

## Liberalizing trade in financial services

# Why it matters

Lower costs, more investments and improved government supervision are among the potential benefits arising out of liberalization of trade in financial services, according to a new study by economists from the WTO Secretariat published on 22 September. The study highlights the importance of international competition in banking, securities and insurance markets while acknowledging the critical need for preserving prudential policies to safeguard financial systems for the benefit of investors and consumers.

The study, *Open Markets in Financial Services and the Role of the GATS*, explains that trade liberalization in this sector will:

- » enhance competition and improve sectoral efficiency, leading to lower costs, better quality, and more choice of financial services;
- » improve financial intermediation and investment opportunities through better resource allocation across sectors, countries and time, and through better means of managing risks and absorbing shocks; and
- » induce governments to improve macroeconomic management, domestic policy interventions in credit markets, and financial sector regulation and supervision.

### *Effects on income and growth*

Liberalization of financial services can have strong positive effects on income and growth. Developed and developing countries with open financial sectors have typically grown faster than those with closed regimes. The economic success of Hong Kong (China) and Singapore has been greatly facilitated by internationally-oriented financial service sectors. Many developing countries such as Argentina, Brazil, Ghana, Hungary, Indonesia, and Pakistan have become



*Singapore's banking district: an open and well-regulated financial services sector in tandem with macroeconomic stability have promoted growth.*

increasingly integrated in the world's financial markets.

The financial services sector has expanded rapidly in recent years. The study notes that employment increased by 25 to 50% in a number of industrialized countries since 1970 and now represents 3 to 5% of total employment. Value-added in the financial service sector has also grown considerably over the past 25 years and now reaches between 7 and 13% of GDP in Hong Kong (China), Singapore, Switzerland, and the United States.

Financial service sector growth reflects the rise in international financial market activities. Lending and securities trading, and derivative markets have experienced rapid growth in the past 10 years, with many developing and transition economies also benefitting from im-

proved international market access. Foreign ownership of banking assets, an indicator of commercial presence in this sector approaches 20% in the United States, Argentina and Chile. Consequently, the study says, cross-border trade in financial services more than tripled between 1985 and 1995 and now exceeds US\$50 billion for the most important trading countries. Data for the United States suggests that trade via commercial presence in foreign markets is even more important than cross-border trade.

The study identifies a number of challenges which must be met if countries are to reap the full benefits from trade liberalization in the financial services sector. It states that "macroeconomic stability, structural policies which minimize distortionary interventions in the financial sector and prudential regulation and supervision" must underpin the

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## ***Financial services***

*(Continued from page 1)*

benefits of liberalization. The study notes that there is no universally applicable liberalization strategy and that the specific circumstances of each country should be taken into consideration.

The study stresses that maintaining the stability and security of the financial services system is of paramount importance. The authors point out that the General Agreement on Trade in Services (GATS) allows WTO Members to take prudential measures to protect investors and to ensure the integrity and stability of their domestic financial systems. It also permits the use of temporary non-discriminatory restrictions on balance-of-payments and transfers in the event of serious balance-of-payments and external finan-

cial difficulties. Moreover, the management of monetary and exchange rate policy falls outside the scope of the GATS.

In its overall assessment concerning the benefits of trade liberalization and the challenges for Member governments, the study states: "The benefits from participating in the multilateral negotiating process under the GATS, through market access and national treatment commitments, can accrue to countries without in any way compromising their ability to pursue sound macroeconomic and regulatory policies." Indeed, notes the study, "there are circumstances where forward commitment to liberalization may help to support the development of better macroeconomic and regulatory policies."

The study, the first in a series of studies on topical issues, may be purchased for CHF 30.- from the WTO's Publications Division. Below is an excerpt from the study:

### ***The benefits from liberalization of financial services trade***

**T**he 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).

From an economic perspective, trade in financial services is no different from trade in other goods or services. Liberalization of trade in financial services can have strong positive effects on income and growth, driven by the same factors as in other sectors — specialization on the basis of comparative advantage, dissemination of know-how and new technologies, and realization of economies of scale and scope.<sup>1</sup> Moreover, liberalization improves financial intermediation, enhancing efficient sectoral, inter-temporal and international resource allocation.

