

POTENTIAL RISKS OF LIBERALISATION OF FINANCIAL SERVICES IN GATS

by Myriam Vander Stichele, SOMO

3.1. Potential Consequences for the International Financial Markets

The negotiations on liberalisation of financial services have generally not involved officials from the ministries and regulatory agencies working on reforms of the international financial system (“financial architecture”); rather, they have been conducted largely by the ministries responsible for trade, and ultimately by the EU Commission. They in turn have formulated their negotiating positions on the basis of detailed requests from the big FSI companies (see Chapter 1.6).

Hence, there is a deficit in concern for GATS in precisely those institutions which have competence regarding issues of national and international finance, while trade-policy interests dominate one-sidedly. This applies both to industrial countries and to developing countries.

3.1.1 The Controversial Interpretations of “Prudential Regulation”

Formally, GATS does not prevent any country from taking prudential measures to protect depositors, investors etc. or to ensure the integrity and stability of the financial system. As is stated in the Annex, however, such measures should not be used to avoid commitments or obligations under the GATS agreement. In other words, if a WTO member challenges a measure of another WTO member as being not a prudential measure, but rather a way to avoid a GATS obligations, a WTO panel must decide whether that is the case or not. Thus, central banks and other regulators lose their freedom to impose the prudential regulations they see as necessary. China, for instance, has imposed regulations which it considers prudential, e.g. regarding capitalisation requirements and setting up branches by foreign financial service providers, which are already being questioned by the EU and other WTO members as constituting unnecessary barriers to trade, or as violations of the principle of national treatment.¹

This raises the question of the danger of a chilling effect on regulations. If, for instance, some countries did not consider a currency tax (“Tobin tax”) a prudential measure, they could accuse another WTO member which imposed such a tax of applying restrictions on international transfers in current transactions (if related to committed financial sectors), which would be a breach of Art. XI obligations.

3.1.2 Increasing Instability

According to the World Bank, IMF and Western countries, deregulation liberalisation of financial services strengthens the financial sector of a country and allows more stable – i.e., less volatile - sources of funds, provided that appropriate regulatory and legal frameworks and adequate supervision are in place, and that a well-sequenced policy of domestic reform of the financial sector and of capital account liberalisation is undertaken. In such cases, liberalisation might even improve the national regulatory framework, because foreign financial

¹ WTO, Committee on Trade in Financial Services Report of the meeting held on 21 October 2002, see document nrs 22 - 71: discussion during the review of the accession of China to the WTO relating to financial services.

service banks could bring in new expertise, including the prudential standards of their home countries, and thus strengthen competitive disciplines. Increased competition due to the entrance of foreign banks can lead to cheaper and better consumer services, which are seen as crucial for economic growth.

However, as experience with the recent financial crises has indicated, deregulation of financial flows, e.g. for investments and loans through capital-account liberalisation, has increased the risk of a financial crisis in countries that failed to develop a strong regulatory and supervisory framework prior to liberalisation. Foreign banks can contribute to a financial crisis by imprudent short-term lending policies, and by “herding behaviour,” as was the case in the Asian financial crisis. It is now recognised that, under the conditions of globalisation, the stability of the national and international financial systems relies on the scale and sequencing of financial reforms, and that a gradual and considered approach to the deregulation of financial services and financial flows is needed to make financial liberalisation beneficial for the economy.²

That the presence of foreign banks and insurance companies also carries with it some particular risks of financial instability, is less recognised. As the World Bank puts it: Access to financial services is what matters for development, not who provides it.³

One way that foreign banks tend to import instability is by lending in foreign currencies. This leads to inflows but also outflows for the repayment of loans, and pressure on foreign exchange reserves, particularly if those loans are short-term. In China for instance, experience of the early phases of liberalisation of financial services has shown that foreign banks have become one of the important channels for bringing in foreign capital, by loans in foreign exchange amongst others. Because this increases the rate of inflow and outflow of international capital, it can dramatically increase the exchange between the local and foreign currencies. Consequently, the balance of payments deficit can increase, and with it the risk of financial instability. These increased capital fluctuations have come on top of China’s dramatic increase in its service trade deficit, which has had a further negative impact on the country’s balance of payments. This has had a major impact on China’s monetary policy, and has strained the macro-regulatory mechanisms of its financial system.⁴

Another way that foreign financial services can bring about pressure on the balance of payments of countries is when foreign financial services increase the outflow of capital by offering services that involve allocating money abroad, such as credit risk mitigation systems, or the purchase of securities abroad.

GATS plays a role in the risks associated with the financial flows related to foreign financial service providers. GATS Art. XI does not allow countries to restrict international transfers and payments for current transactions which are related to services in sectors which they have liberalised under the Agreement (i.e. commitments already entered into). That means, in effect, that a country cannot prevent profit repatriation by foreign service providers in sectors in which a country has made commitments. For instance, the EU requests in the current negotiations that Chile eliminates the “restriction” that prior authorisation by the Central Bank is required before transferring dividends from Chile abroad because this is in breach of Article XI. Thus, if a country has liberalised the financial sectors, foreign banks and insurance companies can transfer their profits abroad without reinvesting them in the country.

