Financial Services in the Uruguay Round and the WTO

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I. Introduction

The General Agreement on Trade in Services (GATS), which was negotiated in the Uruguay Round, marks the first time that services have been covered by a global trade agreement. The GATS brings trade in services into a multilateral framework of rules and disciplines broadly comparable to that provided for trade in goods by the General Agreement on Tariffs and Trade (GATT), originally negotiated in 1947. The overall goal of multilateral trade negotiations is to support economic growth and development by reducing or eliminating barriers to trade, thereby promoting competitive and efficient markets.

To this end, parties to the GATS have agreed to undertake certain obligations and commitments that are subject to enforcement through a dispute settlement mechanism under the auspices of the newly established World Trade Organization (WTO). Once made, commitments to liberalization cannot be withdrawn without compensation of trading partners. A country’s participation in the agreement does not, however, necessarily mean that it has made strong commitments to market opening. Indeed, the strength of commitments can vary substantially among countries. For the future, the GATS requires periodic negotiating rounds to improve commitments and thus achieve “a progressively higher level of liberalization.”
The negotiation of a multilateral agreement for services reflects their increasing importance in international trade, particularly during the last decade or so. This expansion of trade in services has included not only cross-border trade but also foreign direct investment. Indeed, foreign direct investment is an important means of providing services internationally—banks, for example, typically establish branches or subsidiaries within a host country. As a result, the GATS covers foreign direct investment as well as cross-border trade.

The Uruguay Round Agenda
When the agenda for the Uruguay Round was being negotiated in the mid-1980s, the U.S. government, partly in response to an initiative by the U.S. financial services industry, was the primary advocate for including financial and other services. After prolonged negotiations culminating in the Punta del Este ministerial meeting in September 1986, services became part of the agenda in a complicated series of tradeoffs that shaped the Uruguay Round. In effect, industrial countries agreed to strengthen the multilateral framework of rules and disciplines by including textiles and agriculture and, in return, developing countries agreed to the inclusion of services, trade-related intellectual property rights (TRIPS), and trade-related investment measures (TRIMS).

The U.S. financial services industry expected that a multilateral negotiation with simultaneous bargaining across a wide range of goods and services sectors would provide opportunities for tradeoffs that would lead to significant market opening for financial services by a number of the more advanced developing countries, often referred to as emerging market economies. A hypothetical example used by the U.S. industry was that emerging market economies might be willing to make binding commitments to lift restrictions on the provision of financial services by foreign firms in return, explicitly or implicitly, for concessions by the major industrial countries in other sectors such as textiles. However, as will be discussed later in this paper, such tradeoffs between financial services and other sectors did not occur.
Free Riders

The financial services negotiations—like those for other major service sectors such as basic telecommunications, maritime transport, and audiovisual services—proved to be very difficult. As the Uruguay Round drew to a close in December 1993, the hoped-for commitments to market opening had still not materialized. For financial services, some of the most significant problems involved foreign direct investment—for example, the refusal by some emerging market economies to make commitments to allow foreign financial firms to hold majority-ownership positions in domestic firms.

Although the United States and the European Community shared the goal of obtaining strong commitments to market opening in financial services from emerging market economies, their approaches differed. The European Community's priority was putting in place a multilateral agreement that included binding commitments for financial services, even if some of the initial commitments were weak. By contrast, the United States gave priority to obtaining strong initial commitments and was unwilling to allow emerging market economies to become so-called free riders.

The free-rider problem arises because the GATS—like the GATT—is based on the most-favored-nation (MFN) principle, which precludes discrimination among foreign countries. (Literally, no foreign country can be accorded treatment less favorable than that accorded to the most favored foreign nation.) This makes it possible for a country that does not offer strong commitments to market opening to become a free rider. That is, without opening its own market, its service providers have the opportunity to benefit from the openness provided by other countries.

The U.S. government took the position that, unless improvements were made in the commitments being offered by a number of emerging market economies, it would make only a limited commitment for banking and securities in the GATS. That is, the United States would guarantee market access and national treatment only for existing operations of foreign financial firms. The United States would then take a broad MFN exemption that would leave open the possibility of discriminating among countries with regard to new entry or operations. Thus, without violating the GATS, the United States could prohibit future entry into the U.S. market for firms whose home countries were not sufficiently open to U.S. financial
firms; for firms already established in the United States, expansion into new activities or new locations could be prohibited.

In the final hours of the Uruguay Round, negotiations between the United States and the European Community resulted in the extension of the financial services negotiations for eighteen months. The new deadline was June 30, 1995, six months beyond the establishment of the WTO and the entry into force of the GATS and other Uruguay Round agreements. Although the United States took a broad MFN exemption for banking and securities, the compromise provided that MFN exemptions would be suspended pending the results of the extended negotiations. Financial services thus became one of several sectors for which negotiations were extended at the close of the Uruguay Round—the others were basic telecommunications, maritime transport, and movement of natural persons.

The Interim Agreement on Financial Services

Some offers were improved during the extended financial services negotiations. However, just prior to the deadline, the United States announced that the market opening being offered by a number of countries was still not sufficient and that it would make a binding commitment only for existing operations of foreign financial firms and take a broad MFN exemption with regard to new entry and operations. To avoid losing what had been accomplished in the negotiations up to that point, the European Community then took the lead in trying to preserve the commitments that had already been offered by other countries. The result—the so-called interim agreement on financial services—was that other countries agreed to maintain their existing MFN-based offers through the end of 1997 despite the minimal commitment and broad MFN exemption that had been taken by the United States.

Financial services negotiations resumed once again in Geneva in April 1997, with an agreed deadline of mid-December. In July, the United States submitted an MFN-based offer with strong commitments that was expressly conditioned on the strength of the commitments to be offered by other countries. As of this writing (October 1997), offers from most emerging market economies have not yet been submitted.
Liberalization in the GATS in Perspective

In the financial services negotiations in the Uruguay Round and the WTO, the main focus has been on liberalization involving the reduction or removal of discriminatory barriers and other barriers that, in economic terms, have a similar effect. The former discriminate against foreign services and service providers vis-à-vis their domestic counterparts with regard to entry and operation in a host-country market; the latter, while not overtly discriminatory, are also used to keep foreign services and service providers from entering the market.

A host country might, for example, discriminate against foreign financial firms by refusing to grant licenses for their branches or subsidiaries, imposing limitations on their aggregate market share, or prohibiting them from engaging in certain activities that are permissible for their domestic counterparts. A country might also impose certain other restrictions, such as economic needs tests or quantitative limits on the total number of new banking licenses, that may, at least on their face, appear to be nondiscriminatory; however, their practical effect is usually similar to that of the more overtly discriminatory barriers. To deal with discriminatory barriers to entry and operation and with other barriers to entry, the GATS uses the widely accepted principles of "national treatment" and "market access," which are discussed in the following chapter.

Another major type of liberalization involves nonquantitative and nondiscriminatory structural barriers. Such barriers arise from aspects of national regulatory systems that do not discriminate between foreign and domestic services and service suppliers. For example, fundamental differences among nations in rules for permissible activities for banks or the types of products that may be offered can create significant barriers to trade. Even if they are nondiscriminatory, a country's rules may be so much more restrictive than those in other major countries that they create market distortions and inefficiencies.

Removing such barriers goes far beyond ensuring that foreign services and service suppliers can enter a host-country market as currently structured and enjoy equality of competitive opportunities vis-à-vis their domestic counterparts. Instead, it represents an effort to create maximum potential competitive opportunities in a host-country market, often referred to as "international contestibility of markets." Achieving such opportunities would require liberalization
and reform of domestic regulatory structures, including, for example, competition policy, which covers the actions of private parties. Such liberalization would necessarily involve some degree of convergence of national regulatory systems, either de facto or through negotiated harmonization. The European Community's internal market program represents the most far-reaching effort to date to remove nondiscriminatory structural barriers among a group of nations. However, that effort, in addition to being predicated on political agreement on goals for economic liberalization, is being carried out in the context of the unique supranational legislative, judicial, and administrative structure of the European Community.4

The GATS addresses certain types of nonquantitative and nondiscriminatory structural barriers. For example, it imposes a general "transparency" obligation on WTO members to publish all measures of general application—including statutes, regulations, and administrative decisions—that are relevant to trade in services. It also requires countries to apply domestic regulations in a "reasonable, objective and impartial manner" to avoid undermining commitments to market access and national treatment.7 Moreover, countries must have in place appropriate legal procedures to review administrative decisions affecting trade in services. The GATS mandates further work to develop disciplines to ensure that domestic licensing requirements or technical standards do not constitute unnecessary barriers to trade in services. Meanwhile, countries must refrain from adopting rules or standards that are so burdensome, restrictive of trade, or lacking in transparency that they undermine their commitments to market access and national treatment.

The GATS deals with additional nondiscriminatory structural barriers in provisions applicable only to specific sectors. The most far-reaching example is the establishment of procompetitive regulatory principles in the telecommunications sector. For financial services, nondiscriminatory structural barriers are addressed simply by a "best efforts" commitment made by most of the OECD countries to remove or eliminate any significant adverse effects.8

Besides liberalization to promote competitive and efficient markets, another important policy goal for international trade in financial services is ensuring adequate prudential regulation and supervision of financial firms.5 Current work toward achieving this goal—and thereby to promote the stability of the international monetary and financial system—involves two major efforts, both of which, with leadership from the Group of Seven (G7), have become
a high priority on the international economic agenda. One is enhancement of cooperation and coordination among supervisors in different countries and among supervisors of different types of financial institutions; the other is establishment of strong prudential standards and effective supervisory structures in emerging market economies.

When the idea of including financial services in the Uruguay Round was first proposed, financial regulators were concerned about the possibility of a trade agreement interfering with their ability to regulate and supervise financial institutions. They made it clear that inclusion of financial services in the GATS would be unacceptable without a specific exception for prudential regulation and supervision. As a result, the GATS contains a so-called prudential carve-out to ensure that the opening of markets that the agreement is intended to achieve will not jeopardize prudential regulation and supervision. Now, it is taken for granted by everyone involved that such a provision is necessary whenever financial services are included in an international trade or investment agreement. For example, a prudential carve-out is contained in the North American Free Trade Agreement (NAFTA) and in the Multilateral Agreement on Investment (MAI) currently being negotiated at the Organisation for Economic Co-operation and Development (OECD).