A number of empirical studies have demonstrated that liberalization of the financial services sector, sometimes in conjunction with other reforms, can boost income and growth. Improved investment quality is often the main link between liberalization and growth. Levine (1996 and 1997) and King and Levine (1993) show that both developed and developing countries with open financial sectors have typically grown faster than those with closed ones. Jayaratne and Strahan (1996) find that deregulation of intrastate branching in the United States stimulated growth by 0.3-0.9 per cent of GDP for the 10 year-period following deregulation

<sup>1</sup>This encourages resources to move into the most productive activities, and improves productivity and the investment climate. Economies of scale allow lower average costs through the production of greater quantities of goods and services of the same type. Economies of scope allow cost reductions through the production of related goods or services.

and 0.2-0.3 per cent thereafter.

The growth-stimulating effect of liberalization, however, is likely to be largest in the developing economies with less sophisticated financial systems (World Bank, 1997). In Ghana, for example, a combination of macroeconomic and structural reforms, including in the financial sector, boosted growth from minus one per cent in the 1970s to over 5 per cent in the 1983-90 period (Kapur *et al.*, 1991). The economic success of Hong Kong (China) and Singapore has also been facilitated by internationally-oriented financial services sectors (Bercuson, 1995). The ranking of financial sector development in 53 industrialized and developing countries covered by the World Economic Forum (1997), which includes proxies for the opening and stability of financial systems, tends to confirm these findings. Whilst the 10 countries with the highest ranking grew, on average, by more than 4 per cent during 1990-95, the 10 countries with the lowest ranking posted an average growth rate of zero.

#### **A. Assessing the benefits from financial services trade liberalization**

##### ***Trade liberalization can make the financial services sector more efficient and stable***

**T**here are a number of ways financial services liberalization can enhance the efficiency of the sector and reduce costs. Financial institutions can take advantage of economies of scale and specialize according to their comparative advantage. The emergence of specialized institutions in certain market segments, such as reinsurance, is a case in point. On the other hand, financial institutions can also broaden their spectrum of related services to take advantage of economies of scope. A number of financial institutions have, in fact, become global players, offering a broad range of financial services, not unlike department stores, where consumers can cover all their financial service needs.

Competition, including competition from international sources, forces companies to reduce waste, improve management and become more efficient. Costly rent-seeking activi-

## *Liberalization of financial services trade in the European Union*

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").



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

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 for-

eign 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.

Commitment to macroeconomic stability has been one of the most important factors explaining Singapore's success in building its financial sector. Gross domestic product has grown steadily at an average rate of 7 per cent over the past decades. Inflation, averaging 4 per cent, has been low and relatively stable over this period. The government budget has been in surplus, with moderate levels of expenditures and taxation. At the same time, the Monetary Authority of Singapore has balanced the need to liberalize and to maintain financial stability via a tight regime of prudential regulation and supervision. Today, Singapore has evolved into one of the world's most important financial centres and the fourth largest centre for foreign exchange trading. □

Sources: Bercuson, (1995); Economist Intelligence Unit, (1996); Euromoney, (1994); Financial Times, (1996 and 1997); SICC, (1996); WTO, (1996a).

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

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*"Singapore's Monetary Authority is balancing the need to liberalize and to maintain financial stability via a tight regime of prudential regulation and supervision..."*

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(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

## Indicators of operational efficiency, selected OECD countries<sup>1</sup>

(In per cent unless otherwise indicated)

	1979-84	1985-89	1990-92
Net interest margin <sup>2</sup>	2.57	2.58	2.61
Gross income to capital <sup>3</sup>	0.76	0.73	0.65
Staff costs to gross incomes <sup>3</sup>	0.40	0.35	0.34
Average commissions <sup>4</sup>	0.50	0.33	0.25
Bid-ask spreads <sup>5</sup>	0.32	0.13	...
Automatic teller machines <sup>6</sup> (per million inhabitants)	95	186	379

Sources: Edey and Hviding (1995), Piggott and Harris (1997)

<sup>1</sup>Weighted average of commercial banks in United States, Japan, Germany (all banks), France, Italy, Canada, Belgium, Denmark (all banks), Finland, Greece, Luxembourg, Norway (all banks), Portugal (all banks), Spain (all banks), Sweden and Switzerland. <sup>2</sup>Also including United Kingdom. <sup>3</sup>Gross income defined as net interest revenues plus fee income. Income from "net interest and fees" is expressed as a ratio to capital rather than assets in this table because asset growth understates the growth of the total banking business. <sup>4</sup>UK equities (per cent). <sup>5</sup>Eurocurrency deposits (percentage points). Simple average of US dollar, pound sterling, French franc, Deutsche mark and Japanese yen. Average of daily spreads. <sup>6</sup>Average of the United States, Japan, Germany, France, Italy, United Kingdom, Canada, Belgium, Denmark, Finland, Netherland, Norway and Sweden.

adequate prudential regulation and supervision of financial institutions. As discussed in another section, financial institutions can be quite vulnerable to macroeconomic instability and inappropriate government regulation.