² Finance matters - Finance liberalisation: too much too soon?, id21 Insights #40, March 2002 (at: www.id21.org/insights/insighths40/insights-iss40-art00.html); see also: World Bank, Finance for growth: Policy choices in a volatile world, Policy research report, May 2001.

³ World Bank, Finance for growth: Policy choices in a volatile world, Policy research report, May 2001: summary of the report, p. 4 at www.worldbank.org/research/interest/policyresrpt.htm

⁴ WTO, Communication from the People’s Republic of China - Assessment of Trade in Services, document nr. 18, 27, 41, 43, 49

Moreover, Art. XI has a special effect in relation to financial services provided by foreign banks, insurers and asset managers established in countries which have deregulated these services under GATS (Mode 3), in cases where these financial service providers view financial inflows and outflows as essential to their services, i.e., lending in foreign currency (see China); buying securities abroad to balance the risks in pension fund management and to increase the return of asset management services for local clients; or providing derivatives and using international credit risk mitigation mechanisms.

If such capital flows reach significant volumes, they can increase financial instability in the country itself, but also import financial crises from abroad. Footnote 8 of the GATS agreement commits a country to allowing inflows of capital related to sectors which it has deregulated under GATS. In principle, countries can regulate the outflow of capital, but many countries have already deregulated capital flows. Moreover, capital flow restrictions as mentioned above related to foreign financial service providers present in the country might be seen as a breach of Art. XI. So far, this is a little discussed area about which experts yet have no clear answer.

Discussions have recently started⁵ in the WTO on the deregulation of financial services that do not have a presence in the country (Mode 1 and e-financing through e-mail and the Internet), but rather provide their services from abroad. Liberalisation of such cross border financial services can have a destabilising effect because they are typically in foreign currency and involve cross-border financial flows through such financial “products” such as lending of all types, and asset and portfolio management provided by foreign service providers.

Footnote 8 of GATS Article XVI (“Market Access”) states that if a country makes a market access commitment in Mode 1 of a sector, it also commits itself to allowing cross-border movement of capital that constitutes an essential part of the service itself. In the view of Brazil, this footnote could be tantamount to capital account liberalisation, i.e., the deregulation of major transfers of money for loans, even if a country has not fully liberalised its capital account system. Such cross-border capital transfers could affect the balance of payments and the whole financial stability of a country.

The GATS Understanding on Commitments in Financial Services (Art. 3 and 4) requires countries to make commitments in Mode 1 in a broad range of financial services, such as lending of all types. The European Union, the US and other western countries downplay the importance of the impact of opening up Mode 1 in financial services, but little research has been done to date on this issue. The impact of e-financing for cross-border capital movements and consumer protection is still being discussed by the supervisory authorities. The EU has made requests to open up Mode 1 to the US for selling derivative products, and to many developing countries what is required in Art. 3 the GATS Understanding (MAT insurance, reinsurance, and provision and transfer of financial information).

The increased inflows and outflows of foreign capital that might result from the liberalisation of financial services need careful monitoring and management by the financial authorities, especially in small countries where swift flows can have a major impact.

WTO members are allowed to **not** apply Art. XI, provided they do not thereby restrict trade and commitments made. Art. XII allows countries to restrict their market opening commitments in the financial sector (or other sectors), and the international transfer of money related to it, in case of serious balance of payment problems. A country that invokes these restrictions, however, needs to fulfil a number of conditions, including the criteria of non-discrimination and least-harmful affects upon foreign service providers, consistence with the Articles of the IMF, and time limitation of the measures. The country also must undertake

⁵ See WTO, Committee on Trade in Financial Services Report of the meeting held on 2 December 2002; IDEM, Report of the meeting held on 26 February 2003.

consultations with WTO members; ultimately, the assessment of the IMF of the financial situation of the country determines whether the restriction measures are to be allowed.

Art. 2 on domestic and prudential regulation in the GATS Annex on Financial Services also allows a country to take prudential measures against foreign exchange exposure. As explained, the Article states that such measures should not be used to avoid commitments or obligations under the GATS agreement. However, the conditions attached to the prudential carve-out measures may cause countries to avoid taking measures which, while contravening GATS commitments, are nevertheless the most effective for dealing with financial instability .

