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Liberalizing Trade in the Financial Services Sector

The financial sector is a critical component of a nation's economy: it not only contributes directly to output and employment but also provides an essential infrastructure for the functioning of the entire economy. International trade in financial services—in combination with reforms to strengthen domestic financial systems—can play an important role in helping countries build financial systems that are more competitive and efficient, and therefore more stable.

In *The Doha Round and Financial Services Negotiations*, Sydney J. Key of the Federal Reserve Board's Division of International Finance* analyzes the role of the General Agreement on Trade in Services (GATS) and the World Trade Organization (WTO) in the liberalization of the financial services** sector. Her unique analysis integrates the very different perspectives of trade policy and financial regulatory policy.

Key emphasizes the mutually reinforcing relationship between GATS negotiations to open host-country markets to foreign financial firms and the intensive work on strengthening domestic financial systems that is taking place in a variety of international institutions ranging from the International Monetary Fund (IMF) to specialized bodies such as the Basel Committee on Banking Supervision. A major part of this work involves setting voluntary—but widely accepted—international minimum standards and codes of good practices, monitoring their application, and helping to build institutional capability for their implementation. These standards and codes cover three broad areas of critical importance for sound financial systems—namely, transparency of macroeconomic policy and data; institutional and market infrastructure, including, for example, accounting, insolvency, and payment and settlement systems; and "prudential" regulation and supervision, which is aimed at ensuring the integrity and stability of the financial system and protecting consumers of financial services.

Key's study identifies six broad goals for the financial services negotiations in the Doha round. The first four goals, which are described by the author as "first-pillar liberalization," aim to secure the opening of markets to foreign financial firms and to assure that these foreign firms will receive substantially the same treatment as their domestic counterparts. These goals include formalizing as GATS commitments liberalization measures that are already in effect, or scheduled to go into effect, but not yet "bound" in the GATS; the removal of barriers that a number of WTO members continue to impose and the formal "binding" of the resulting liberalization; narrowing or withdrawing broad most-favored-nation exemptions in order to prevent WTO members from pursuing unilateral reciprocity policies; and an incremental approach for negotiations on cross-border services.

A difficult issue to resolve is how far the Doha round financial services negotiations should extend into the realm of "second-pillar liberalization," which is aimed at removing nonquantitative and nondiscriminatory structural barriers. Key suggests that the financial services negotiations should proceed selectively in dealing with domestic structural reform and singles out two second-pillar goals: The first "second-pillar" goal would be to strengthen GATS disciplines on regulatory transparency. Key argues that stronger GATS rules on transparency are needed for developing and applying regulations as well as for the related principle of procedural "fairness." This would help eliminate barriers created by opaque and unfair regulatory procedures and would also help ensure that a country does not use its regulatory process to undermine the market-opening commitments it has made in the GATS.

The next "second-pillar" goal singles out domestic regulatory measures that cannot be justified on prudential grounds and which serve primarily to deny foreign firms "effective market access" by making entry impractical or too costly. Even though such measures legally permit foreign firms to enter the market—without, for example, being subject to numerical quotas for new licenses—and to operate under the same rules as domestic firms, their practical impact is to create a major barrier to entry. Key notes that a model for reducing barriers to "effective market access" that could be negotiated in the Doha round is provided by Japan's so-called "additional commitments" in the 1997 financial services agreement, which included removing certain restrictions on asset-management services and on lines of business in insurance.

Key also discusses the liberalization of capital movements, the "third pillar" of liberalization necessary to achieve "international contestability of markets"—that is, markets that are competitive and efficient on a global basis. She explains that the GATS deals with the liberalization of capital movements only as it affects WTO members' specific commitments to liberalize trade in services.

Key stresses that success in achieving the goals discussed in the study depends significantly on factors beyond the scope of the Doha round negotiations. She points out that the process of liberalization for financial services is being driven not only by market forces and new technologies but also by the growing recognition among policymakers that opening markets can both benefit host-country consumers of financial services and contribute to the resiliency of domestic financial systems.

The author also emphasizes that the development and implementation of international minimum standards and codes of good practices for sound financial systems—especially with regard to prudential regulation and supervision—provide a strong foundation for moving ahead with further liberalization of trade in financial services. Key concludes that the negotiations in the Doha round can play an important role in accelerating the process of liberalization of trade in financial services and in solidifying this liberalization in the form of binding GATS commitments subject to the WTO dispute settlement mechanism.

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* The views expressed by the author in this publication should not be interpreted as representing the views of the Board of Governors of the Federal Reserve System or anyone else on its staff.

** In this study, "financial services" refers to financial services other than insurance (which is the subject of an earlier study in this series) and includes activities such as commercial and investment banking, securities trading, and asset management.

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