Much emphasis has been placed on the dangers for the financial system emanating from failures in the macroeconomic and regulatory sphere. The opportunities arising from using financial services trade liberalization as a pre-commitment device for complementary reform in these areas have been less well publicized. Pre-commitment to simultaneous financial services trade liberalization, and macroeconomic and regulatory reform can help bring about the benefits from more trade as well as from more financial and macroeconomic stability. In fact, credible policy pre-commitments to good and stable policy making are now considered key in explaining rapid growth and development (see, e.g., Borner, Brunetti and Weder, 1996; World Bank, 1997a). Moreover, there is evidence of beneficial links between open markets and economic stability. In Indonesia, for example, open financial markets are often credited with a beneficial effect on macroeconomic stability in the past decades (World Bank, 1997). It is reported that in Hong Kong (China) and Singapore (Box 2), a rapidly developing, open and well-regulated financial services sector, in tandem with macroeconomic stability, have together strengthened the economy and promoted growth.

Other benefits typically arise as distortionary domestic regulation is removed in the context of liberalization. Highly regulated financial markets, for example, often feature interest rate controls and credit ceilings for individual institutions. Lending interventions by governments funnel resources into priority sectors or the financing of government deficits. This can lead to distortions, especially when interest rates are below market level and require cross-subsidization from other lending. The inefficient use of scarce capital in some sectors results in credit-rationing and short-

ages in others. Some potentially profitable investments are, therefore, not undertaken. Alternatively, investors can seek financing in the informal economy from money lenders or relatives. This is often very costly and the scope of investments becomes relatively limited.

Liberalization of the financial services sector requires a reduction of these kinds of direct financial market interventions, especially when they do not address market imperfections. Their reduction (or elimination) changes relative funding costs, and capital is redirected away from previous "priority" sectors into investments with the highest (risk-adjusted) return. As a result, loan costs rise in sectors which previously benefitted from cross-subsidization. In other sectors, however, borrowing costs fall and a broader spectrum of investments can be financed. Small or less well-connected investors are likely to attain better access to the financial system when previously they could only borrow informally. This can have positive effects on income distribution.<sup>2</sup>

### *Liberalization may improve inter-temporal and international resource allocation*

Open and more efficient financial markets affect savings and investment and improve the inter-temporal allocation of resources. Competition among financial institutions, the liberalization of interest rates, and the emergence of new savings instruments are likely to increase the returns to investments. This stimulates aggregate savings and higher investments which, in turn, boost growth. However, easier availability of credit, particularly consumer credit, can have the opposite effect and reduce aggregate savings. The empirical evidence is mixed. Hoj, Kato and Pilat (1995) do not find a significant effect from liberalization on aggregate savings in OECD countries. King and Levine (1993), however, report that the quantity of investment is strongly correlated with financial sector development. Data from the World Economic Forum (1997) also suggest a positive link between a strong financial sector with high-quality financial intermediation and the level of savings and investment in developing countries. The top ten countries in the Forum's ranking in terms of the quality of the financial sector record average levels of savings and investment of over 33 per cent of GDP, while countries figuring among the lowest ten have average ratios of 22 per cent.

Even if aggregate savings and investment are not always affected, liberalization of the financial services sector can have beneficial effects on individual income streams. Consumer credits, for example, facilitate more stable consumption over time ("consumption smoothing"). This can be a valuable choice for people with volatile incomes or for those hit by unemployment (Edey and Hviding, 1995). The rapid development of life insurance and private retirement insurance in recent years allow consumers to make their own provisions for old age, accidents and sickness (Skipper, 1996). Given rapidly aging populations in many countries, especially the industrialized countries, the beneficial effect which financial market liberalization has on opportunities for individual consumption smoothing and insurance should not be underestimated.

<sup>2</sup>It may be noted that similar positive distributional effects are likely to arise with more stable macroeconomic policy. This is because, in an inflationary environment, the less well-off are more likely to hold their assets in liquid form and are less able to hedge effectively against rising prices.