3.1.3 Insufficient Considerations for National Regulations

At the national level, not all countries are prepared to face the risks of greater liberalisation of financial services. For instance, sudden intensification of competition may encourage short-sighted panic responses by previously protected domestic financial institutions.⁶ For in the negotiations, virtually no concrete link is made between the existing state of a country's financial system or its needs for a functional regulatory framework and supervisory system on the one hand, and the requests or offers of financial service providers on the other. For one thing, the regulatory authorities will have to handle new financial services which GATS permits foreign financial service providers to introduce.⁷

The EU requests do not address the capacity of countries to deal with these increased risks. For instance, the EU has asked China to open itself up for derivative products and investment fund management, instruments which involve a significant speculative component. China has gradually reformed its regulatory framework to adapt to international practice, but admits that its regulatory authority still falls behind that of the developed countries, the homes of the foreign banks. It recognises that the tremendous changes due to entrance of foreign banks and their impact on domestic banks increase the risk of instability and make regulation even more difficult to enact than it already is in a country like China – and add costs to the financial administration.⁸ Although the IMF has a programme⁹ in place to monitor the reforms and the strength of financial-sector regulation and supervision, it is, as the US representative put it during a WTO meeting of the WTO's Working Group on Financial Services, up to the negotiators of each country concerned to deal with the issue themselves.¹⁰ The EU claims that the regulatory and supervisory issues will be discussed during the bilateral negotiations – i.e. far from public eyes, when the pressure to liberalise is the highest priority. How will the EU deal with the IMF's assessment that the regulatory system in Thailand is not yet efficient enough and that further liberalisation entails systemic risks for that country?

The IMF and others have recognised that considerable and costly capacity building is often required to educate regulators, supervisors, legislators and the judiciary in order to create the appropriate framework for financial services.¹¹ Although the operation of foreign banks is under the supervision of the authorities of the home country, which might have ample experience in monitoring their operations, these authorities are mainly interested in avoiding bankruptcy of the bank. This means that they are less concerned with the needs of the country in which their banks operate. Also, this means that regulators and supervisors of

⁶ Eichengreen, *Toward a new international financial architecture: A practical post-Asia agenda*, Washington (Institute for International Economics), 1999, p. 46-48.

⁷ Art. 7 and Art. 11.D.3. of the Understanding on commitments in financial services, which is part of the GATS agreement.

⁸ WTO, *Communication from the People's Republic of China - Assessment of Trade in Services*, document nr. 29, 30, 50.

⁹ The IMF's Financial Sector Assessment Programmes (FSAPs) monitor and provide technical assistance capacities on the strengthening of domestic financial sectors, apart from its monitoring and assistance on the liberalisation of capital accounts, which has been seen as one of the problems leading to the Asian financial crisis.

¹⁰ WTO, *Committee on Trade in Financial Services*, Report of the meeting held on 26 February 2003,

¹¹ *Ibidem*, report nr. 14

countries in which foreign banks operate might not have all the information they need, although co-operation between home and host country supervisory authorities does exist.

3.1.4 Liberalisation of Financial Services in the Fast Lane - Reform of the International Financial System Stuck in Traffic

At the international level, the current GATS negotiations on financial services are taking place at a time when the reform of the financial system announced after the Asian financial crisis has bogged down. At the spring meeting of the IMF in 2003, the discussion of an insolvency regulation for sovereign debtors (states), which had originally been proposed by the U.S. vice-director of the IMF, Ann Kruger, was removed from the agenda. Merely a so-called "collective action clause" was accepted. The German federal government had, as recently as the autumn of 2002 in its post-election coalition agreement, declared itself in favour of an insolvency procedure for sovereign debtors.

Proposals for reform involving improved supervision and stricter regulation of offshore centres and tax havens have largely fallen by the wayside. Some countries with tax havens have not yet reformed their systems. A considerable amount of money from drug-trafficking, the illegal arms trade and other criminal operations is laundered in this manner. International measures to control the risks stemming from the highly speculative hedge funds, which are increasingly active in times of low value of stocks are still very weak. Whether the new multilateral standards for risk management in lending ("Basel 2") will in fact fulfil their much-lauded promise, remains to be seen. Indeed, Basel 2 could actually increase the tendency of international banks to take more risks in their lending and investment activities. Only the next crisis will tell.

An important issue in the reform of the financial system is improved transparency by banks operating internationally. Publishing more information increases "market discipline" in the financial markets because investors and customers can assess the bank's state of affairs and act accordingly; in addition it opens up more opportunities to supervisory authorities to play their role. A review of fifty-four international banks in 2001 showed that they disclosed only 63% of the items considered important by the Basel Committee of Banking Supervision (the association of all major supervisory authorities). While that was an improvement over the previous years, it was still far from sufficient. In particular, information about their techniques for mitigating credit risks (including more speculative credit derivatives) was lacking, which makes it difficult to monitor from the outside their practices and expertise for avoiding bad loans, a major source of instability. Ironically, while GATS makes greater transparency of governments on service regulation a priority, it does not address the lack of transparency of service providers operating internationally, which poses many problems for host country authorities, particularly in the financial sector.

Liberalisation of financial services which is not embedded in a new financial architecture that serves the needs of the poor and of sustainable development is a dangerous strategy that increases the overall instability of a globalised economic system.