These three aspects of international trade in financial services—discriminatory barriers and barriers that have a similar effect, nonquantitative and nondiscriminatory structural barriers, and prudential regulation and supervision—are being addressed in a variety of international fora. These fora differ markedly with regard to their mandates, powers, and institutional arrangements, as well as with regard to the sets of countries participating. Besides the WTO, they include other multilateral organizations such as the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (World Bank); "plurilateral" fora and organizations such as the G-7, the Group of Ten (G-10), the OECD, and Asia-Pacific Economic Cooperation (APEC); regional trade arrangements such as the NAFTA, Mercosur, and the Association of South East Asian Nations (ASEAN); and sector-specific fora such as the Basel Committee on Banking Supervision, the International Organization of Securities Commissions (IOSCO), and the International Association of Insurance Supervisors (IAIS).
An overview of the GATS and its application to financial services is provided in the next chapter of this paper. The third chapter examines the challenges of the financial services negotiations that have made it difficult to obtain strong commitments to market access and national treatment from emerging market economies. The fourth chapter considers options for dealing with the free-rider problem, especially the use of phased and safeguarded commitments. The concluding chapter discusses the role of the WTO in dealing with financial services beyond the current negotiations.
II. The GATS and Financial Services

Most of the restrictions facing foreign services and service suppliers described in the introductory chapter—discriminatory barriers to entry and operation, barriers that have a similar effect in restricting entry, and nonquantitative and nondiscriminatory structural barriers—are regulatory barriers. The main exception comprises certain barriers to entry that are more akin to quantitative restrictions applied to trade in goods. For services, tariffs are not an issue. Thus a global negotiation on trade in services necessarily had to address regulatory barriers at the outset. Unlike most goods, services—and financial services in particular—tend to be highly regulated domestically, the regulations usually apply to producers rather than to output, and the output itself is often intangible. In addition, providing services often requires proximity of producers and customers. For example, in the financial sector, as already mentioned, foreign direct investment plays a major role in the international provision of services.

The result was that many of the most complicated and difficult types of issues were telescoped into the first global negotiation on services. Such an effort was unprecedented. In the goods sector, early negotiations dealt almost exclusively with tariffs and quantitative restrictions. The process of dealing with barriers that result from domestic policies evolved over several decades—beginning primarily
with the focus in the 1970s on production subsidies, product standards, and government procurement. In the 1990s, the potential scope of the multilateral trading system has been further broadened—although, at present, without a mandate to negotiate—by establishment of the WTO Committee on Trade and the Environment and working groups on the relationship between trade and competition policy and between trade and investment.

National Treatment and Market Access

The GATS, as already noted, relies on the principles of national treatment and market access to reduce or eliminate discriminatory barriers to entry and operation and barriers that, in economic terms, have a similar effect in restricting entry.

The GATS uses a generally accepted definition of national treatment, that is, it requires a host country to treat foreign services or service suppliers no less favorably than "like" domestic services or service suppliers. Use of the broad term "treatment no less favorable" has the effect of requiring both de jure and de facto national treatment. Moreover, it does not require precisely identical treatment of domestic and foreign services and service suppliers. The GATS goes beyond previous usage in clarifying this point: It explicitly states that national treatment could comprise formally identical or formally different treatment provided that the "conditions of competition" are not modified in favor of domestic services or service suppliers.12

In theory, market access could be defined as the right to enter a host-country market in whatever form a service supplier chooses. Under this definition, a foreign service supplier could decide to eschew establishment in a local market and instead provide its services across borders to host-country customers; alternatively, the foreign service supplier could choose to invest locally, de novo or by acquisition, and operate through a commercial presence in the host country. The specific type of legal entity—such as a branch or a subsidiary—would be chosen by the investor. A right of entry to a host-country market could not, of course, be absolute, since the foreign financial service provider would need to meet prudential and other applicable regulatory standards.

However, in contrast to its handling of the concept of national treatment, the GATS does not attempt to define market access.
Instead, the GATS provides a list of restrictive measures, primarily quantitative, that are typically used to deny entry to a host-country market to foreign services or service suppliers. These barriers include limitations, in the form of numerical quotas or economic needs tests, on the number of service suppliers or their total assets and limitations on foreign ownership of domestic firms. The barriers listed also include restrictions on the type of legal entity through which a service may be supplied, for example, requiring establishment of a subsidiary as opposed to a branch.

The line between barriers that restrict market access and those that deny national treatment in the GATS is not always clear. On the one hand, the definition of national treatment is not limited to discrimination that occurs after a foreign service provider has established operations in a host country. On the other hand, the list of measures restricting market access includes some barriers to entry—such as restrictions on ownership positions in local firms by foreign service providers—that are overtly discriminatory and thus would also be a denial of national treatment under the GATS.

In general, it is difficult to realize fully the benefits of liberalization of trade in financial and other services without free cross-border movement of capital. The GATS therefore contains certain provisions aimed at ensuring that a country does not apply restrictions on payments and transfers that would undermine its commitments to market access and national treatment. The provisions refer to and are consistent with the IMF’s responsibilities in this area; consideration is currently being given to strengthening the IMF Articles of Agreement to include formal responsibility for capital account convertibility.

Structure of the GATS

The GATS, which is part of the Agreement Establishing the World Trade Organization, has two major components. The first consists of a so-called framework agreement, which establishes overall rules and disciplines for trade in services, together with various annexes, including one dealing with issues specific to financial services. The second consists of each country’s schedule of specific commitments and list of MFN exemptions.

For financial services, there is a unique additional element, namely, the Understanding on Commitments in Financial Services. The Understanding provides an alternative approach to scheduling
commitments that was used by most of the OECD countries to supplement the requirements of the framework agreement. In legal terms, the Understanding is incorporated by reference into the GATS through the schedules of commitments of the countries that use it. Commitments scheduled under the Understanding are extended to all members of the WTO, regardless of whether the members scheduled commitments under the Framework or the Understanding.

The expression “financial services agreement” is widely used to refer to the GATS as it applies to financial services, although in fact, a separate agreement for financial services does not exist. Table 1 highlights some of the principal features of the GATS that are relevant for financial services. Outside the GATS, other provisions of the WTO Agreement—in particular, the strengthened dispute settlement mechanism that was an important achievement of the Uruguay Round—are also relevant for financial services, as are various ministerial declarations and decisions.

Because of the special characteristics and sensitivity of the financial sector—in particular, the role of financial firms and markets in financing the real economy, the role of banks in monetary and payments systems, and the phenomenon of systemic risk—finance ministry officials in the United States and other countries insisted
that financial services negotiations required financial as well as trade expertise. Accordingly, although trade officials retained overall responsibility, finance officials played a major role in the financial services negotiations for those countries that were the most active participants. Thus, while the GATS framework agreement and the structure of the schedules of commitments were negotiated by trade officials, the Annex on Financial Services, the Understanding on Commitments in Financial Services, and the contents of the schedules of commitments for financial services were negotiated primarily by finance officials. Possible effects of the separateness of the financial services negotiations are discussed later in this paper.

Methods of Providing Services Internationally: Modes of Supply

In an effort to include all of the various means through which services are traded internationally, the GATS covers four so-called “modes of supply”: (1) the cross-border provision of services, which is analogous to trade in goods, for example, reinsurance provided by a company in another country; (2) consumption abroad, which usually, but, as currently defined, not necessarily, involves physical movement of the consumer such as tourism, and for financial services is difficult to distinguish from the cross-border mode; (3) establishment of a commercial presence such as a branch or a subsidiary—that is, foreign direct investment; and (4) the temporary presence of natural persons, including, for example, the nonlocal staff of a branch of a foreign bank.

The inclusion of foreign direct investment in the GATS as a recognized way in which services are provided internationally differs markedly from its treatment in the multilateral agreements governing trade in goods. The GATT does not cover foreign direct investment, and for goods there is only a relatively narrow agreement, negotiated in the Uruguay Round, on trade-related investment measures (TRIMS). However, although the GATS covers foreign direct investment, it does not have a separate framework for investment like that of the NAFTA or the investment agreement now being negotiated at the OECD. These agreements, unlike the GATS, include provisions to ensure the protection of investments from, for example, expropriation, and provide for arbitration of disputes between private investors and host-country governments.
General Obligations: MFN and Transparency

Two major “general obligations” of the GATS are the MFN principle and “transparency,” which were discussed in the introduction. A country is required to honor a general obligation for all services sectors regardless of whether it has included a particular sector in its schedule of commitments. However, subject to certain conditions, the GATS allows a country to take exemptions from the general MFN obligation. The United States, as discussed earlier, took a broad MFN exemption for financial services. No exemptions are permitted from the transparency requirement.

Specific Commitments: Market Access and National Treatment

In the GATS, market access and national treatment are “specific commitments” as opposed to general obligations. As a result, national treatment and market access do not apply across-the-board to all services sectors; instead, they apply only to sectors, subsectors, or activities that are listed in a country’s schedule of commitments. The use of specific commitments for market access and national treatment instead of general obligations applicable to all services sectors is widely regarded as a structural weakness of the GATS. This weakness is usually discussed in terms of the associated scheduling techniques—the so-called “hybrid list” approach used in the GATS and the “negative list” approach that had been advocated by the United States.7

Negative versus Hybrid Lists. If market access and national treatment were general obligations applicable to all services sectors, a negative list of exceptions or “top-down” approach could be used for scheduling. Under this approach, all “nonconforming measures”—that is, measures that do not conform to the principles of market access and national treatment—must be listed as limitations in a country’s schedule of commitments. As a result, for all sectors, market access and national treatment apply to all measures not listed in a country’s schedule (see table 2). For example, in the banking subsector, if a country prohibited branches of foreign banks from taking domestic deposits and wished to continue to do so without violating its GATS obligations, it would need to inscribe that limitation in its schedule. The only nonconforming measures that would not need to be listed are those covered by specific public policy exceptions such as national security or, in the case of financial services, prudential regulation and supervision.
Table 2: Negative Lists and GATS Hybrid Lists: Applicability of Market Access and National Treatment

<table>
<thead>
<tr>
<th>Scheduling Technique</th>
<th>Approach</th>
<th>Coverage of unlisted sectors/subsectors/activities/measures</th>
</tr>
</thead>
<tbody>
<tr>
<td>Negative list</td>
<td>General obligations of market access and national treatment apply to all services sectors except for nonconforming measures listed</td>
<td>Market access and national treatment apply</td>
</tr>
<tr>
<td>GATS hybrid list</td>
<td>Commitments to market access and national treatment undertaken only for sectors/subsectors/activities listed</td>
<td>Market access and national treatment do not apply</td>
</tr>
<tr>
<td>Positive list of sectors/subsectors/activities</td>
<td>For each sector/subsector/activity listed, market access and national treatment apply except for nonconforming measures listed or for “unbound” modes of supply</td>
<td>Market access and national treatment apply only within listed sectors/subsector/activity</td>
</tr>
</tbody>
</table>

Beginning in mid-1989, the United States, with initial support from the European Community, pushed hard for a negative list approach in the GATS. However, this initiative faced strong opposition from emerging market economies and other developing countries fearful of undertaking general obligations that would be binding across all services sectors subject only to specified exceptions. These countries also noted that they did not have the administrative resources and the research capability necessary to determine the exceptions they would want to take under a negative list approach. They pointed out that so-called “positive lists”—where the only commitments being made are explicitly listed—would be much easier to construct and argued use of such a “bottom-up” approach. Although discussions continued for more than a year, developing countries remained adamantly opposed to general obligations and negative lists. With time seemingly running out—the Uruguay Round was supposed to terminate in December 1990—the United States agreed to accept a hybrid approach for scheduling as a compromise.

