Lower costs, more investments and improved government supervision are among the potential benefits arising out of liberalization

The benefits from liberalization of financial services trade

The magnitude of benefits from trade liberalization can be significant. This has been shown convincingly in the area of trade in goods. Sachs and Warner (1995), for example, found a positive correlation between openness and economic growth amongst developing countries. Other studies have shown that in the area of services, liberalization has resulted in significant economy-wide gains. Large price reductions in air transportation and certain telephone services, for example, have been associated with liberalization (Hoj, Kato and Pilat, 1995). It is by now well accepted that the multilateral trading system has played a key role in increasing income and growth via trade liberalization (Marvel and Ray, 1983; Moser, 1990; Francois, McDonald and Nordstrom, 1995 and 1996; Petersmann, 1997).

Liberalization of financial services trade in the European Union

EU consumers are benefitting from more competion through lower prices for financial services, including insurance. (ILO)

The liberalization of financial services in the European Union (E.U.) has been part of the E.U.'s broader strategy to create a single market for goods, services, labour and capital. First efforts to create a single European financial market date back to the 1970s. At that time, some countries already removed their restrictions on capital movements. In the late 1980s, the creation of a single market was put at the top of the policy agenda of the then European Community. Meanwhile, a series of directives has completed liberalization of trade in banking, insurance and investment services.Liberalization in the E.U. is based on three fundamental principals: first, minimum harmonization of standards at the E.U. level; second, mutual recognition of national laws and regulations between E.U. Member States; and third, supervision of companies in their (E.U.) country of registration (home country control). The regulatory framework has been completed by the entry into force of the Second Banking Directive in 1993, the Third Life and Non-Life Insurance Directives in 1994, and the Investment Services Directive in 1996. These directives are complemented by a series of other directives defining key concepts and establishing essential prudential requirements. This framework grants E.U. companies and incorporated foreign subsidiaries in the E.U. the right of operation in all E.U. countries when they are registered in just one ("Single Passport").

The single market initiative has strongly influenced the financial sector in the E.U. It has had its greatest impact on wholesale and corporate markets, whereas the impact on retail business in banking or insurance has been relatively small (until 1997). Cross-border branching by E.U. banks and credit institutions increased by 50 per cent between 1993 and 1996, with institutions taking advantage of the Single Passport. Third-country financial institutions branched out their activities from existing (E.U.-incorporated) subsidiaries rather than from their parent firms. Between 1993 and 1996, 43 foreign banks from 12 non-E.U. countries notified their intention to establish subsidiaries in the E.U. The single market has also intensified competition within the E.U. This has encouraged consolidation within the sector and a growing number of cross-border mergers and acquisitions. Profit margins have been squeezed and consumers have benefitted from lower prices.

The process of market integration, however, is still continuing. In the insurance sector, for example, a 1995 survey shows that considerable further benefits from liberalization are yet expected. Three quarters of the surveyed insurance companies expect better services and better value for money for corporate customers in the future. Sixty per cent also expect private customers to benefit from further market integration. Products will become more customized and flexible, with companies offering more complementary financial services. Telecommunication-based trading is on the increase. Consolidation in the financial service sector is likely to continue with positive effects on costs and efficiency. A new impetus to financial service trade within the E.U. can be expected from the introduction of the single currency. This will further lower transaction costs and improve transparency to the benefit of consumers. □

Sources: Loheac, (1991); WTO, (1995 and 1997); Weidenfeld, (1996); and Financial Times, 1 and 9 July, 1997.

ties, intended to gain or maintain preferential credit access or other privileges, are also less feasible in a liberalized environment. All these changes can reduce the operational costs of providing financial services. Competition then forces institutions to pass on cost-savings to consumers, and the spreads between lending and deposit rates, commissions or insurance premiums go down.

Liberalization can also improve service quality. With increased competition, financial institutions are more likely to be attentive to the needs of consumers, and to advise clients on how best to tailor financing packages to meet their specific needs. In large insurance projects, for example, support services for prevention, engineering and risk management can be very valuable, and competition is likely to improve such services (Carter and Dickinson, 1992). Depositors are also likely to benefit from better advice on investment strategies as financial institutions compete for their savings.

International trade can create significant benefits from the transfer of knowledge and technology. This includes knowledge on best practices in management, accounting, data processing and in the use of new financial instruments. Such benefits largely depend on the commercial presence of foreign banks and insurance companies (Zutshi, 1995; Agosin, Tussie and Crespi, 1995).

The range of available services is likely to increase with more open markets, as consumers seek out ways of optimizing their financing and insurance packages. The emergence of many new financial instruments should be seen from this perspective. In a liberal environment, companies can more easily choose the optimal combination of equity, bonds or loans to finance their activities. Derivatives allow economic agents to hedge against the risk from interest or exchange rate fluctuations. Edey and Hviding (1995) report that banks have started making more money from securities trade relative to traditional bank credits, as they have ventured into new areas of business. Companies switched to bond financing when this was cheaper than traditional credit-financing, and small savers started investing in various types of funds to benefit from higher returns than in classical savings accounts.