3.1.5 Greater Concentration in Financial Services?

A recurring demand in the EU requests, even to many developing countries, is that countries give up their restrictions on full foreign ownership of banks, and their legal requirements that foreign banks only participate through joint ventures. The argument is that full ownership results in better allocation of resources than in financial service companies which must have local elements. However, increased full foreign ownership of banks would raise many questions. For instance, how will the presence of foreign financial service providers lead to a transfer of know-how to local banks, given the fact that foreign banks tend to attract more

experienced personnel from domestic banks and other foreign banks in the host country (see China's experience, below) than they lose personnel to those local banks? What would be the consequences of having 80% of private financial assets in the hands of foreign financial service providers, as is the case of Mexico?

A major issue related to the full ownership request by the EU is the continuing consolidation and concentration of the financial service sector. Analysts predict that there will be only five to ten top banks in the world in ten years' time.¹² Citigroup once declared that it wanted to have one billion customers in ten years. Allowing more international banks to fully own banks in an increasing number of countries is likely to increase this trend towards world wide concentration of financial services in the hands of a few big players. This involves the risk of creating banks which are too difficult to monitor and "too big to fail" – i.e., they will be prevented from going bankrupt even if they handled things wrongly as the government steps in as the "insurer of last resort" – "socialising" the losses, while profits are privatised.

Such a high concentration of economic power leaves governments – which have to borrow – and customers too little choice, which can unnecessarily increase prices. During the first phase of competition, prices might fall, but later, when only a few players dominate the sector, tacit price-fixing may drive them back up. These are not hypothetical questions; rather, such secret price-fixing has occurred repeatedly, even if it only seldom comes to light, as it did recently in Germany. Authorities reported that the insurance companies Allianz, Gerling, HDI, Axa, Aachener, Münchener, Gothaer and Victoria, engaged in illegal price-fixing to the detriment of their industrial customers. Allianz board member Hagemann has now admitted: "There were informal contact groups."¹³

Consolidation is, ironically, a response by the financial industry to increased competition, in order to increase profits. The GATS liberalisation of financial services in general have increased this worldwide competition and now the EU requests much more market opening in financial services (through full ownership and otherwise) and . Strong competition among financial services leads to difficult dilemmas.¹⁴ On the one hand, it may enhance the efficiency and lending of the banks with the resulting benefits of lower prices for consumers and the whole economy. On the other hand, more competition may tempt banks to engage in too-risky lending – as was the case in the Asian financial crisis – and other practices that destabilise the banking industry, which has very costly repercussions for the economy.

These issues are increasingly being discussed at top governmental levels. According to a recent finding,¹⁵ many forms of competition do not endanger financial stability, and in cases where competition does affect financial stability, the appropriate safeguard is sound prudential regulation or good corporate governance, rather than limiting competition. This means, however, that the functional regulatory and supervisory authorities have to be in place and efficient, in order to guarantee fair competition, which is not always the case in many developing countries. Governments thus have to be cautious when liberalising financial services, in cases where national and international instruments designed to deal with the risks of greater competition are not in place.

Due to increasing competition and pressure to step up profitability, as well as to successful demands by the financial sector for more deregulation, ever more international banks tend to be integrated banks i.e. active in a number of types of financial services (e.g. banking, insurance and securities). More competition among banks due to GATS might increase this tendency. However, while increased integrated banking brings with it such benefits as reduced costs, more product diversity and cross-subsidisation of the different activities within

¹² M. Vander Stichele, *Is de financiële crisis voorbij?*, SOMO, November 1999.

¹³ Frankfurter Rundschau, 31.7.2003

¹⁴ See for instance recent World Bank research on bank concentration and competition.

¹⁵ M. Canoy, M. van Dijk, J. Lemmen, R. de Mooij & J. Weigand, *Competition and Stability in Banking*, CPB (Netherlands Bureau for Economic Policy Analysis) Document nr. 015, December 2001

the financial company, it also involves such risks as conflicts of interests between the different services (as seen at the major investment banks), more concentration of economic – and hence political – power, the greater difficulty for the authorities in monitoring integrated banks, and the necessity of providing “safety nets” for those activities of a financial service company which go beyond banking.¹⁶

3.1.6 The impact of the EU’s demand for liberalising pension fund management

The EU has made requests to many developing countries to liberalise their pension fund management services. Such expansion of European pension fund services to the rest of the world could introduce imprudent practices in other parts of the world. Pension fund management has increasingly relied on buying shares to provide the necessary returns on capital to finance current and future pensions. When share value decreased dramatically and pension funds lost money, it became clear how risky this strategy had been and how it could endanger the provision of pensions by these privatised systems. For instance, the Dutch pension funds and their managers invested 46% of their capital funds in shares on the national and international stock markets as of June 2002. In 2003, it was revealed that many pension funds could not fulfil their obligations any longer, as the return on investments over the previous three years had been 30% less (i.e. around €135 billion less!) than expected by the fund managers: in May 2003, one in five pension funds had mismanaged the funds used to cover future pension payments. The pension fund supervisory authorities had to intervene to force pension funds to come up with strategies to ensure all future payment obligations. Now, new income is generated by increased contributions by employees and employers – decreasing workers’ income and companies’ profits – or by lowering payments to pensioners. At the same time, some pension funds are restructuring or merging, decreasing their numbers. In the UK, pension funds face similar problems.