The hybrid list approach used in the GATS relies on both positive and negative lists (see table 2). It requires a positive list of
sectors or subsectors; that is, commitments to market access and national treatment are undertaken only for sectors or subsectors listed. However, for financial services, some countries used such narrow subsectors—for example, "acceptance of deposits and other repayable funds from the public"—that the portions of their schedules devoted to financial services are, in effect, detailed lists of activities. Within each sector, subsector, or activity, a negative list approach is used; that is, limitations on market access and national treatment must be listed. Such limitations include nonconforming measures, as is customary under a negative list approach. However, the practice under the GATS is to schedule commitments separately for each mode of supply, which means that the limitations may also include one or more modes of supply. For example, by entering the term "unbound," a country could avoid making any commitments for an entire mode of supply.10

It is, of course, technically possible to construct a negative list and a hybrid list that produce the same result in terms of reduction or removal of restrictions on market access and national treatment. However, for trade in services, the two approaches are qualitatively different. Most important, negative lists provide an inventory of all remaining barriers in all sectors and are therefore much more transparent than hybrid lists, under which no accounting of barriers is provided for unlisted sectors or for "unbound" modes of supply. As a result, negative lists can facilitate future liberalization, both in international negotiations and in the domestic political process.

Moreover, negative lists make possible—and are normally accompanied by—an across-the-board "standstill" obligation, which precludes new measures inconsistent with market access and national treatment in all sectors.11 In addition, negative lists can significantly affect the dynamics of the negotiations by putting a burden on countries to inscribe exceptions to liberalization in their schedules, since "silence" means adherence to market access and national treatment in all sectors. Because of these advantages, negative lists are used in the OECD framework of obligations and in the NAFTA, where market access and national treatment are, in effect, general obligations.

Absence of a Standsstill. The absence of a standstill is another major weakness in the structure of the GATS. Although an across-the-board standstill obligation applicable to all sectors requires a negative list approach, a standstill could nevertheless be superimposed
On the hybrid list approach in the sense that it would apply to the sectors, subsectors, or activities listed in a country's schedule of commitments. Within each listed sector, subsector, or activity, the only permissible limitations would be existing nonconforming measures; entire modes of supply could not be excluded. However, during the negotiations, emerging market economies and other developing countries made clear that a services agreement that included a standstill provision would be unacceptable to them. As a result, the GATS allows a country to introduce new barriers to market access and national treatment and continue to benefit from the openness provided by other parties to the agreement.

In the absence of a standstill, some countries schedule commitments in financial services that are more restrictive than measures currently in force. Suppose, for example, a host country currently allows foreign banks to have 60 percent ownership positions in domestic financial firms. By making a binding commitment guaranteeing an ownership position of only 40 percent, the country retains the option of restricting foreign ownership positions to that level. Indeed, one emerging market country made clear its intention—subsequently enacted into law—to require divestiture of existing majority-ownership positions by foreign insurance companies. Such a measure violates the principle of "grandfathering" existing operations and activities. This principle, which is also referred to as guaranteeing the retention of "acquired rights," is often accepted as a basis for national policies dealing with foreign direct investment in the financial sector.

Commitments beyond Market Access and National Treatment.

The GATS provides an opportunity for countries to make additional commitments that go beyond market access and national treatment. Accordingly, besides the columns for market access and national treatment, the schedules contain a column entitled "additional commitments" for liberalization involving nonquantitative and nondiscriminatory structural barriers. To date, this column has been used mainly for the procompetitive regulatory principles agreed in the telecommunications sector. For financial services, the additional commitments column has almost never been used. However, if, for example, Japan decides to incorporate into its GATS financial services schedule the commitments it made in bilateral U.S.-Japan agreements covering insurance and other financial services, it might prefer to list those commitments in the column for additional commitments.
since they address barriers that are, technically, not denials of market access or national treatment.\textsuperscript{21}

Special Provisions for Financial Services

The Annex on Financial Services and the Understanding on Commitments in Financial Services, already mentioned, contain provisions specific to financial services. These provisions emerged from a text originally developed by an informal group of finance officials from Canada, the European Community, Japan, Sweden, Switzerland, and the United States. This group had initially gathered to discuss how financial services should be handled in the GATS and was known as the “Fu Lung group” after the restaurant where its first meeting was held in September 1989.

In 1990, the Fu Lung group was broadened to include selected Asian, Eastern European, and Latin American countries, with the result that the interests of nearly 40 countries were represented. However, upon completion of a text for a proposed financial services annex in the autumn of 1990, the emerging market economies, led by Mexico, suddenly and unexpectedly withdrew.\textsuperscript{22} In December 1990 at the beginning of the ministerial meeting in Brussels that was supposed to conclude the Uruguay Round, a slightly revised version of the Fu Lung text—the so-called “four-country text”—was formally submitted by Canada, Japan, Sweden, and Switzerland to the committee overseeing the Uruguay Round negotiations.

Trade negotiators used two ideas from the Fu Lung text to strengthen the GATS framework agreement. First, they expanded the scope of the general obligation of transparency to include administrative measures in addition to statutes and regulations. Second, they clarified the definition of national treatment to emphasize the importance of the conditions of competition, regardless of whether treatment of foreign services or service suppliers is formally identical to or formally different from that of domestic services or service suppliers.

Provisions on which only the industrial countries could agree, which had formed an optional second section of the Fu Lung text, became the Understanding on Commitments in Financial Services. The remaining provisions of the Fu Lung text became the Annex on Financial Services. Initially, finance officials from the United States had envisaged the Fu Lung text as a financial services agreement separate from the GATS framework agreement. However, the idea
of a separate agreement for financial services was unacceptable to trade officials, both in the United States and other countries. It was also opposed by finance officials in some countries and by the U.S. financial services industry.

**Understanding on Commitments in Financial Services**

For the financial services schedules of the countries that use it, the Understanding on Commitments in Financial Services addresses the structural weaknesses of the GATS and thus offers an approach that would have been desirable, but was not achievable, in the framework agreement. Countries that choose to schedule commitments in accordance with the Understanding undertake commitments to market access and national treatment—under the framework agreement as supplemented by the Understanding—for all financial services subsectors and use a negative list approach to scheduling. The Understanding also contains a standstill, whereby limiting exceptions to existing nonconforming measures. Countries using the Understanding retained mode of supply as a scheduling technique. Although a standstill would normally preclude taking an exception for a mode of supply, countries using the Understanding retained the flexibility to conform their commitments regarding temporary entry of natural persons to those set forth in their so-called horizontal commitments applicable to all services sectors.

As regards market access, the Understanding supplements the framework agreement’s list of prohibited measures by setting forth a broad commitment to the right of establishment or expansion of a commercial presence. However, the Understanding’s provision regarding cross-border services is designed to facilitate a narrower commitment for this mode of supply, reflecting in part the concerns of financial regulators in a number of countries. For example, the U.S. Securities and Exchange Commission (SEC) does not allow soliciting from abroad for securities that are not registered in the United States or, absent an exemption, for mutual funds not registered in the United States. As regards national treatment, the Understanding relies on the definition in the framework agreement, but clarifies its application in the financial services sector with regard to both payment and clearing systems and self-regulatory bodies.

For nonquantitative and nondiscriminatory structural barriers, the Understanding includes a “best-efforts” undertaking to remove or limit any significant adverse effect. It also states that this undertaking
does not endorse reverse discrimination against domestic service providers. The Understanding deals separately with one type of nondiscriminatory structural barrier, namely, barriers to the provision of new services. The Understanding requires each host country to allow an office of a foreign financial firm to offer “any new financial service,” defined as a financial service already being supplied in another country but not in the host country. The purpose of this provision, which was strongly supported by the U.S. financial services industry, is to allow innovative products introduced by financial institutions in other countries—and approved by the relevant home-country authorities—to be introduced by their offices in other countries. However, the scope of the provision appears to be relatively narrow.

Annex on Financial Services

The prudential carve-out mentioned in the introduction to this paper is contained in the Annex on Financial Services. Other provisions in the Annex deal with dispute settlement, recognition of prudential measures in other countries, and the coverage and definition of financial services.

Prudential Carve-Out. The prudential carve-out for domestic regulation permits a country to take prudential measures “for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed” or “to ensure the integrity and stability of the financial system” regardless of any other provisions of the GATS. This provision may not, however, be used to avoid a country’s obligations and commitments under the agreement.

Disagreement over whether a particular national measure falls within the prudential carve-out is subject to WTO dispute settlement procedures and thus, if necessary, to a determination by a dispute settlement panel. However, most regulators do not appear to be particularly concerned about this possibility. For one thing, if a country is concerned that a particular measure might not be generally accepted as prudential in the future, it could list the measure as an exception in its initial schedule of commitments. Indeed, some countries may have been too cautious in this regard. That is, they may have taken exceptions for measures that are clearly prudential, for example, requirements for applications by foreign financial firms to set up host-country offices. For another, if a prudential issue reaches dispute settlement, the panel will have appropriate
financial services expertise, as discussed below. In addition, only
governments—not private parties—may bring claims to dispute
settlement, and, absent a truly egregious action, governments may
prefer to respect each other’s ability to determine which rules are
prudential.

Dispute Settlement. Ensuring financial services expertise in the
handling of disputes involving financial services was another issue
of particular concern to financial services regulators. Indeed, at one
point, financial officials from the major industrial countries were
pushing the idea of a separate body for settlement of disputes
involving financial services, an idea that trade officials found
unacceptable. Ultimately, the concerns of financial officials were
addressed by inserting a requirement in the Annex that dispute
settlement panels on prudential issues and other financial matters
must have the expertise necessary to deal with “the specific financial
service under dispute.”

This standard is more narrowly drawn
than the general standard applicable to the GATS, which requires
panels to have the “necessary expertise relevant to the specific
services sectors which the dispute concerns.”

Another aspect of dispute settlement of concern to financial
officials was the possibility of cross-sector retaliation against financial
services. Such retaliation would involve a suspension by one country
of concessions for financial service providers from an offending
country in accordance with a ruling by a dispute settlement panel
involving a controversy in a different sector. Because of concern
that such retaliation could disrupt the smooth functioning of the
financial system, some finance officials advocated an asymmetric
 provision whereby retaliation in another sector would be allowed
for disputes involving financial services but not the reverse. The
approach that was adopted in the new WTO dispute settlement
mechanism requires that a country first seek to retaliate with respect
to the sector in which the violation was found. If that is not
practical or effective, the party may retaliate in other sectors covered
by the same agreement—for example, in the case of GATS, other
services sectors. As a final resort, a party is allowed to retaliate in
any sector covered by any Uruguay Round agreement, for example,
in a services sector for a goods dispute, or vice-versa.

Recognition of Prudential Measures. The Annex allows a country
to recognize prudential measures of selected other countries—either
unilaterally or through a negotiated arrangement or agreement—
without such a step being challenged by excluded countries as a denial of MFN treatment. A country must, however, be willing to accord similar recognition to measures of other countries that meet the same standards. Despite the prudential carve-out, finance officials from the industrial countries considered this provision necessary to ensure that arrangements such as the multijurisdictional disclosure systems (MJDS) adopted by the U.S. Securities and Exchange Commission (SEC) and by securities regulators in Ontario and Quebec would be immune from MFN challenges under the GATS. In effect, the recognition provision in the Annex elaborates on the application to the financial services sector of a “mutual recognition” provision in the framework agreement that allows a country to recognize standards or licensing or certification requirements of selected countries without being subject to the MFN obligation of the GATS.