Trade in financial services can also reduce the systemic risk for small financial markets which are less able to absorb large shocks. Liberalization can help to deepen and broaden financial markets by increasing the volume of transactions and the spectrum of services, thus reducing volatility and the

Singapore: Developing towards an international financial centre

Financial sector development has been a key element in Singapore's impressive economic success over the past three decades. Since the late 1960s, the government has implemented a number of far-sighted policies and regulations to promote Singapore as an international financial centre. In 1968, the introduction of an international banking facility (Asian currency unit) initiated the rapid development of the Asian Dollar Market and Singapore's financial services sector. Extensive liberalization measures were taken in the late 1970s. Reserve requirements, credit guidelines, minimum cash ratios, interest-rate setting and exchange controls were either streamlined or abolished. In 1984, the Singapore International Monetary Exchange (SIMEX) became the first futures exchange in Asia. Tax concessions have helped, in particular, the development of the offshore market.

Singapore's attractiveness as a financial centre has been aided by its strategic location in a fast growing region, political and financial stability, a skilled labour force, and a strong commitment to openness. Consequently, the contribution of the financial services sector to the economy has increased from 5 per cent of GDP in 1978 to 12 per cent in 1995. Its contribution to employment has increased from 2.7 per cent of the total labour force to almost 5 per cent over the same period. The productivity of the financial services sector is about three times the national average.

vulnerability to shocks. Shocks to the domestic market can also be absorbed more easily through the multinational "parents" of local branches or through reinsurance in international markets (USITC, 1993). Goldstein and Turner (1996) report that relatively high shares of foreign ownership have helped to maintain stable banking systems in Hong Kong (China), Chile and Malaysia.

Empirical evidence for OECD countries shows significant positive effects on financial sector efficiency associated with liberalization. Liberalization by the United States and other NAFTA signatories, and between European Union Member States is often quoted in this context (Harris and Piggot, 1997); and Box 1 illustrates the European Union experience in detail. Financial reform in OECD countries' banking sectors has resulted in improvements in most indicators of operational efficiency (Hoj, Kato and Pilat, 1995; Levine, 1996). The table (page 5) illustrates that interest margins have been constant, despite a likely increase in the average riskiness of bank lending (as liberalization eliminated the bias towards low-risk lending in many OECD countries). This suggests that risk-adjusted lending-deposit spreads have declined (Edey and Hviding, 1995). The same table shows that competition squeezed the ratio of gross income to capital. Competition forced companies to rationalize. Staff costs as a percentage of gross income have declined from an average of 40 per cent to 34 per cent between the early 1980s and the early 1990s. Lower costs and competition have also driven down commissions by over 50 per cent during the same period. Automatic teller machines have become a common means of banking in all industrialized countries over the past decade. After liberalization of United States intrastate branching, the share of non-performing loans declined by 12-38 per cent, and the share of loans to "insiders" (connected lending) decreased by 25-40 per cent (Jayaratne and Strahan, 1996).

It must be recognized that there are going to be adjustment costs from liberalization, at least in the short-term. Less efficient financial institutions with high operating costs are likely to suffer from competition. Companies and sectors which previously benefitted from preferential access to credit may also lose. Some political costs to government are, therefore, likely to arise from resistance by these groups to liberalization. The transition period may also involve some economic costs as output declines in the previously privileged sectors and resources are reallocated. These factors suggest that it may be desirable to create safety nets to help firms and individuals deal with the costs of adjustment, but they should not put at risk the considerable benefits that flow from financial sector liberalization.

An open financial sector increases the incentive for better macroeconomic policies and regulation

There are strong reasons to believe that liberalization of financial services trade promotes better macroeconomic policies and government regulation. First, monetary policy is likely to improve. Credit and interest ceilings often serve as monetary policy instruments to control credit expansion and inflation in a closed financial system. Liberalization requires the replacement of such controls by indirect policy instruments, such as open market operations, to control liquidity. Indirect monetary policies are considered less distortionary and they help develop financial markets. Liberalization in the financial sector also puts pressure on governments to pursue prudent monetary, fiscal and exchange rate policies. By the same token, it may be argued that liberalization strengthens the incentive for governments to eliminate distortionary interventions and to introduce

Liberalization of the financial services sector improves the potential for risk management and insurance. With access to international markets and know-how, financial institutions can provide the best possible investment strategies. Investors can, therefore, hedge or insure against many risks much better than in a closed financial market, and they are likely to adjust their portfolios accordingly. Very large and risky projects which promise a high expected rate of return can, nonetheless, go ahead more easily. The small trader who can receive better or cheaper insurance for his trade or investment activities, or who can hedge the related currency or interest rate risk may also be better off.