Experience in Latin American countries shows that the benefits of pension reform and privatisation have been overestimated, and that the administrative costs are high.¹⁷ The question is whether European and other foreign pension fund managers will be cheaper and make additional pension insurance available to more poor workers. Moreover, new pension funds raise new regulatory questions for which there are not always any answers yet, and require regulatory capacity which, as already mentioned, is not always available, especially in developing countries.

Even in developing countries, pension funds are buying national and international shares to diversify their risks and achieve a guaranteed return on capital. However, the uniformity of the investment portfolios of many pension funds can undermine the risk-diverting strategies. Moreover, the purchase of international shares has caused great instability in the financial system, because pension funds have billions of dollars to invest. It has helped to create the bubble of high share prices and rapid decrease in share values, once prices started falling, and pension funds have tried to limit damage by reorganising their portfolios. It could also mean that pension funds in the South would be buying more shares and bonds in the North, thus increasing the flow of capital from the South to the North.

The linkage of pensions to the international capital market raises basic, long-term questions. In effect, the purchase of shares in slowly-ageing countries such as the “emerging markets” by funds in such fast-ageing countries as those of the OECD is a strategy designed to maintain high returns on capital for more and more pensions, since the return on capital will decrease in OECD countries as the share of non-working segment of the population rises.

¹⁶ See S. Claessens & D. Klingebiel, Competition and scope of activities in financial services, in *The World Bank Observer*, vol. 16, nr. 1, Spring 2001, p. 19-40.

¹⁷ M. Queisser, Pension reform: lessons from Latin America, OECD Development Centre Policy Brief, nr. 15, 1998, see also H. Reisen, Liberalisation foreign investment by pension funds: positive and normative aspects, OECD Development Centre Technical Paper nr. 120, January 1997.

However, research shows that such strategies only slightly attenuate but do not reverse the consequences of ageing populations.¹⁸ The capital flows to slowly ageing countries nevertheless have an important effect on the distribution of wealth: they benefit especially the working population of the slowly ageing countries of the south – as long as there is no crash. In the fast ageing countries, they benefit the rich elderly with well-funded pension systems, while hurting the poor pensioners who rely on payroll-tax financed pension systems.

At a time when there is increasing social protest unrest (Spring 2003) in countries like France and Italy against privatization of pension funds, it would be politically inadvisable for the EU to put pressure on developing countries to allow European companies to impose such a pension system there.

3.2. Risks of Commercial Presence of Foreign Banks in Developing Countries Need More Attention

In the literature, many arguments can be found in favour of, as well as against the presence of foreign banks.¹⁹

The arguments put forward by those in favour of liberalisation are:

- reduction in overhead expenses and profit-taking by domestic banks due to increased competition by foreign banks;
- increased efficiency and diversity of financial services;
- spill-over effects of foreign bank entry, such as the introduction of new financial services and of modern and more efficient banking techniques, and the improvement of domestic bank management;
- improvement in bank regulation and supervision due to the entry of new financial service providers and new financial services;
- less interference by government in the financial sector, to cover up bad practices;
- training by foreign banks, resulting in more experienced personnel in the financial sector of a country;
- the presence of foreign banks stimulates domestic investment in the host countries;
- foreign banks may attract (other) foreign direct investments and enhance a country's access to international capital;
- well capitalised foreign banks may be able and willing to keep lending to domestic firms during adverse economic conditions, while domestic banks would probably reduce the credit supply;
- foreign bank entry leads to better lending terms (lower interest rates, lower fees, longer maturities) for all but larger firms.

The arguments put forward for those opposing foreign entry are:

- domestic banks are not able to cope with increased competition, and may stop operating, which can cause disruptions and political concerns about increased foreign control of the financial market;
- trying to cope with increased competition from the foreign banks and implementing new techniques may raise costs for local banks in the short term, which they would then finance by raising their profit margins, in turn leading to price increases for consumers;
- foreign banks get higher interest margins;
- foreign banks entry into the market of loans to corporations does not decrease the margins and profits in the personal loan market;
- foreign banks will not provide additional credit during an economic downturn in a host country;

¹⁸ L. MacKellar & H. Reisen, A simulation model for global pension investment, OECD Development Centre, technical papers (part of the research programme on Macroeconomic Interdependence and Capital Flows) nr. 137, August 1998, p. 35.

¹⁹ For an overview see for instance G. Bies, Financial liberalisation in Latin America, case study as part of a joint research effort at the University of Groningen, presented to the Dutch Ministry of Foreign Affairs, April 2003.

- foreign banks will leave the country when the profitability is too low, which can undermine stability in financial services;
- changes in economic conditions in the foreign bank's home country may have a negative effect on bank activity in the local market;
- foreign banks only provide credit to large and often foreign-owned (multinational) firms, and tend to lend less to small firms and poor consumers;
- domestic supervisory and monetary authorities often fear that their influence on banks' behaviour may diminish as supervision of foreign banks is done by the authorities of the home country.