Coverage and Definition of Financial Services. The Annex defines a financial service as any service of a financial nature offered by a financial service supplier of a WTO member and provides a nonexclusive list of financial services. If a firm supplies any one of the listed services, it falls within the GATS definition of a financial service supplier and can benefit from the GATS regime for financial services. The list is product-based, that is, it enumerates various types of banking and other financial services as well as insurance and insurance-related services. It includes instruments such as derivatives and appears to be sufficiently broad to encompass new instruments. The definitions section of the Annex also clarifies that the exclusion from GATS coverage for services supplied in the exercise of governmental authority applies to activities of central banks or monetary authorities in pursuit of monetary or exchange rate policies.
III. Challenges in the Financial Services Negotiations

The strength of the liberalization achieved in the GATS depends largely on the schedules of commitments, as explained in the previous chapter. However, it was not until 1991, when draft texts of the Uruguay Round agreements were nearing completion, that negotiators were able to begin intensive work on the substance of the GATS schedules. In seeking to obtain strong commitments to market access and national treatment from emerging market economies, financial services negotiators faced several major challenges.

The first was the need to focus on regulatory barriers as opposed to tariffs. The second was the absence of cross-sector tradeoffs involving financial services in the Uruguay Round. The third was the lack of negotiating leverage within the financial services sector. The fourth comprises the linkages between the ability and willingness of emerging market economies to make strong commitments in the GATS and their progress in areas outside the scope of the negotiations, such as reform of domestic financial systems and strengthening of prudential regulation and supervision. This chapter discusses each of these challenges in turn.
Regulatory Barriers versus Tariffs

Tariffs provide a continuously adjustable price mechanism that can readily be used to achieve a gradual lowering of barriers, both through phased reductions under the terms of a particular agreement and through commitments made in successive negotiating rounds. Compromise on the extent of reductions in any one agreement are facilitated by the knowledge that future negotiating rounds will lead to further reductions along the same well established path.

By contrast, the regulatory barriers and quantitative restrictions that constitute the denials of market access and national treatment at issue in the financial and other services negotiations lack a continuously adjustable price mechanism. Moreover, the barriers are difficult to quantify in terms of tariffs or taxes in any meaningful way. In addition, the inclusion of foreign direct investment as well as cross-border trade brings an "all-or-nothing" quality to certain barriers and creates a greater need for certainty or, at the least, predictability with regard to removal of barriers. Even more difficult issues arise with respect to nonquantitative and nondiscriminatory structural barriers, since reducing or eliminating such barriers involves some movement toward convergence of national regulatory systems.

However, for financial services, the latter type of barriers were not the focus of the negotiations.

Translating regulatory barriers and quantitative limitations that are designed to protect the domestic financial services industry— as well as discrete changes in such barriers—into an equivalent tax or tariff would be extremely difficult. The approach of "tarification," extensively used in agriculture, depends on the existence of a stable, and thus reasonably predictable, relationship between the price of the product and the quantity demanded by consumers. For financial services, however, it is difficult to translate how a change in the availability of a financial service, say, of a loan, would affect the price of a loan, that is, its interest rate. For one thing, the relationship between price and quantity for financial services is complicated by the extensive underpinning of prudential regulation and supervision applied to the providers of financial services and the existence of a so-called safety net, including provision of credit to troubled banks, "too-big-to-fail" policies, and deposit-protection schemes. For another, the service provided can be very complex; thus the possibilities for substitution among alternative instruments and modes of supply
would be difficult to take into account. Finally, as already noted, some restrictions on foreign direct investment have an “all-or-nothing” aspect.

An example of an “all-or-nothing” barrier is provided by one of the most difficult issues in the financial services negotiations—namely, restrictions on foreign participation in ownership of domestic financial firms. Such restrictions are denials of both market access and national treatment under the GATS. An incremental increase in the limit on foreign ownership positions in domestic financial firms from, say, 30 to 40 percent would not be meaningful because the critical issue is allowing majority ownership, whether through acquisition or de novo entry. Indeed, some large U.S. banking organizations generally require their foreign banking ventures to be majority-owned.

For foreign direct investment, the equivalent of a so-called “ceiling binding” for tariffs—that is, binding a tariff at a level higher than the status quo—is unacceptable. The reason is that raising a tariff to the ceiling level, which, other things being equal, will reduce the flow of exports to a country, is very different from introducing restrictive measures that reduce from the status quo for foreign direct investment—by, for example, requiring divestiture of existing ownership interests or operations. Acceptance of the principle of grandfathering, that is, retention of acquired rights, discussed in the previous chapter, might address that problem; however, to avoid discrimination between existing foreign firms and new entrants, a standstill would also be necessary.

Enabling the investor to choose the organizational form for entry and operation in a host country—including the use of branches, which are an important form of organization for banks operating internationally—also has an “all-or-nothing” element. Unlike subsidiaries, branches are an integral part of the bank; that is, they are not separately incorporated in a host country and thus operate off the capital of the bank. A host-country prohibition on branch entry would constitute a market access barrier under the GATS.

Treatment of branches also illustrates the importance of providing both market access and national treatment. Suppose that a host country allows branch entry but imposes individual lending and other operating limits based on branch capital-equivalency requirements. Such measures restrict the operations of the branch by, for example, tying the size of individual loans to the amount of
"capital" attributable to the branch. Since domestic banks operate on the basis of their consolidated worldwide capital, national treatment would require allowing branches to operate on the basis of the bank's consolidated worldwide capital. In this regard, a U.S. government study concluded that although restrictions might need to be applied to address specific prudential concerns in problem cases, general application of such restrictions would have the effect of denying a foreign bank the economic benefits of the branch form of organization.39

Despite the impracticability of translating them into tariffs, barriers to market access or national treatment that do not present major discontinuities could be reduced in discrete steps. For example, a series of increases in the number of new banking licenses allowed each year or the ceiling on the aggregate market share of foreign banks could be negotiated. However, particularly with a large number of countries, difficult issues regarding allocation of quotas in a manner consistent with the MFN obligation could continue to arise. But, even for barriers without major discontinuities, agreement still needs to be reached on the strength of the underlying commitments.

The problem remains that for financial and other services it is conceptually difficult to find the equivalent of the lower tariffs that are an acceptable outcome for a negotiating round dealing with goods. Together with the absence of a clearly defined and generally accepted path for reducing barriers to market access and national treatment in future negotiating rounds, this makes it politically difficult to reach agreement on an outcome short of substantially full market access and national treatment. Thus, even if some financial services commitments were to be phased in, as discussed in the following chapter, the issue of reaching agreement on the strength of a country's underlying commitments to market access and national treatment remains.

The extent to which carefully designed, country-specific transitional safeguards—for example, a temporary halt in granting new licenses if a specified aggregate market share is reached—might be used to help obtain strong underlying commitments to market access and national treatment for the financial services sector is discussed in chapter IV. The underlying commitments would need to cover not only the barriers used to define the safeguard but also other major barriers that constitute denials of market access.
or national treatment. Such barriers include the limitations on majority-foreign ownership of domestic financial firms and on branch entry and operation discussed above and other denials of national treatment such as discriminatory restrictions on the types of activities that foreign financial firms may conduct in a host country.

In goods negotiations under the GATT, the problem of reaching agreement on an outcome with strong underlying commitments to national treatment in a single negotiating round does not arise. The reason is that national treatment for goods—which precludes measures that discriminate against foreign products once they have crossed the border—was accepted as an immediate goal in the original negotiations. As a result, in the GATT, national treatment is a general obligation from which exceptions may not be listed in a country’s schedule of commitments.26 That is, apart from public policy exceptions for areas such as national security, national treatment applies to all other measures except those involving subsidies or government procurement; no exceptions for existing nonconforming measures are allowed.27

Absence of Cross-Sector Tradeoffs

Cross-sector tradeoffs are an important feature of a multisector negotiation such as the Uruguay Round. Indeed, as mentioned in the introduction to this paper, the U.S. financial services industry had hoped to be able to benefit from such tradeoffs in the Uruguay Round. Typically, trade negotiations involve two very different kinds of cross-sector tradeoffs: high level political tradeoffs, which usually occur at the beginning of a negotiation or just before a major deadline; and routine tradeoffs that occur at the technical negotiating level.

The “single undertaking” of the Uruguay Round—which meant that countries had to accept all of the multilateral Uruguay Round agreements—created considerable pressure for cross-sector tradeoffs, and political tradeoffs did occur. For example, developing countries linked their demand for a ten-year phase-in for TRIPS obligations to the ten-year phase-out of restrictions on textiles by industrial countries. Similarly, France linked its concessions in agriculture to its demands to maintain protection in the audiovisual sector. Financial services, however, were not part of any comparable political tradeoff, in part because of a lack of political consensus. During the extended financial
services negotiations, some emerging market economies attempted to link concessions in financial services to concessions by some industrial countries on the temporary presence of natural persons, but this effort was unsuccessful.

As regards routine cross-sector tradeoffs, for all services sectors the focus on regulatory barriers appears to have limited a priori the scope for such tradeoffs with other services or with goods. Routine tradeoffs depend in large part on being readily able to exchange concessions of equivalent value, that is, on the ability to convert barriers to tariffs or taxes, thereby making them fungible across sectors. The lack of such fungibility tended to preclude routine cross-sector tradeoffs not only between services and goods but between different services sectors. Thus, contrary to a widely held view, the lack of fungibility—as opposed to the unusual degree of separation between financial services and the rest of the Uruguay Round negotiations—was the major reason for the absence of routine cross-sector tradeoffs.

Whether the separateness of the financial services negotiations contributed to the absence of political tradeoffs is a more difficult question. The answer depends in part on the political dynamics in each country between ministries responsible for the overall trade negotiations and those handling the financial services negotiations. In the early stages of the Uruguay Round negotiations, trade and finance officials had difficulty understanding and dealing with the significantly different perspective and culture of the other. Indeed, at times, it appeared that financial services had to be negotiated on two fronts—not only between countries but also between trade and finance officials. However, by the end of the Uruguay Round—when many of the major political tradeoffs were being made—financial services had been integrated into the overall negotiating process and good working relationships had been established between trade and finance officials.

A relatively minor negative cross-sector influence may have been inadvertently introduced into the Uruguay Round financial services negotiations by logistical considerations. Because of the time and expense of travel to Geneva, a number of countries, especially emerging market economies, relied on officials at their Geneva missions, necessarily trade not financial experts, for at least some of the bilateral negotiating sessions dealing with financial services. In some cases, these negotiators, in implicit retaliation for
positions of the United States and other industrial countries on issues involving goods, may have taken a harder line than would have been taken by financial officials.

