faith", p.456.

⁸⁰⁶ See Tuck, Simon, "U.S. tax cut puts heat on Ottawa: With Bush set to unveil \$ 600-billion plan, squeezed Manley faces calls to keep up", The Globe and Mail, Tuesday January 7th, 2003, A1. The following day, the same sentiment was announced with respect to tax cuts. See McKenna, Barrie, "Bush warns of tax cut delay", The Globe and Mail, Wednesday January 8th, 2003, B1.

and the FSA each provide exceptions for the special needs of developing countries. This addresses the unequal bargaining powers of the countries and the unique developing country demands. The concerns about domestic regulation and the necessity test are topics for future investigations. In financial services, as in other services, it should be considered that the level of liberalization that is ever *required* by the WTO, should not exceed that deemed as desirable or legitimately prudential by domestic political institutions.

The third main conclusion of this dissertation is that the GATS FSA has not been of primary importance, or a significant pressure on countries to liberalize their financial services sectors. The agreement's value has come mostly in political and structural terms, by creating a multilateral agreement covering trade in financial services, and a mechanism to continue the process. Issues that have arisen throughout the negotiation process have been mostly conceptual and structural, since services were a relatively new sector in international trade negotiations. The result was that the GATS achieved more in the way of rule-making than it did in actual liberalization. This included definitions, rules, principles, scope of the agreement, and how liberalization could be pursued in the future.

WTO Members have paid relatively little attention to the WTO's Financial Services Agreement (FSA) and the negotiated process of liberalization it entails.⁸⁰⁷ This is because countries see it as only one part of their economic strategies, and have been liberalizing unilaterally based on the state of their economic goals and the corresponding circumstances. The actual level of services openness in many countries goes beyond what has been formally

⁸⁰⁷ Practitioners interviewed in the process of this dissertation from both developed and developing countries strongly agreed with this fact. They also do not see the GATS as exerting pressure on them to liberalize, and assert that they do so at their own pace.

committed to under the FSA framework. Countries have opened up their financial services industries because they recognize the significance of global integration, or they are experiencing global pressures, or they are concerned about national development. Most recent movements in liberalization have been made through unilateral initiatives, based on domestic considerations and needs, rather than through multilateral trade agreements and other international mechanisms. This raises some concerns about the utility of the FSA to be the liberalizing mechanism of choice. However, multilateral agreements have many advantages. They can lock-in the degree of current or future liberalization commitments, help to shape macroeconomic and regulatory reforms, and encourage liberalization efforts globally. In the developing countries, their financial systems usually operate under a wide range of economic circumstances and are at different stages of development. They may therefore consider a more cautious unilateral approach to be more flexible in relation to their particular needs and priorities. The FSA's value is in binding the current levels of commitments and the promise of further liberalization in the future, as well as serving as a hindsight check for compliance on international standards. The reason for this is that liberalization in financial services is usually part of a larger economic reform process, especially in developing countries. Based mostly on the domestic interests of an economy, the sequencing of appropriate reforms often takes precedent over the specific concerns of the FSA. Even in the face of requests to fully liberalize in financial services, most countries maintain some level of protection over the domination of their financial sectors by foreign interests. The purpose behind this protection is to ensure that domestic financial institutions keep focused on the 'national interest'. Within this whole scheme of issues which are of

importance to the economic well-being of WTO members, countries still play significant roles by strategically orchestrating their own financial liberalization schemes. They do this in order to improve their policy effectiveness while satisfying domestic interests.

WTO Members recognize that they can only support a certain amount liberalization at any one time. For example, it takes time to institute new domestic legislation and to make sure that it is compatible with existing practices related to financial services including those set by the WTO, the Bank for International Settlements (BIS), and international accounting and securities standards. Governments will no longer limit their economic choices so easily in a highly uncertain world and an interdependent international economy. Achieving broader commitments in the principles of nondiscrimination and unconditional MFN in the GATS will be slow because concessions made to one party must be given to all parties. More progress in the future will involve gradual unilateral opening as part of overall structural reforms. For example, Singapore unilaterally accelerated its financial liberalization program in order to remain competitive as an international financial center.

Future advances in liberalization will probably not come solely from multilateral negotiations, because other regional, unilateral, and institutional approaches can be strongly complementary to the multilateral process. Arguments in favour of regional free trade agreements suggest that they can be formed relatively quickly, are often smaller and more manageable than multilateral arrangements, and they often produce potent results that can go hand in hand to advance the progress of the international trade regime.⁸⁰⁸ Regional liberalization experiences, from that of the EU to those of NAFTA and APEC, provide useful

⁸⁰⁸ Ostry, S., The Post-Cold War Trading System: Who's On First ?, p.203

lessons on the considerable difficulties of liberalization and on how to achieve progress toward that goal. Many of these organizations could play a role in offering an informed view on the path that regulations in financial services could take. An example of this occurred at the seventh annual conference of the International Association of Insurance Supervisors (IAIS) in October 2000. Insurance industry representatives tabled a paper proposing a draft “Model Schedule” of GATS commitments on insurance, expressing in GATS language, the insurance regulatory principles put forward in 1999. In the process of liberalization, regulators and trade policy experts will be key players, but there may also be an essential role for the private sector. The ultimate test for the WTO process will be the willingness of its Members to liberalize further within its framework.

Many attributed the success of the GATT to liberalize trade to its ability to tie together domestic export interests with trade liberalization more generally. Since this linkage is less established in services, the future GATS negotiations may necessitate tradeoffs between goods and services sectors in order to expand opportunities. Developing countries especially need these incentives to liberalize further. Seeking this more balanced and comprehensive coverage of services sectors and modes of supply should be one of the priorities in future negotiations. In the next rounds, negotiations should not be limited to individual sectors such as financial services, but rather, broader tradeoffs will be required.

A more comprehensive focus in the negotiations may be useful. Since market-access discussions encompass all sectors, allowing cross-sectoral concessions to take place much more easily would give the negotiations a mobilizing political objective. It would shift the multilateral services negotiations from a focus on specific trade instruments and practices to

the whole set of measures and regulatory practices. In financial services, for example, there could be a shift in the oversight of regulation from a system under which the financial authorities supervise by authorizing specific transactions by financial institutions to a system under which they supervise by monitoring the overall financial condition of financial institutions. In taking a broader focus on market access for all sectors, it should elicit strong support from various interest groups and encourage them to join forces to promote its progress.

There is significant potential for more expansion in financial services trade as economies continue to be opened and technological developments provide new opportunities. In the process to liberalize financial services in the WTO, the differing interests of countries and the lack of cross-sectoral tradeoffs reduced the agreement's attractiveness for many countries. However, the successful conclusion of the negotiations in financial services represented a major success for the WTO as a whole. Its members confirmed their commitment to the process of liberalization in an important sector of international trade, in turn strengthening the WTO's credibility.

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