In the following, some concrete experiences of developing countries are described, in order to examine the real impact that further liberalisation of financial services might have under GATS.

The experience of 80 countries between 1988 and 1995 shows that foreign banks in developing countries tend to have greater profits, higher interest rates and higher tax payments than domestic banks. Also, competitiveness is increased much more by a large number of entrants than by a few with large market shares.²⁰

In Latin America, which has high foreign bank presence, research shows that the argument for increased efficiency of domestic banks through lower overhead expenses and less profit taking only holds true for countries at the lower end of the economic development scale (e.g. Peru, Colombia, Ecuador and Bolivia), but not for the more developed countries such as Brazil.²¹ The research also shows that foreign bank entry can have positive effects on the credit stability of domestic banking systems. However, before opening up, the less economically developed countries need to consolidate and strengthen the domestic banking system in order to be able to face international competition. These findings confirm a case study of the Dutch bank ABN Amro in Brazil, which showed that it was not more efficient than domestic banks which had experienced – and survived – many financial crises.²² ABN Amro's higher profitability, like that of other foreign banks, was due to a large extent to Central Bank policies and its status as a foreign bank, which many people trust, even if they have to pay more.

3.2.1. Effects of Liberalisation on Emerging Markets

The financial sector in "emerging markets" and higher-income developing countries are a major target of the EU requests, although the EU has also addressed financial service requests to 20 least developed countries and 30 low-income countries. The financial sectors of emerging markets was already a major target of the North during the previous GATS negotiations. Because the US was not satisfied with the initial offers for market opening in financial services by the emerging market countries of Southeast Asia, the financial service agreement could not be completed until after the Uruguay Round was over. In 1997, the Asian financial crisis did not stop the Western negotiators on financial services, and especially the US, from demanding further liberalisation. The US abused the need for external rescue packages by the countries in financial crisis to pressure them to open their markets even more; the WTO took the position that liberalisation of financial services would tend to help avoid future financial crises.

²⁰ H. Huizinga, S. Claessen & A Demirgüç-Kunt, How does foreign entry affect the domestic banking market?, World Bank Working paper nr. 1918, June 1998.

²¹ G. Bies, Financial liberalisation in Latin America, case study as part of a joint research effort at the University of Groningen, presented to the Dutch Ministry of Foreign Affairs, April 2003.

²² M. Vander Stichele, Liberalisation in Banking Services Does not Have the Stated Effects Summary of a case study of ABN Amro in Brazil, SOMO, December 2001.

China has, in the course of its negotiations for accession to the WTO and during the current GATS negotiations, become a major target for financial services providers. China's opening up to foreign banking and insurance companies promises more profits for big internationally operating banks.

In China, the experience of liberalising financial services to date – full opening has still not taken place - reflects experiences in other countries.²³

(a) Positive:

- Foreign banks are improving the functioning of the financial system: they are promoting the competitiveness of domestic banks and bringing in new experience in risk management, internal controlling, incentive mechanisms, business innovation and accounting.
- There have been increased foreign capital inflows, and an improvement of the investment environment.
- After entering the Shanghai market, a major US insurance group (American International Group) introduced a recognised insurance marketing system, stimulated the domestic insurance market, strengthened the idea of customer-oriented service among Chinese insurance companies, and promoted the development of the personal life insurance market.
- Foreign financial service companies provide more advanced services and financial innovations to consumers in China.

(b) Negative:

- "Cherry picking":²⁴ Domestic banks lose especially rich clients ("high end consumers") to foreign banks. Since such rich clients provide most of the profit for a bank (according to Chinese statistics: 80% of the profits come from the richest 20% of the clients), domestic banks are losing profitable clients and are left with the less profitable ones, which can further undermine their capability to compete with foreign banks, which in turn are not interested in serving poorer clients.
- Brain drain: Domestic banks are losing many capable senior executives and key personnel. This leads to a lack of experienced executives in domestic banks and further undermines the swift development and improvement of these banks.
- Widening the gap: The imbalance of economic development between the eastern and western regions of China is widening further as more foreign investments – and their banking services – flow to the more developed eastern part of the country.