In the NAFTA negotiations, in contrast to the Uruguay Round negotiations, political tradeoffs led to agreement on financial services. For one thing, the expected political benefits of the NAFTA were of such importance to Mexico that it was not willing to jeopardize the agreement because of financial services. For another, the United States, while indicating that it was willing to address Mexican concerns about the impact of opening its financial sector, apparently took the position early in the negotiations that failure to achieve a strong agreement on financial services would be a “deal breaker” for the agreement as a whole. In addition, the NAFTA negotiations benefited from the domestic political momentum within Mexico for financial sector reform.37

An example of a successful negotiation not part of a multisector round—and thus without the same opportunities for political cross-sector tradeoffs—is provided by the extended telecommunications negotiations, concluded in February 1997. The conventional wisdom is that these negotiations demonstrate that other single sector negotiations can also succeed. However, because of substantial differences between the telecommunications and financial services negotiations, the outcome of the former is relevant for financial services primarily insofar as it creates overall political momentum for negotiations under the auspices of the WTO.38

Lack of Negotiating Leverage within the Financial Services Sector

A major difficulty in the financial services negotiations was that virtually no leverage exists within the financial sector to obtain strong commitments from emerging market economies. In particular, most of the existing financial firms from emerging market economies that wish to establish a presence in the U.S. market—and can meet the prudential criteria—have already done so. In addition, the possibility of being barred from future geographic and product expansion does not appear to be an immediate concern. Over time, this situation could change, that is, leverage in financial services could increase as financial institutions from the current emerging market economies become stronger and more competitive and have
a much greater interest and ability to operate in the United States and other industrial countries.

A broad MFN exemption, combined with a commitment covering only existing operations, allows a country such as the United States to preserve this potential future leverage. That is, it would leave the United States free to pursue a unilateral reciprocity policy in an effort to open markets and to obtain strong GATS commitments from emerging market economies in the future. The U.S. experience with legislation enacted in 1988 regarding primary dealers in U.S. government securities—an exception to the overall U.S. policy of national treatment for foreign banking organizations—is seen by some as an example of a “successful” unilateral reciprocity policy. For example, in combination with market forces, it led to a rapid opening of this segment of the Japanese market without sanctions being used, that is, without the United States having to deny primary dealer status to Japanese firms. In this case, substantial leverage existed, since Japanese firms wanted primary dealer status in the United States. However, because of ongoing liberalization in Japan, the legislation may have served primarily to accelerate the timetable, that is, market forces would probably have led to a similar result but over a somewhat longer period.

By preventing discrimination among foreign countries, a multilateral MFN obligation precludes the use of unilateral reciprocity policies. A major risk of such policies is that sanctions will actually be used and have a contagion effect; once one country begins to use sanctions, the likelihood of other countries doing so is increased, which could lead to a significant decrease in world welfare. This could occur even if the original sanction had a negligible direct effect on the welfare of the country imposing it.

The GATS and other trade agreements serve, in effect, to channel demands for reciprocity into an organized multilateral process of liberalization. In the negotiations, countries trade “concessions” of market opening that, in economic terms, should be in their own interest in the first place. Indeed, in financial services, besides benefiting host-country consumers of financial services, market opening could, with concomitant strengthening of prudential supervision, contribute to ongoing reform and strengthening of a country’s domestic financial system. If all participants were to make strong commitments, the agreement would, in effect, provide reciprocal market access and national treatment on a multilateral basis.
Linkages with Progress in Areas outside the Negotiations

The commitments for financial services being sought from emerging market economies in the GATS involve only barriers to market access and national treatment. However, a country’s willingness and ability to make such commitments may depend significantly on its progress in two areas outside the GATS financial services negotiations. The first is the ongoing, but gradual, process of domestic liberalization in emerging market economies which involves reducing or eliminating what is sometimes referred to as economic—as opposed to prudential—regulation. The second involves efforts to strengthen financial systems in emerging market economies, including prudential regulation and supervision. The success of the multilateral financial services negotiations depends, to a significant extent, on their timing vis-à-vis developments in both of these areas.

The focus of efforts for domestic liberalization is primarily on nondiscriminatory structural barriers, but removal of restrictions on capital movements and market access for foreign financial firms is usually an integral part of any liberalization. However, sequencing remains an issue. For example, a policy goal of most emerging market economies is enhancing the ability of domestically owned financial firms to compete with foreign financial firms. This ability depends in large part on the competitiveness and efficiency of the domestic market, which, in turn, could be significantly increased by the presence of foreign financial firms. But some emerging market economies are reluctant to grant substantially full market access and national treatment to foreign financial firms early in the liberalization process. The reasons include concern that foreign financial firms will dominate less efficient domestic firms—discussed in the following chapter in relation to phased and safeguarded commitments—and concern about stability of the domestic financial system.

If handled properly, liberalization—including both domestic structural change and openness to foreign financial firms—and the strengthening of prudential regulation and supervision are mutually reinforcing. Establishment of strong prudential standards and effective supervisory structures in emerging market economies is a critical factor in ensuring that liberalization will go as smoothly as possible. Liberalization, in turn, can contribute toward system strengthening.
through the creation of more competitive and efficient host-country financial markets.

At present, various international efforts are underway to promote financial stability in emerging market economies, especially to strengthen prudential regulation and supervision. Although these efforts should facilitate market opening, their timing is independent of the WTO financial services negotiations. In accordance with a mandate from the Lyon G-7 Summit in June 1996, the Bade Committee on Banking Supervision—working closely with non-G-10 supervisory authorities—published in April 1997 a set of "Core Principles for Effective Banking Supervision." The committee has suggested that the IMF and the World Bank, as part of their work in promoting overall macroeconomic and financial stability in individual countries, use the core principles in assisting countries in strengthening their supervisory arrangements. In addition, substantial technical assistance is being provided, both bilaterally and multilaterally, to emerging market economies to help improve their regulatory frameworks and supervisory capabilities.
IV. Options for Dealing with Free Riders

The challenges in the financial services negotiations have made it difficult to obtain strong commitments from some emerging market economies, thereby opening up the issue of free riders. Suppose that some emerging market economies are free riders in a multilateral agreement for financial services. Does it matter? Economic theory tells us that for the world as a whole, welfare will not be maximized if some markets remain restricted. But it also says that, in general, a country will maximize its own welfare by opening its markets, even if some of its trading partners do not provide reciprocal access. However, as already noted, in conducting trade negotiations, countries ignore this principle and trade "concessions" of market opening that, in economic terms, should be in their own interest in the first place.

The focus of the U.S. concern about free riders is, however, atypical. The usual issue is whether, despite free riders, a country will lift its own barriers; in this case, the United States already has one of the most open markets for financial services in the world. Similarly, immediate, as opposed to future, entry into the U.S. market by additional service providers from countries that are free riders is not an issue. Thus the policy question for the United States is whether to make a binding commitment now that would preclude the possibility of imposing restrictions in the future if some emerging
market economies continue to restrict significantly entry and operation of foreign financial firms.

The potential for developing countries to be free riders is built into the GATS. The framework agreement states that the process of liberalization shall take place "with due respect for national policy objectives and the level of development of individual Members" and calls for "appropriate flexibility" for individual developing countries to open fewer sectors or liberalize fewer types of transactions. Accordingly, the GATS makes it possible for developing countries to receive special treatment. Although, as part of the "single undertaking" of the Uruguay Round, each WTO member must be a signatory to all of the multilateral agreements, a GATS signatory need not submit a schedule of commitments that covers every services sector. For example, a number of developing countries submitted services schedules covering only tourism. Moreover, as already discussed, countries can submit schedules with few commitments—for example, schedules for narrowly defined subsectors, with commitments for only one mode of supply, or with other major limitations. The GATS does not, however, contain a framework comparable to that of the GATT for granting positive preferences to developing countries.

The U.S. objection to free riders is not absolute; it focuses on emerging market economies, not the less advanced developing countries. Although about 80 countries—more than two-thirds of the WTO membership—made commitments in financial services (counting the European Community and its member states as one), the United States conducted extensive negotiations in the Uruguay Round with only about 40 of these countries, including approximately 30 emerging market economies.

As a political matter, the strength of commitments to market access and national treatment made by emerging market economies must be addressed for a successful outcome to the financial services negotiations. But, if having such countries as free riders in a multilateral agreement is not acceptable, what are the options? The choices fall into three broad categories: first, departures from the MFN principle; second, phased and safeguarded commitments; and third, fixed-term agreements. Although all three categories will be discussed in this chapter, the main focus will be on the issues involved in using phased and safeguarded commitments in the GATS. In contrast to the other options, phased and safeguarded commitments have the
potential to solve the free-rider problem within the context of a permanent MFN-based agreement with strong underlying commitments by all parties.

Departures from the MFN Principle

In general, the MFN obligation in the GATS prevents a country from taking measures that discriminate among foreign countries with regard to trade in services. However, the GATS does allow specified departures from the MFN principle. First, subject to certain conditions, exemptions from the MFN obligation may be taken by individual countries upon entry into force of the agreement—for example, the MFN exemption taken by the United States for financial services. Second, the GATS makes an exception for agreements that qualify as economic integration agreements, typically free trade areas or customs unions. Third, the MFN obligation does not apply to recognition of standards or licensing or certification requirements. Such recognition, which could be accorded unilaterally or through a negotiated arrangement or mutual recognition agreement (MRA), was discussed in chapter II with regard to the Annex on Financial Services and recognition of prudential measures of selected countries.

MFN Exemptions

The GATS allows one-time MFN exemptions to be taken that are effective upon entry into force of a country’s schedule of commitments. In principle MFN exemptions should not exceed a period of ten years; they must be reviewed after five years and, in any event, are subject to negotiation in subsequent rounds. As already explained, the broad MFN exemption for financial services taken by the United States, together with its commitment to market access and national treatment only for existing operations of foreign financial firms, provides leeway to pursue a unilateral reciprocity policy outside the WTO with respect to new entry or expansion into new activities or new locations. During the course of the Uruguay Round, two other types of unilateral determinations for services were advocated by the United States but were unacceptable to almost all other countries: “sectoral nonapplication” and, subsequently, a “two-tier” approach. The appendix explains the details of these approaches.
Economic Integration Agreements

Under the GATS, parties to an economic integration agreement are not obliged to extend its benefits to nonparticipants. However, such an agreement must meet stringent criteria. In particular, it must have substantial sector coverage, not exclude a priori any of the four modes of supply, and provide for the absence or elimination of substantially all discrimination incompatible with national treatment among the parties. In addition, the agreement must not increase existing barriers to trade in services with nonparticipants. Although no formal legal determination has been made, the services provisions of agreements such as the EC Treaty, the NAFTA, and the Australia-New Zealand Closer Economic Relations Trade Agreement appear to meet these criteria. Especially in areas that are relatively new and deal with barriers not yet addressed in multilateral negotiations, regional agreements can be a useful complement to multilateral agreements by going beyond the liberalization that has been achievable on a global scale and serving as a model for rules that could be adopted in future multilateral negotiations.

Reach of the MFN Obligation of the GATS

In contrast to treatment accorded under economic integration agreements, treatment accorded under agreements such as the Multilateral Agreement on Investment (MAI) now being negotiated at the OECD is covered by the MFN obligation of the GATS. As a result, measures taken in connection with MAI obligations regarding services must be extended to all WTO members. The goal of the United States in negotiating the MAI is to try to reach agreement among OECD countries on a high level of protection for investment that could eventually become more widely accepted, either by accession of non-OECD countries to the MAI or by serving as an example for future negotiations in the WTO. The MAI negotiations have, however, proved more difficult and complicated than had been expected, and the deadline for reaching agreement has been extended by one year to May 1998.