A further benefit of international trade in financial services is that it facilitates the flow of capital from countries with capital surpluses to those with shortages. This reduces the interest costs of investments in the latter countries.[3] Countries with high savings rates and relatively low returns to investment can export capital and thereby raise their returns. Financial services trade and the related capital flows should then equalize interest rates across countries. In fact, this seems to have happened in the E.U. in recent years (Edey and Hviding, 1995).

B. Why Trade Protection Is Not The Best Means to Attain Certain Policy Objectives

A number of reservations are sometimes expressed about trade liberalization and its effects, leading to the argument that liberalization should be arrested or even reversed. One concern is that foreign financial institutions will end up dominating the domestic market after liberalization and will abuse this position. If foreign suppliers are much more

The Trade Policy Review Body (TPRB) concluded its first review of Benin's trade policies on 15 and 16 September 1997. Excerpts from the Chairperson's concluding remarks:

Benin was commended on the institutional reforms and positive macroeconomic performance since 1990. These had been reflected in solid economic growth, improved public finances and a modest rate of inflation. Some Members expressed concern about the high dependency of Benin's trade structure on cotton exports, and its vulnerability to trade policy changes in Nigeria. In this regard, they inquired about plans for diversification of export products and destinations.

In response, the representative of Benin noted his government's long-standing concern over the country's dependence on a single crop, and efforts to diversify the economy, particularly agricultural production. He noted that three-fourths of all economic activity takes place in the informal sector, which the Government considered a key element to support Benin's growth. Thus, a vast programme was in place to provide a proper framework for informal activities, and eventually incorporate them into the formal economy.

Generally, Members appreciated the considerable steps taken by Benin to liberalize its import markets, and to reduce export restrictions. Benin was urged to continue its trade liberalization and to embed it within the rules and principles of the multilateral trading system by increasing its binding commitments.

Questions were raised over the justification for the con-

DSB adopts banana reports

The Dispute Settlement Body (DSB), on 25 September, adopted the Appellate Body report, and the panel reports as modified by the Appellate Body, on the complaints by Ecuador, Guatemala, Honduras, Mexico and the United States against the European Communities' regime for the importation, sale and distribution of bananas. The Appellate Body upheld most of the panel's findings that the EC regime was inconsistent with the WTO rules.

The EC said it accepted the verdict of the Appellate Body and the panel but expressed deep concern over the consequences of their findings to the ACP (Africa, Caribbean and Pacific) countries that were dependent on exports of bananas. It said that the rulings confirmed the legality of certain aspects of its arrangement with the ACP, including preferential tariff treatment. On the other hand, it regretted other rulings, including what it said was a narrow interpretation of the WTO waiver granted to the EC-ACP Lomé Convention.

Guatemala welcomed the findings, which proved that any member could use the WTO to protect its trade rights. Ecuador said that the new WTO rules had led to the adoption of the reports in a straightforward manner, whereas in the old GATT, the EC was able to block two panel reports on its banana regime.

Jamaica and St. Lucia expressed serious concerns over the impact of the rulings on the Caribbean ACP countries, which were heavily dependent on exports of bananas to the EC.

Regarding panel reports on complaints by Canada and the United States against EC measures concerning meat and meat products (hormones), the Chairman, Ambassador Wade Armstrong (New Zealand), said that the EC had appealed the findings.

Panel requests

The DSB considered the following panel requests for the first time, and after objections by the subjects of complaints, agreed to revert to them at its next meeting (16 October):

- By the EC and the United States, respectively, on Korea's taxes on alcoholic beverages;
- By the EC on India's patent protection for pharmaceutical and agricultural chemical products;
- By the EC on Argentina's measures affecting textiles, clothing and footwear.

Korea maintained that its measure conformed with the WTO and regretted that the EC and the US had chosen not to continue with consultations.

In requesting panels on measures by India and Argentina, the EC explained that while panels had been already established on these measures at the request of another member (the US) and that in both cases, the EC was a third party, it had become aware only recently that rights of third parties were not the same as the complainants in the implementation of panel recommendations.

India said that the request violated a legal principle that a matter which had been adjudicated could not be litigated again.

Argentina expressed concern that the EC's request would mean that it would have to defend itself twice before a panel on the same subject. This added expenditure in time, work and funds would have implications regarding the DSU rights of the subject of the complaint.

Reports on implementation

The United States reported that the US Environmental Protection Agency, in August, had amended regulations regarding US standards for reformulated and conventional gasoline. Thus, it said it had implemented the recommendations of the DSB with respect to this dispute within the 15-month time frame agreed with Venezuela.

Venezuela and the other complainant, Brazil, reserved their rights to come back to the matter after they had examined fully the new regulations.

Norway and the EC, third parties to this dispute, expressed satisfaction at the practical benefits of the new regulations to their companies.

Japan reported that the Diet, in March, approved amendments to the Liquor Tax Law that would eventually