(c) Challenges:

- The entrance of foreign insurance companies has shown a dramatic expansion of these companies in a short period of time. Foreign banks have developed their activities very fast. This makes it difficult for Chinese companies to meet the fierce competition, while the supervisory and regulatory authorities have trouble keeping abreast of the developments and their risks.
- GATS has also provided for China's insurance companies the opportunity to establish abroad, but Chinese financial services lack the competitive edge (and still need a lot of

²³ WTO, Communication from the People's Republic of China - Assessment of Trade in Services, document nr. 19, 21, 22, 26, 41, 43, 44, 45, 47, 48, 49, 50; WTO, Report of the meeting held on 9 December 2002- 13 January 2003 (TN/S/M/5) 12 February 2003, document nr. 7

²⁴ This phenomenon is being used in many countries, for instance in Turkey (see: M. Karatas & M. Broadbent, Foreign banks in emerging markets: a Turkish success story, in id21 Society & economy, 29 April 2003 (www.id21.org/society/s7amk1g1.html) : Turkey is not considered to be typical of emerging markets because foreign banks only control 2% of domestic banking operations (in Poland they control 36%) and 40% is still in hands of large public banks. Twenty-one foreign banks are operating in the country. The most successful foreign bank has first served multinational and government clients and was able to survive the financial crisis in Turkey (high inflation, volatile market) through adaptive and aggressive strategies and by segmenting the market amongst others to financing of the many privatisation projects, focusing on corporate banking and credit cards, limiting its physical distribution network and careful selection of clients and sectors to which it provides services. In other words, foreign banks have the ability carefully select the most profitable sectors and clients and are not interested in full expansion all over the country, increasing the unequal development between the different Turkish regions.

restructuring) to expand abroad to the extent that foreign financial services are capable of entering the Chinese market. This adds to a deficit in services trade, and to balance-of-payments problems.

- China needed to introduce new regulatory bodies for supervising the insurance and securities sectors, alongside those regulating and supervising the banking sector. (Note that in the West, regulators and supervisors have come to the conclusion that banking and insurance regulatory bodies are not adequate, but need to be integrated, as financial institutions are increasingly involved in banking, insurance and securities at the same time);
- Loans issued in foreign exchange have rapidly become an important channel for capital inflows into the country, providing capital for domestic enterprises, but also increasing foreign exchange and capital flow instability (see above), which requires careful macro-regulatory management of the financial system and monetary policy by the authorities. Transaction techniques have become more complicated, and China's financial institutions are experiencing tremendous changes which increase the risk of instability. China admits that its administrative capacity of the regulatory authority still falls far behind that of many developed countries and that continuous reform and improvement is needed, which adds to the difficulties and costs of administering the financial system.

3.2.2. Consequences for Other Developing Countries

Especially in poorer developing countries, the banking system is considered inefficient and unreliable, which carries with it a high economic cost and prevents economic development, trade and investment. Therefore, it is claimed, the entry of foreign banks makes domestic banks more efficient by more competitive banking markets. However, "more efficient" also means "less profit". Moreover, less profitability and greater competition can also lead to more risky lending practices by smaller local banks.²⁵ Also, volatility risks are greater for smaller economies, which are more vulnerable to capital movements.

In Sub-Saharan Africa, experience of increased foreign participation in the domestic banking sector to date has shown such benefits as improved quality, pricing and supply of financial services and in risk management, accounting and transparency as well as increased competition.²⁶ On the other hand the costs have included increased exposure to capital flight, which destabilises domestic bank credit: Foreign banks withdraw quickly from the domestic market in face of a financial crisis. Moreover, they are not necessarily better capitalised than local banks – although better capitalisation is often claimed as an advantage they enjoy, making them more resistant to financial crises – nor do they have fewer bad performing loans. They use their financial power and international status to focus on the most lucrative transactions ("cherry-picking"). The presence of foreign banks increases loans by both domestic and foreign banks, but the variability of the loan supply decreases. Foreign banks can out-compete locally owned banks in smaller economies because they can recover their high set-up costs from profitable operations elsewhere. And they can expand rapidly: in Tanzania, liberalisation for foreign banks increased their presence from 5% before 1980 (when policies were restrictive) to 76% in 2002.

Also, the insurance sector in Africa has so far remained underdeveloped and without the necessary backing from governments. Lack of capacity and expertise has prevented the sector from starting viable commercial relations among African countries and making them fully prepared for international competition at home and on international markets²⁷.

²⁵ H. Huizinga, S. Claessen & A Demirgüç-Kunt, How does foreign entry affect the domestic banking market?, World Bank Working paper nr. 1918, June 1998.

²⁶ V. Murinde & M. Tefula, A foreign affair? How far does Africa need foreign banks? in Finance matters - Finance liberalisation: too much too soon?, id21 Insights #40, March 2002 (at: www.id21.org/insights/insighths40/insights-iss40-art02.html)

²⁷ Africa's insurance industry needs assistance in Addis Tribune, 7 June 2002

This means that the EU demand for eliminating restrictions on the full foreign ownership in small or poor developing countries can easily lead to domination by foreign banks. Dominance by foreign banks makes these countries vulnerable to strategies of financial companies which leave the country when profits decline and make it more difficult for the authorities to manage the financial system. This was illustrated in Kenya when foreign banks formed a cartel that fixed high interest rates, which resulted in high costs for the consumers and the economy. Moreover, the question as to how profits are to be reinvested in the country remains unanswered, as GATS Art. XI forbids a restriction on the transfer of profits.