Similarly, measures taken under bilateral services agreements such as the U.S.-Japan agreements regarding insurance and other financial services are now governed by the MFN provisions of the GATS. Although the benefits of the measures in the U.S.-Japan agreements are already being applied on an MFN basis, Japan is nonetheless under considerable pressure from other WTO members.
to include these measures in its GATS schedule of commitments so that they become formal multilateral commitments directly and fully subject to WTO dispute settlement. 49

Phased and Safeguarded Commitments

Phased and safeguarded commitments, defined below, could be used to help obtain strong underlying commitments to market access and national treatment from emerging market economies in the GATS with concomitant MFN-based commitments by all parties. As suggested earlier, the negotiating tradeoff consists of allowing commitments of an individual country to be phased or safeguarded in return for a substantial strengthening of its underlying commitments. The phased or safeguarded commitments would thus be tailored to the circumstances of a particular country.

The United States raised the possibility of phased commitments during the Uruguay Round financial services negotiations, but this approach was not actively pursued by emerging market economies or the United States. In March 1995, during the extended negotiations, Canada circulated a brief communication regarding "staged liberalization" based on phased and safeguarded commitments in the NAFTA, discussed below, but, at the time, the communication did not receive much attention. 50 During the current negotiations the possibility of using both phased and safeguarded commitments is being further explored. Indeed, in August 1997, the United States publicly stated its willingness to consider phased or safeguarded commitments provided that the underlying commitments are sufficiently strong. 51

Phased Commitments

"Phased commitments" refers to commitments that are guaranteed to be implemented by a specified future date that marks the end of a transition period. The commitments may also specify a series of benchmarks for reducing or eliminating current restrictive measures. Phased commitments are completely different from agreement to negotiate, at a specified future date, additional market opening measures. Phased commitments should also be distinguished from making a commitment now to "schedule" (that is, add to a schedule of commitments) future domestic liberalization measures within a specified time, say, one year, after enactment. While the latter type
of commitment is clearly important, it is not a substitute for a phased commitment because a fixed date by which a strong scheduling commitment will be in effect is not specified.

The approach of phased commitments assumes that the domestic political will to achieve the necessary liberalization already exists. Indeed, a country can make a binding commitment to lifting specified restrictions by a certain date only if it can do so by regulation or, if legislation is necessary, it has already obtained the necessary mandate or will be able to do so as part of the implementing legislation for the agreement itself. Thus a fundamental question is whether some emerging market economies are in a position to offer phased commitments and then be able to abide by the phasing.

The NAFTA. Phased commitments—together with safeguarded commitments discussed below—were used in the NAFTA to address the concerns of Mexico about the possible domination of its financial markets by U.S. and Canadian firms as it moved from a regime virtually closed to foreign entry to one that was relatively open. In the banking sector, for example, during a six-year transition period, which extends until 2009, Mexico may impose specified limits on aggregate and individual market shares for subsidiaries of U.S. and Canadian-chartered banks. In fact, in its effort to attract foreign investment to help support domestic banks during the peso crisis, Mexico accelerated the phase-in schedule.

Safeguarded Commitments
The term "safeguarded commitments" is used in this paper to refer to commitments that may be temporarily suspended under future contingencies specified in the GATS framework agreement or in a country's schedule. A safeguard may be transitional—that is, available only during a specified period of time—or available indefinitely into the future. Safeguards are inherently more sensitive and controversial than phase-ins: While a phase-in always involves positive movement toward the goal of greater openness, invocation of a safeguard, at best, interrupts that process and, at worst, involves backward movement. The latter situation raises issues of compensation and countermeasures. Moreover, if safeguards are not sufficiently narrow or are misused, they could undermine an entire agreement. Safeguards should be distinguished from certain exceptions from the obligations of the GATS that are allowed for reasons of public policy. The GATS provides such exceptions for "necessary"
measures in several areas: national security; public health, order, and morality; tax collection and bilateral tax treaties; and ensuring compliance with measures to combat fraud and protect individual privacy and safety. For financial services, as already discussed, an exception is provided for prudential regulation and supervision.

**Balance-of-Payments Safeguard.** The GATS does contain a safeguard, available indefinitely into the future, that allows a WTO member to impose restrictions that surpass its commitments in the event of "serious balance-of-payments and external financial difficulties or threat thereof." Such restrictions, which must adhere to the MFN principle, must be temporary, consistent with the IMF Articles of Agreement, no more stringent than necessary, and avoid unnecessary damage to the economies of other WTO members.

**"Emergency" Safeguard.** In the Uruguay Round negotiations, agreement was not reached on an "emergency" safeguard. This was envisaged by some as a GATS counterpart of the safeguard provision of the GATT dealing with an unforeseen import surge causing or threatening serious injury, which must be well documented, to domestic producers. Although the deadline for agreement was extended until January 1998, little progress has been made or seems likely. One reason for the lack of consensus on the need for—or terms of—such a safeguard is that the issues are more complicated for services than for goods. In particular, the GATS includes services provided through foreign direct investment; moreover, the issues vary among services sectors.

For financial services, the closest parallel to an import surge for goods that causes actual or potential injury to domestic producers would be a surge in services supplied across borders. For example, a surge in cross-border retail insurance activity might conceivably injure domestic companies. In future, such surges could occur through electronic commerce. However, where establishment of a local presence is involved, there is no direct parallel to trade in goods. The "surge" may involve more than a rapid increase in the number of new entrants to the market; instead, something roughly comparable to a surge could occur later if, say, the host-country offices of foreign service providers were rapidly increasing their market share. A very broad definition of "import" would be required, since at that point the service is being provided domestically, not imported across a border. Moreover, both the concept of injury from foreign direct investment and the potential link between the injury and the
import, broadly defined, are more ambiguous than for cross-border trade.

In this regard, two separate, but related, issues appear to be of particular importance to emerging market economies. The first involves the speed with which foreign competition affects the domestic "infant industry." In particular, upon opening of a host-country market, the activities of foreign financial firms that establish offices there might expand so rapidly that domestically-owned firms would have no time to adjust—that is, to become stronger and more efficient and thus able to compete more effectively. The second issue, which results from the sensitivity and role of the banking sector, involves preserving a "domestic core" of a country's banking system, that is, protecting some of the largest banks from acquisition by foreign financial firms. As explained below, this raises even more difficult issues.

In any event, if safeguards were to be used to address these types of concerns in the financial services sector, they would have to be carefully tailored to the circumstances of a particular country and applied in a manner consistent with the MFN obligation. Adherence to four principles could help to minimize the possibility of undermining the GATS: First, to avoid long-term conflict with the goal of promoting competitive markets, the safeguard should be transitional, that is, available only for a fixed period of time. Second, within the period in which a safeguard is available, to avoid creating unacceptable uncertainty for foreign service providers, a country should be allowed to invoke the safeguard only once and only for a specified period of time. Third, the measures allowed by a safeguard must not violate the principle of grandfathering of acquired rights. Thus the measures would not involve anything more than "stopping the clock," that is, a hiatus in the process of eliminating barriers. Fourth, before invoking a safeguard, a country should be required to provide notification to the WTO Committee on Trade in Financial Services and, on the request of any trading partner, engage in consultations. As already noted, the negotiating tradeoff for such safeguards would involve strong underlying commitments, including commitments for the most difficult types of barriers to market access and national treatment.

The NAFTA. In the NAFTA, for example, commitments in the banking sector are safeguarded in addition to being phased. During a safeguard period which extends for four years after the end of the
transition period, that is, until 2004. Mexico may "freeze" aggregate market shares if specified thresholds of foreign ownership are reached—for example, 25 percent of the total capital of the banking system. Mexico may invoke this safeguard provision only once for a period of not more than three years; thus any limitation imposed under this provision must be abolished by 2007, that is, seven years after the end of the transition period. In this context, market share is used to measure results—that is, the extent of foreign presence in a host-country banking system. Market share, by itself, does not measure opportunities—that is, the extent to which a host-country's regulatory framework provides market access and national treatment.

**Bulgaria's WTO Accession Agreement.** The approach of safeguarding commitments for services has already been used in Bulgaria's WTO accession agreement. In return for strong commitments by Bulgaria to market access and national treatment in the GATS, commitments are safeguarded until the end of 2000 "in order to address specific adjustment concerns." During the safeguard period, Bulgaria may suspend, for a period of up to two years that may not last beyond 2001, its commitments to foreign service providers to permit establishment of a new commercial presence or new branches of a previously established subsidiary. Bulgaria's underlying commitments were sufficiently strong that a more detailed or quantitative specification of adjustment concerns was considered unnecessary.

**"Domestic Core" for Banking System.** Concern about preserving a domestic ownership presence in a country's banking system is not unique to emerging market economies. Moreover, it is not really a transitional issue. The line between outright protectionism and what might be considered reasonable concern about the banking sector is difficult to draw. Thus an attempt to deal with this issue in a trade agreement risks opening the door to unacceptable restrictions. The problem was considered both by the Fa Lung group and in the NAFTA negotiations, with opposite results.

A draft version of the Fa Lung text contained a provision recognizing the need to maintain a minimum presence of domestic service providers in the financial sector and allowing temporary and reasonable restrictions on market access in the event that foreign participation surpassed that level. However, this safeguard—which would have been available indefinitely—was not included in the final Fa Lung text on the grounds that it opened too big a loophole.
In the NAFTA, this issue was addressed by a permanent limitation on Mexico's market access commitment as opposed to a safeguard contingent on future circumstances. The limitation was designed to preserve the domestic core of the Mexican banking system by preventing U.S. or Canadian banking organizations from taking over the largest Mexican banks. Specifically, the market share controlled by an individual U.S. or Canadian banking organization through acquisition or merger is limited to four percent of the total capital of commercial banks operating in Mexico. As a result, the very largest Mexican banks are effectively protected from takeover by foreign banking organizations, although not from direct competition, including acquisition of smaller Mexican banks as well as de novo establishment of subsidiaries. Such a limitation must, however, be viewed in the specific context of the NAFTA—two major industrial countries together with one emerging market country, geographic proximity of the countries, and the starting point of a virtually closed financial system in Mexico. Thus it does not appear to provide a useful model for the GATS.

Fixed-Term Agreements

The use of phased or safeguarded commitments is predicated on the willingness and ability of countries to offer strong underlying commitments. Suppose, however, that sufficiently strong commitments are not forthcoming. Another approach to dealing with the free-rider problem is to negotiate a fixed-term MFN-based agreement for financial services. This approach implicitly recognizes that some emerging market economies are not yet ready to make strong commitments to market access and national treatment but, at the same time, preserves potential future negotiating leverage—without the use of broad MFN exemptions—for countries that do make such commitments.

Specifically, a fixed-term approach could lock in—and subject to the WTO dispute settlement mechanism—commitments that represent the maximum progress achievable at a particular point in time. An MFN obligation could be accepted by all countries, but only for a specified period, perhaps until the conclusion of the next multilateral services negotiating round. Indeed, the GATS requires such a round to begin no later than the year 2000. The expiration of a fixed-term agreement could provide each country a window of
opportunity to reconsider its acceptance of the MFN obligation and its schedule of commitments. Thus potential future leverage would be preserved for the next set of negotiations. Such an approach would be similar to that of the MFN-based interim agreement for financial services now in force, but, unlike that agreement—which was negotiated by other countries after the United States had submitted its limited GATS financial services commitment and taken an MFN exemption—could include all countries.