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.<sup>3</sup> 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 efficient than domestic ones, they will certainly be effective in penetrating a liberalized market. But there is no reason to assume that foreign suppliers will always be more efficient than domestic ones; their presence will in fact promote the efficiency of the domestic sector.

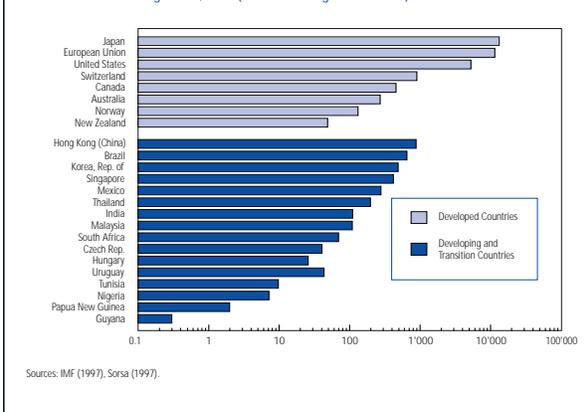
To the extent that domestic firms need time to adjust to new competition, trade liberalization can be phased in over time. Alternatively, if a government wishes to maintain a certain national presence in the domestic market, or wishes to provide temporary support to national suppliers, then from an efficiency perspective these objectives are better attained through fiscal incentives rather than through restrictions on trade, provided that the necessary fiscal resources can be raised through less distortionary means.

As for the question of the abuse of market dominance, competition between incumbent suppliers, both domestic and foreign, combined with the openness of the market for new entrants, should minimize the danger of abuse. If this were to prove insufficient, governments could deploy competition policies to help secure competition.

Another concern relates to the potential for selective servicing by foreign suppliers. It is feared that the latter will only service profitable market segments referred to as cherry-picking and that the resulting underprovision of retail banking in rural areas, for example, could then have detrimental effects on the economy. A question to be asked is whether

<sup>3</sup>Opening to foreign direct investment can, however, place domestic investors at a disadvantage compared to foreign investors in the same sector, on account of higher financing costs they may face in their operations.

Chart 1a. Total Banking Assets, 1994 (US\$ billion - logarithmic scale).



underprovisioning is the result of government regulation, or the absence of certain underlying conditions, which makes certain market segments unprofitable. Some have argued, for example, that the absence of a well-functioning judiciary which can enforce claims makes lending to certain market segments very risky (World Bank, 1997a). If other reasons account for a need to promote financial service provisioning in certain markets, such as the cost of services in certain geographical regions or in relation to the purchasing power of low-income consumers, then alternative measures, such as fiscal incentives, would seem more appropriate than keeping financial markets closed. It is also possible to impose certain requirements, such as universal service obligations, on foreign as well as domestic financial institutions to ensure that social objectives are met without sacrificing the efficiency benefits of competition.

The presence of too many financial institutions is sometimes cited as an argument against liberalization in financial services trade. It is argued that the entry of more foreign firms would aggravate the problem of “overbanking” or “overinsuring”. “Overbanking,” for example, suggests that there are already too many banks trying to attract business in a given financial market. To the extent that this reflects concern about the viability of individual financial institutions, it is best addressed through prudential measures and measures to facilitate orderly exit from the market. In some countries, the licensing or liquidation regime for banks is deficient. This leaves the economy with a crowded banking sector featuring unsound banks. The right response, however, would be to permit an orderly consolidation in the financial system rather than protectionism. In Russia, for example, 450 out of 2,150 banks were wound down in 1995 and 1996. In Argentina, one quarter of the country’s 200 banks were liquidated in 1995 and 1996. In Malaysia and Korea, mergers have been encouraged in recent years, to facilitate consolidation and increase the competitiveness of the financial sector.

Finally, it has been argued that liberalization of financial services trade worsens a country’s balance-of-payments position. In principle, however, better access to international capital should ease payment pressures on countries. Initially, capital flows into the country as foreign financial institutions establish themselves. The resulting effects on growth and income are likely to generate income which more than pays, for example, for the remitted profits of foreign financial institutions. □

TPRB: Benin

## Strong encouragement to accelerate reform

*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:*

**B**enin 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 continuing export ban on food products (*produits vivriers*), and about plans for the future liberalization of remaining state monopolies. Details were also requested on Benin's use of rules of origin under the WAEMU Agreement. Members sought confirmation that Benin maintained no investment schemes notifiable under the TRIMs Agreement.