3.2.3. Undermining Poverty Eradication

So-called micro-credits of just a few hundred dollars have proven an effective instrument for development. Micro-credit organisations in Africa demand stronger domestic banks and no domination by foreign banks. Foreign banks have shown little interest in providing credit to poorer clients, or managing their finances. Their “cherry-picking” policies, especially in the poorer countries, are oriented towards the richer market segments; this leaves the poorest, who are most in need of better financing, to other initiatives such as micro-financing.

According to the World Bank, the entry of foreign banks results in the spread of better lending techniques, so that small borrowers gain new access to financing, and to a greater diversity of financial products and allocation of capital, which stimulates the economy.²⁸ By this logic, there should be no reason for countries to restrict foreign banks to take deposits from small depositors as has been the case in South Africa. However the case of Ghana, where a British bank has been asking payment for deposits below a certain amount, shows one of the problems.

The situation is similar for foreign health insurance companies, as was researched in Kenya.²⁹ These companies tailor their services to the wealthy city-dwellers who are already able to pay their hospital bills. They charge high premiums, unaffordable to poor patients. They refuse to accept patients who suffer from illnesses such as HIV/AIDS. This is in sharp contrast to the government’s public health insurance system, which is obligated to accept all patients. During the previous GATS negotiations, Kenya agreed to liberalise its financial services without fully realising that it was also subjecting the health insurance sector to the GATS rules. Article XVI prohibits governments from taking six specific kinds of measures to place limitations on companies, such as restricting the number of service suppliers. During the negotiations, the Kenyan government could have reserved the right to impose a universal service requirement for foreign insurers only, but did not do so. The government can now require foreign companies to insure poor and vulnerable (HIV-positive or terminal) patients only if it also sets the same requirement for Kenya-based insurers, according to the GATS principle of non-discrimination and national treatment (Article XVII). Whether countries will impose universal service obligation is another matter, as it is considered to have an unfavourable impact on the banks’ profitability and stability.³⁰

The EU requests are addressing measures that support poverty alleviation. For instance, the EU considers the requirement applied to all banks in Malaysia to provide quotas for low-cost housing as a limitation that should be scheduled. This means that measures to provide poorer families with the financial resources needed for housing are not considered falling under the “right to regulate”, but rather as a trade barrier that must be exempted from the GATS agreement, and ultimately eliminated.

²⁸ World Bank, Finance for growth: Policy choices in a volatile world, Policy research report, Overview and summary, May 2001.

²⁹ Challenges for the South in the WTO Negotiations on Services - Summaries and Conclusions from Three Case Studies: Health Care (Kenya), Electricity (Colombia), Tourism (India), edited by SOMO & WEMOS, Amsterdam, January 2003 (see www.somo.nl).

³⁰ J. Marchetti (WTO Economic Affairs Officer, Trade in Services Division), letter of 25th June 2003.

CONCLUSIONS

During the current GATS negotiations on liberalising financial services, the benefits of a strengthened financial system have been highlighted, while the risks of increased instability have been underestimated, especially by the Northern countries. This paper has identified several ways in which liberalisation of financial services can contribute to financial instability.

In order to address this increased risk of instability, an appropriate regulatory and supervisory framework for banking, insurance and securities is required. Developing countries often lack the capacity and resources for such necessary safeguards. Therefore there should be much more open public and political discussions linking the degree of liberalisation requested by the EU and the degree of regulation and supervision already in place to deal with new financial service providers and their services. No commitments should be made in this area during the bilateral GATS negotiations, unless there is full guarantee by both sides that the necessary safeguards are in place, nor should the EU insist on any such commitments.

Given the risks of financial instability, of higher regulatory and supervisory costs and of a reduction in domestic financial sectors, developing countries should not make further commitments to liberalisation in the financial services area unless they get major concessions during the WTO negotiations in services and other areas.³¹

The current negotiations on financial service have so far completely failed to address issues of increased access and quality of financial services for consumers, especially poorer ones, and the necessary contribution by the financial sector to socially and environmentally sustainable development. This paper has argued that foreign financial services (banks, health insurance, etc.) tend to focus on the rich, which has a negative distributional effect, not only in the home country but also internationally, when profits made from rich clients in poor countries are siphoned off to the home countries in the North. Therefore the current negotiations in GATS, and especially in financial services, should be stopped and new ways should be worked out for international cooperation that makes financial services at the service of the poor and sustainable development.

Amsterdam, August, 2003

=====
For comments on this article please contact:

Myriam Vander Stichele

Researcher

SOMO (Centre for Research on Multinationals)

Keizersgracht 132

NL-1015 CW Amsterdam

Tel.: + 31-20-639.12.91

Fax: + 31-20-639.13.21

E-mail: m.vander.stichele@somo.nl

For the full publication about liberalisation of financial services in GATS, see:
<http://weed-online.org/>

More information on financial services will follow on the SOMO website

³¹ See also L. Schuknecht, P. Harms & A mattoo, Explaining liberalisation commitments in financial services trade, World Bank Working paper nr. 2999, 14 March 2003.