However, a fixed-term agreement loses the advantage of locking in commitments and beginning future negotiating rounds with what has already been 'bound' and moving forward. Upon expiration of a such an agreement, a country would be free to adopt new restrictive measures regardless of its previous schedule of commitments. Unless market access and national treatment granted to foreign service providers during the term of the agreement were permanently grandfathered, a fixed-term agreement could create considerable uncertainty with regard to foreign direct investment. By contrast, in a permanent agreement, while commitments can be improved at any time, they cannot be withdrawn without compensation of trading partners. Moreover, a fixed-term agreement in one sector could create a precedent that might encourage the use of such agreements in the future. Alternatively, a fixed term agreement might create an irreversible impetus toward renewal and thus fail to preserve the desired leverage.
V. Conclusion

In the current negotiations on financial services, the goal is to achieve a permanent MFN-based agreement with strengthened commitments from emerging market economies and a concomitant MFN-based commitment from the United States. Some developments since the end of the previous financial services negotiations in mid-1995 could be expected, other things being equal, to contribute toward achieving such a result. However, the coincidence of the timing of the negotiations with the financial market turmoil in Asia will, in the short run, complicate the negotiations.

First, despite the current difficulties, the lapse of time per se since the end of the previous negotiations should be helpful. Domestic liberalization programs in some emerging market economies are further along, as are efforts to strengthen prudential regulation and supervision. In addition, recognition that market opening can benefit consumers of financial services and contribute toward the resiliency of domestic financial systems is becoming more widespread. It remains to be seen, however, whether enough progress has been made to affect the willingness of certain emerging market economies to make stronger commitments to market access and national treatment in the GATS. Moreover, current difficulties and immediate political considerations could overshadow the decision-making necessary for a longer term agenda to achieve greater openness. A continuing challenge for negotiators is to try to harness—and thereby also
provide support for—any market or political pressures for openness within emerging market economies. The use of phased or safeguarded commitments could be helpful in this effort.

Second, the role of the private sector has changed. Previously, U.S. industry had been virtually alone in pushing for stronger commitments from emerging market economies. Now, representatives from the financial services industry in the United States and Europe, as well as in some additional countries, are working together under the rubric of a so-called financial leaders group. The group has identified for negotiators key countries for financial services liberalization and specific barriers in each country.

Third, because the financial services sector, at present, constitutes the only major negotiation at the WTO, it can be given higher priority both by national governments and the WTO. Overall political pressure to obtain improved offers can more readily be brought to bear, although without the same possibilities for political tradeoffs presented by simultaneous negotiations in other sectors. In addition, more time and resources—both in the WTO and national governments—can be directed toward financial services and thereby encourage consideration of ways in which commitments might be strengthened. In an effort to facilitate the negotiating process, the WTO has been providing assistance to developing countries with regard to the technical aspects of preparing schedules. Such assistance is similar to that provided as part of a World Bank-managed program in the extended telecommunications negotiations.

Fourth, political momentum from the successful conclusion of the extended negotiations on basic telecommunications services in February 1997 could benefit the financial services negotiations.

Some factors, however, have not changed. Most important, negotiating leverage within the financial services sector remains virtually nonexistent. In addition, although both the United States and the European Community are seeking stronger commitments from emerging market economies, their assessments of the strength of commitments necessary to reach agreement could diverge, as they did in the previous negotiations.

For the future, the GATS requires successive rounds of negotiations on specific commitments in all sectors—which must begin no later than 2000—to achieve a “progressively higher level of liberalization.” The term “liberalization” is used broadly to encompass both strengthening of commitments to market access
and national treatment and the introduction of additional commitments that address nonquantitative and nondiscriminatory structural barriers. To some extent the WTO is already being used as a forum to deal with nondiscriminatory structural barriers in areas such as telecommunications and intellectual property. In the financial services negotiations, however, as already discussed, liberalization that involves nondiscriminatory structural barriers has been addressed only peripherally. For the financial sector, it remains to be seen what role, if any, the WTO will play with regard to such barriers.

The role of the WTO, as now structured, is to serve as a periodic forum for intensive negotiating efforts to obtain binding commitments and to provide a strong enforcement mechanism for such commitments. Unlike, say, the OECD, the WTO is not designed to serve as an ongoing forum for discussing and encouraging liberalization through peer pressure. For financial services, such a role for the WTO would not seem productive. Many fora and institutions dealing with these issues already exist. In addition, the special characteristics of the financial sector would require participation by finance officials as well as considerable financial services expertise and staffing within the WTO in order to deal with these issues on an ongoing basis. The WTO has established a Trade Policy Review Mechanism (TPRM), but its reviews, conducted by the Trade Policy Review Body, are designed to provide an overall review of a member’s trade policy. They do not focus on the details of remaining barriers in specific sectors or on a comparison of barriers in a single sector across countries. Moreover, for smaller countries the reviews are conducted relatively infrequently.

In order to maximize the productivity of future negotiating rounds, the WTO does need to focus on its role and interaction with other fora in promoting the process of liberalization between such rounds. In the financial sector, a major challenge for the WTO is to find effective ways to ensure that its negotiating rounds build on the efforts in other fora—multilateral, plurilateral, regional, or sector-specific—to achieve liberalization in the financial services sector. In turn, the WTO can facilitate and reinforce those efforts. The progress that the WTO can hope to achieve in future negotiating rounds on financial services also depends on both international and national efforts to strengthen prudential regulation and supervision and to enhance cooperation and coordination among supervisors, although these issues are outside its purview.
The structure of the GATS—in particular, the failure to use general obligations and a negative list approach for market access and national treatment and the absence of a standstill on new restrictive measures—is not sufficiently conducive to future liberalization. Additional countries could be encouraged to schedule financial services commitments using a negative list approach and a standstill in accordance with the Understanding on Commitments in Financial Services, but its widespread use seems unlikely. Perhaps at some future date it, for example, a full-scale investment agreement were to be negotiated at the WTO, the need to reexamine the treatment of foreign direct investment in the GATS could lead to major structural improvements.59

For the present, the WTO could take steps to try to overcome some of the structural deficiencies in the GATS. For example, the WTO Committee on Trade in Financial Services could take the lead in producing an inventory of all remaining barriers to market access and national treatment for all financial services—including any new barriers that are imposed in the absence of a standstill. In effect, such an inventory would be a noncontractual, nonbinding negative list of barriers and could facilitate the process of liberalization both domestically and internationally.

The WTO has already begun to establish procedures for cooperation and sharing of some information with the IMF, the World Bank, and the regional development banks. These procedures focus especially on areas with potentially overlapping responsibility such as current IMF work on capital account convertibility. Since the WTO is a contractual trade institution—as opposed to a financial or development institution that provides funding and imposes conditionality—its role vis-à-vis developing countries is very different from that of the other international financial institutions. However, as the WTO becomes more involved with financial services and other new areas, opportunities for creative interaction with other fora need to be fully explored.

The international arrangements to deal with trade in financial services contrast sharply with those within the European Community. The Community deals with all aspects of trade in financial services among its member states—including discriminatory barriers and barriers that have a similar effect, nonquantitative and nondiscriminatory structural barriers, and prudential regulation and supervision—and relies on a supranational legislative process
for essential harmonization of national laws. On a global scale, the situation could be compared to different painters from different schools working, each at his or her own pace and own style, on a huge mural. In the world of trade in financial services—if not in the world of art—as long as everyone has more or less the same idea of what the overall picture should be, is working toward that goal, and tries to avoid overlap and to cooperate when necessary, these efforts can all reinforce each other in a positive way. Ultimately, market forces, not dictates of design, will link together all of these efforts.
Appendix: U.S. Proposals for Allowing Unilateral Determinations under the GATS

During the course of the Uruguay Round, the United States proposed several types of unilateral determinations under the GATS to deal with the free-rider problem. In addition to MFN exemptions, the approach that was adopted, the other proposals were “sectoral nonapplication” and the “two-tier approach.”

Sectoral Nonapplication

The U.S. push for sectoral nonapplication was motivated primarily by concern about the financial services sector. Under this approach, the United States would have been able to “nonapply” its GATS commitments in any services sector to one or more countries. Although both sectoral nonapplication and MFN exemptions involve departures from the MFN principle, there is an important difference between them: Sectoral nonapplication would have allowed the United States to make strong commitments to market access and national treatment in financial services within the GATS, without having to apply these commitments to countries with weak commitments. Moreover, a country subject to nonapplication would not have any commitments vis-à-vis the United States in financial services. Emerging market and other developing countries strongly opposed sectoral nonapplication on the grounds that it would undermine the overall balance of obligations and concessions achieved in a multisector negotiation.

“Sectoral nonapplication” in the GATS should be distinguished from the “nonapplication” of the Uruguay Round agreements as a whole, which is allowed by the WTO agreement vis-à-vis new WTO entrants and countries that did not apply the GATT to each other. Such global nonapplication, based on an article in the original GATT, is designed primarily for political purposes to enable a member to “nonapply” the WTO agreement to a country with which it does not have diplomatic relations.
Two-tier Approach

In mid-1993, the final year of the Uruguay Round negotiations, the United States put forward a so-called "two-tier" approach for banking and securities, that is, financial services excluding insurance. Under this approach, the United States would have made a limited lower-tier commitment to all members of the WTO similar to the one currently in effect under the MFN-exemption approach. In the upper-tier, the United States would have made additional, enhanced commitments within the GATS to countries which had themselves made commitments to substantially full market access and national treatment. These enhanced commitments—similar to those the United States would have made if sectoral nonapplication had been allowed—would have covered new entry, new locations, and any future broadening of permissible activities. Although the upper tier would have applied only to certain countries, both tiers would have been binding within the GATS. The two-tier approach was rejected by virtually all other participants in the negotiations as undermining the MFN foundation of the GATS, and in late 1993 the United States withdrew the proposal.
Notes


2 "European Community" as opposed to "European Union" is used throughout this paper because, from a legal point of view, the European Communities and their Member States are members of the WTO. The reason is that the area of trade is governed by the three Community treaties: the Treaty establishing the European Community (EC), formerly the European Economic Community; the Treaty establishing the European Coal and Steel Community (ECSC); and the Treaty establishing the European Atomic Energy Community (EURATOM). These treaties were amended but not replaced by the Treaty on European Union (the Maastricht Treaty). The three supranational European Communities constitute the first of the so-called three pillars on which the European Union, which does not have legal personality, is founded. The two other pillars—foreign and security policy and justice and home affairs—are intergovernmental. "European Community" as opposed to "European Communities" is used in this paper for simplicity, although GATS issues involve both the EC Treaty and the Euratom Treaty.

3 See Shaffer and Lang (1995) for an EC perspective, see Brittan (1995). The MFN exemption taken by the United States in 1995 covered all financial services; the MFN exemption taken at the end of the Uruguay Round in 1993 covered banking and securities but not insurance.

4 The so-called interim agreement was embodied in a protocol to the GATS and several related decisions. See Freiberg (1996) and Kumpf (1995).