In response, the representative of Benin noted that Benin did not maintain any local content requirements outside those contained in the rules of origin under the WAEMU and ECOWAS Agreements in order to qualify for preferential treatment.

### Regional integration

Members took note of Benin's recent efforts to increase participation in regional trade agreements, including the customs union planned among WAEMU countries. In this respect, many participants asked about the prospects for the union, its expected timing, and whether it would lead to the abolition of non-tariff measures and the creation of an internal market within the union. Members emphasized the risk that the tariff convergence required by a customs union could lead to MFN tariff increases in Benin.

In response, the representative of Benin declared that WAEMU's fundamental objectives were to ensure rapid convergence towards an economic union, with a common market based on the free circulation of people, goods, services and capital. Important achievements to date included the removal of all non-tariff barriers to internal trade, and a

considerable tariff reduction on internal trade in agreed products. The establishment of a common external tariff was planned for 1 January 1998.

### Benin in the multilateral trading system

Members highlighted Benin's status as a least developed country, and its concomitant special position within the multilateral trading system. It was suggested that ways should be found of ensuring more regular participation by Benin in the work of the WTO. Participants also invited Benin to specify its needs for technical assistance in order to benefit most from WTO Agreements.

In response, the representative of Benin hoped that the High Level Meeting on Least Developed Countries would result in commitments to improve access to markets, increase the competitive capacity of LDCs through training and information for private and public sector operators, and create a system to protect and encourage investment in LDCs. He stressed the need to maintain differential treatment for developing countries during the transition period, and to provide effective assistance to LDCs. In his view, the survival of the multilateral trading system depended on its capacity to reduce inequalities and increase trade on the basis of each member's comparative advantage. He therefore called for a concrete programme of assistance and information to LDCs to implement the WTO Agreements, participate in future negotiations, train producers to satisfy international standards in export markets and prepare strategies for the development of trade, and provided a list of specific areas in which Benin would require such assistance.

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Members welcomed the important steps taken in recent years by Benin towards a more open and liberal economy, through constitutional, legislative and administrative reforms and privatization programmes. They emphasized the importance of diversification of the economy and the need for development to be pursued on a sustainable basis. Members also stressed the importance of further steps to increase predictability, transparency and certainty in Benin's trade practices. The need for improved access in various fields of services was particularly noted. Overall, Members offered strong encouragement to Benin to continue and accelerate the reform process in all economic areas and responded positively to Benin's requests for assistance in the framework of WTO activities. □



*Members responded positively to a call by Benin's Minister of Trade, Handicraft and Tourism Gatién Houngbedji for a concrete programme of assistance to the LDCs. (Photo by Tania Tang/WTO)*

## 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.

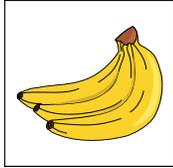
Guatemala welcomed the findings, which proved that any member could use the WTO to protect its trade rights. Ecuador said that the new WTO rules had led to the adoption of the reports in a straightforward manner, whereas in the old GATT, the EC was able to block two panel reports on its banana regime.

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 eliminate tax differentials between local and imported alcoholic beverages. It said these amendments reflected its agreement with the EC regarding the implementation of the DSB recommendations.

Co-complainants United States and Canada urged Japan to respect the 15-month implementation period determined by an arbitrator.

Canada announced agreement with the United States to implement DSB recommendations on its measures concerning periodicals within a 15-month period □

## MEETINGS

### NOVEMBER

3-4	Working Group on Transparency in Government Procurement
3-5	Committee on Regional Trade Agreements
5-7	WP on Preshipment Inspection
7	Council for Trade in Goods
10	Cttee. on Trade in Civil Aircraft Cttee. on BOP Restrictions
10-12	Textiles Monitoring Body
11	Council for Trade in Services
12-13	Cttee. on Tech. Barriers to Trade
13	Council for Trade in Goods
14	Cttee. on Trade in Financial Serv.
17	Cttee. on Government Procurement Cttee. on Trade and Development
17-21	Council for TRIPS
18	Dispute Settlement Body
19	Council for Trade in Goods
20-21	Committee on Agriculture
21	Committee on Rules of Origin
24-26	Cttee. on Trade & Environment
25-26	Trade Policy Review: EC
26	Working Party on GATS Rules
27-28	WG on the Interaction between Trade and Competition Policy

## WTO FOCUS

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