5 See Beviglia Zampetti and Sauvé (1996), Graham and Lawrence (1996), and Lawrence (1996b). The term "market access" has also been used for this concept, that is, used very broadly to refer to maximum potential competitive opportunities as well as to equality of competitive opportunities.

6 See Key (1989).

7 GATS, art. VI, para. 1.

8 See discussion of Understanding on Commitments in Financial Services in chapter II.

9 See Key and Scott (1991).

10 The Group of Seven, or G-7, consists of Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States. Beginning in June
1997, Russia has been invited to participate in the annual summit meeting, now known as the "Summit of the Eight," or S-8.

11 "Plurilateral" is a term used by the WTO to refer to agreements within the WTO among a subset of members; in this paper, it is used more generally to refer to any arrangement among a group of countries that does not include all WTO members (see note 47 below). The Group of Ten, or G-10, actually consists of twelve countries: Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, Switzerland, the United Kingdom, and the United States.

12 GATS, art. XVII. In the NAFTA financial services chapter, negotiated subsequently, a similar statement includes the requirement that the treatment afford "equal competitive opportunities." NAFTA, art. 1405, paras. 5-7.

13 See Mattes (1997).

14 The GATS is included in the first annex to the Agreement Establishing the World Trade Organization (the WTO agreement). That annex has three components: (1) the GATT and other multilateral agreements on trade in goods; (2) the GATS; and (3) the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS). The second annex to the WTO agreement contains the dispute settlement rules; the third deals with the Trade Policy Review Mechanism; and the fourth contains four plurilateral trade agreements. World Trade Organization (1995b).

15 For example, for the United States, although the Office of the United States Trade Representative had overall responsibility for the Uruguay Round negotiations and handled the insurance negotiations, the Department of the Treasury handled the other financial services negotiations. For the European Community, although DG-X, the directorate general responsible for external affairs, had overall responsibility for the Uruguay Round negotiations, DG-XV, the directorate general responsible for financial services, handled the financial services negotiations.

16 Such exemptions must be taken upon entry into force of the agreement and, in principle, should not exceed a period of ten years; the exemptions are subject to review after five years as well as to negotiation in subsequent rounds. GATS, art. II, para. 2, and Annex on Article II Exemptions. See chapter IV regarding exceptions for economic integration agreements and mutual recognition agreements.


18 "General obligation" is used here to refer to an obligation that applies to all services sectors for which countries would be allowed to schedule limitations on market access and national treatment. In WTO terminology, however, general obligations would not be subject to scheduling; only specified exemptions, such as the exemptions from the MFN obligation in the GATS, would be allowed. In the GATT, as discussed in chapter III,
national treatment is a general obligation: Specified areas are excluded from the obligation but, in the areas subject to the obligation, limitations may not be scheduled.

19 See Hookman and Susavé (1994).

20 A so-called "ratchet," used in the NAFTA financial services chapter, goes one step beyond a standstill. Suppose, for example, a country that has listed an existing nonconforming measure as an exception in its schedule subsequently amends that measure to provide market access or national treatment. The ratchet locks in the liberalizing amendment, that is, a country is prohibited from going backwards to the original nonconforming measure.

21 Japan—United States Measures Regarding Financial Services (1995) and Japan—United States Measures Regarding Insurance (1994 and 1996). These measures are already being applied on an MFN basis (see chapter IV and note 49 below).

22 The next day, the Fu Lung text was submitted to the official Working Group on Financial Services Negotiations as a Canadian "nonpaper." The chairman of that working group, in an effort to prevent the work of the Fu Lung group from going to waste, submitted the text to the group overseeing the services negotiations on his own responsibility; however, that group did not forward the text to the committee overseeing the Uruguay Round negotiations as a whole.

23 In the financial services negotiations, allowing countries the option of supplementing the framework agreement by using the Understanding on Commitments on Financial Services was referred to as a "two-track" approach. This term should not be confused with the so-called "two-tier" proposal (see chapter IV and the appendix), which, unlike the Understanding, does not adhere to the MFN principle.

24 Even though the treatment of natural persons is classified as a mode of supply in the GATS, it was negotiated separately as if it were a sector, and the scope of commitments is governed by a separate annex. Accordingly, in scheduling, many WTO members listed specific commitments regarding natural persons—or, in some cases, stated that the presence of natural persons was "unbound"—in their horizontal commitments for all services sectors. The Understanding on Commitments in Financial Services does, however, set forth a minimum level of commitments for the temporary entry of natural persons. (In the NAFTA, by contrast, a separate chapter deals with "temporary entry for business persons." NAFTA, ch. 16.)

25 Specifically, the Understanding clarifies that access by host-country offices of foreign financial firms to payment and clearing systems operated by public entities must be granted on a national treatment basis; it also makes clear that when membership in a private self-regulatory body is required by a host country in order for foreign financial firms to compete
on an equal basis with domestic firms, the host country must ensure that the self-regulatory body offers national treatment. Two additional provisions of the Understanding go beyond the framework agreement: (1) an obligation to provide both MFN and national treatment for government procurement of financial services; and (2) a requirement that existing monopoly rights be listed in schedules of commitments, with a ‗best efforts‘ commitment to reduce or eliminate them.


27 On its face, this provision appears to provide for the rules of the home country to govern which financial services a firm may offer in a host country market. However, a host country could invoke its prudential rules, to refuse to allow a particular service or a particular type of entity to provide that service. In addition, a note regarding new financial services in the EC schedule of commitments contains a very broad reaffirmation of the need for consistency with host-country regulatory frameworks, a statement that appears to reflect a general understanding among negotiators.

28 GATS, Annex on Financial Services, para. 2.

29 In contrast to other public policy exceptions such as national security, where only ‗necessary‘ measures are allowed, all prudential measures are considered necessary. This does not, however, resolve the issue of whether a measure is prudential or is being used to avoid the obligations of the agreement.

30 GATS, Annex on Financial Services, para. 4.


33 The MIDS is designed to facilitate the cross-border issuance of securities by U.S. and Canadian companies by recognizing disclosure standards of the issuer’s home country. Issuers of securities, however, are not financial service providers under the GATS. Thus, measures taken under the MIDS are covered by the GATS only to the extent that they involve financial services such as the distribution of securities.

34 The recognition provision in the Annex also excludes recognition of prudential measures from a requirement in the framework agreement for prior notification to the Council on Trade in Services.


36 See note 18 above regarding the use of the term ‗general obligation.‘
37 Countries that are signatories to the plurilateral WTO Agreement on Government Procurement (see note 47 below), which covers both goods and services, must adhere to its requirements. See Hackman and Mavroidis (1997).

38 In the NAFTA, the compromise in the financial sector relied on the use of phased and safeguarded commitments, discussed in chapter IV, and also involved two major limitations on market access by Mexico. The first limitation, as explained in chapter IV, protects the largest Mexican banks from takeover by U.S. and Canadian banking organizations but was not of particular concern to the U.S. or Canadian industry. The second was, in practice, a more significant limitation. Mexico did not agree to allow foreign banks to enter through establishment of branches. The primary reason was that Canada, which only in 1997 announced its own plans to allow branch entry, joined with Mexico in opposing the U.S. demand for market access through the branch form of organization.

39 One difference is that the telecommunications negotiations involved more than North/South issues. Significant issues among the industrial countries had to be addressed and, in addition, the interests of emerging market economies were more diverse. Moreover, the liberalization already underway in certain countries had an important demonstration effect within regions because of visible improvements in infrastructure and services available to consumers. Another important difference is that the telecommunications negotiations were driven by the rapid pace of technological advances, including "callback" services that enable firms and customers to circumvent barriers to market access in the customer's country. Such advances provided a strong incentive for countries to reach agreement on organized market opening before they lost even more control over the situation. Although technological advances play an important role in the international provision of financial services, the timing of these developments vis-à-vis the multilateral negotiations differs from that in the telecommunications sector. Technology has long since had a major impact on the cross-border provision of wholesale financial services, while for retail services, the major impact is yet to come through electronic commerce.

40 The Omnibus Trade and Competitiveness Act of 1988 establishes a policy of reciprocal national treatment for the granting of primary dealer status to foreign firms operating in the U.S. government securities market; that is, primary dealer status is conditional on whether U.S. firms are accorded the "same competitive opportunities" as are available to domestic firms in the foreign country's government debt market.

41 See Group of Ten (1997).

42 Basle Committee on Banking Supervision (1997).

43 GATS, art. XIX, para. 2.
44 GATS, art. II, para. 2, and Annex on Article II Exemptions. Agreement to allow countries to take such exemptions was reached only after protracted negotiations. In particular, the United States was willing to accept the inclusion of a general MFN obligation in the GATS only on the understanding that its acceptance of that obligation would be conditional on the subsequent submission of strong schedules of commitments by other countries.

45 The MFN exemption permits the United States to guarantee to selected countries outside the WTO framework of obligations treatment better than that guaranteed in its schedule of commitments to all members of the WTO. For example, in 1992, at the request of the countries involved, the United States provided written assurances to the European Community, Switzerland, and Japan that, as long as they maintain at least the levels of openness guaranteed by their respective GATS commitments under the interim agreement, the United States will guarantee their financial firms substantially full market access and national treatment, not just the minimal U.S. commitment in the GATS.

46 GATS, art. V. A further limited exception from the MFN obligation is allowed for agreements establishing full integration of labor markets, GATS, art. V bis.

47 See Wimmer (1996). Despite its name, the MAI is a plurilateral agreement in the sense that it does not include the entire WTO membership (see note 11 above). Treaties are not honoured under certain other agreements—such as the plurilateral Agreement on Government Procurement that was negotiated in the Uruguay Round (see note 37 above)—falls outside the scope of measures covered by the GATS and is thus not covered by its MFN obligation. However, for government procurement of financial services, countries using the Understanding on Commitments in Financial Services have already undertaken an MFN obligation (see note 25 above). The plurilateral WTO agreements on government procurement and civil aircraft were originally negotiated among the nine so-called Tokyo Round countries; one, largely successful, aim of the Uruguay Round was to convert most of those codes into multilateral agreements. For new areas not covered by multilateral agreements, the possibility of negotiating additional plurilateral agreements in the WTO remains open but would require the consent of all WTO members.

48 Measures for which MFN exemptions have been taken in the GATS are an exception. Besides measures regarding services, additional measures taken in connection with MAI obligations are covered by the MFN provisions of other multilateral agreements dealing with investment—the Agreement on Trade-Related Investment Measures (TRIMS), the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS), and the Agreement on Subsidies and Countervailing Measures.

49 At present, for example, if a bilateral commitment were suspended by mutual agreement between the United States and Japan, a third country would have no recourse. Moreover, Japan would not violate the GATS if
it did not fully implement a measure vis-à-vis the United States. A GATS violation would occur only if Japan implemented a measure to give the United States more favorable treatment than that accorded other WTO members or if failure to implement a measure led to a denial of national treatment for which Japan had not listed an exception in its GATS schedule.

50 World Trade Organization (1995c).
53 GATS, art. XII, para. 1.
56 World Trade Organization (1996a).
57 NAFTA, Annex VII(c)—Mexico.
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