Financial Services in the Trading System: Progress and Prospects

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FINANCIAL SERVICES IN THE TRADING SYSTEM:

PROGRESS AND PROSPECTS

Eric Miller*

We face major changes in the world's economy. In economic policies and theories, we still act as if we lived in an "international" economy, in which separate nations are units, dealing with one another primarily through international trade and fundamentally as different from one another in their economy as they are different in language or laws or cultural tradition. But imperceptibly there has emerged a world economy in which common information generates the same economic appetites, aspirations and demands - cutting across national boundaries and languages and largely disregarding political ideologies as well. The world has become, in other words, one market ... Yet this world economy almost entirely lacks economic institutions ... (a)nd we are totally without economic policy and economic theory for a world economy.

Peter F. Drucker, 1968

I. A CHANGING WORLD

In the winter of 1996, Canada's third largest financial institution, the Bank of Montreal, launched a now infamous advertising campaign in which it asked the question: Can a bank change? While the resulting ads naturally responded in the affirmative, many other large financial institutions were asking themselves the same question. The dramatic acceleration since the mid-to-late 1980's of the rate at which banks are establishing branches and/or investing in financial institutions outside of their home markets combined with the dismantling by governments around the world of many traditional regulatory restrictions is resulting in the re-making of the financial services industry in its entirety. Central to this process has been a wave of mergers and alliances, many of which increasingly cut across the classical sectoral sub-divisions (commercial banking, securities, insurance etc.). The end result has been the gradual emergence of singular financial amorphisms capable of offering any service globally. In addition to these structural changes, an important result of this wave of mergers, alliances and foreign investment has been that financial institutions have become global players in terms of market presence, rather than just loan portfolios. This, in turn, has meant that the volume and importance of international trade in financial services has substantially increased in recent years.

As the international trade of financial services has developed, governments have sought to establish a framework of rules to govern it. However, this process has not occurred in a vacuum. Over the past 15 years, international trade in goods has become substantially freer, international trade in services (of which financial services constitutes a part) has grown dramatically, and international capital flows have become more open. While volumes have been written about both international trade in goods and international capital flows and a burgeoning literature exists on trade in services, comparatively little has been written specifically about international trade in financial services. This paper is designed to help fill this void. It will examine both how and why trade in financial services entered on to negotiating agendas at the regional and global levels and

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it will assess the evolution of international disciplines in this area to date. In doing so, the paper will first explain the often overlooked distinction between trade in financial services and capital flows. It will then briefly discuss the growth and development of disciplines on services and in the world trading system and assess why it is that financial services have been treated as separate from all other areas in this process. The core of the paper consists of three specific cases: 1) the Canada-United States Free Trade Agreement (CUSFTA); 2) the North American Free Trade Agreement (NAFTA); 3) the World Trade Organization (WTO) Agreement on Trade in Financial Services. These selections constitute a logical progression. The CUSFTA was the first trade agreement ever to include provisions on financial services. The NAFTA, negotiated shortly thereafter contains the most far-reaching provisions in the world in this area. Finally, the WTO Financial Services Agreement marks the first time that such disciplines have been successfully negotiated on a global level. In order to make an examination of an Agreement consisting of 56 different schedules possible, this section will focus on the commitments of a number of sample countries in a specific region of the world, namely Latin America. In concluding, the paper will draw lessons from the case studies in order to assess the probable future directions of the evolution of rule making in this area of trade in financial services.

II. TRADE IN FINANCIAL SERVICES: WHAT IT MEANS. WHAT IT DOES NOT

One of the most common misunderstandings in the debate over liberalizing international trade in financial services is that it is believed that such a move would automatically imply an easing of controls on international capital flows. However, a liberalization of international trade in financial services and a liberalization of the capital account are very different matters. The former centers on the nature and scope of the rights and obligations of foreign financial service providers in the domestic marketplace, i.e. the right to entry and establishment, the right to acquire domestic financial institutions, the types of activities which they are allowed to engage in, etc.. In "deep integration" agreements, it may also involve provisions on a common regulatory framework. The latter centers on the scope and impact controls that govern the flow of capital into and out of a given country. In recent years, the debate in this area has centered on the virtues and vices of unregulated flows of short-term portfolio investment, often known as "hot money". While the liberalization of trade in financial services and the liberalization of the capital account obviously have an impact on each other in economic and policy terms, they are completely distinct when it comes to trade negotiations. While financial services has been on the trade agenda for over a decade-and-a-half, with the exception of provisions on foreign direct investment, the nature of policies governing national capital accounts are viewed as well beyond the scope of anything that would be contemplated in a free trade agreement.

TABLE ONE
DOMESTIC VS. INTERNATIONAL CAPITAL FLOWS & FINANCIAL SERVICES PROVISION: FOREIGN SUPPLIER ABROAD

Type of Capital	Source of Loan	
	Loan Provided by Domestic Supplier	Loan Provided by Foreign Supplier Abroad
Loan Involves Domestic Capital Only	I. Neither financial services trade nor international capital flow	II. Financial services trade only
Loan Involves International Capital Only	III. International capital flow only	IV. Financial services trade and international capital flow

Source: Kono and Schuknecht

From a policy and negotiating perspective the distinction between the two is very clear. However, from an analytical point of view, further explanation is required. In order to facilitate this, Tables One and Two use the example of the provision of lending services.

TABLE TWO

DOMESTIC VS. INTERNATIONAL CAPITAL FLOWS & FINANCIAL SERVICES PROVISION: LENDING BY FOREIGN SUPPLIER ESTABLISHED IN THE COUNTRY

Type of Capital	Source of Loan	
	Loan Provided by Domestic Supplier	Loan Provided by Foreign Supplier Established in the Country
Loan Involves Domestic Capital Only	Ia. Neither financial services trade nor international capital flow	IIa. Financial services trade plus inward direct investment
Loan Involves International Capital Only	IIIa. International capital flow only	IVa. Financial services trade plus inward direct investment and international capital flow related to the supply of the loan

Source: Kono and Schuknecht

In examining the Tables, Cells II/IIa and IV/IVa clearly establish that in order for the granting of a loan to be considered as a financial services trade, it must be provided by a foreign supplier whether or not said firm is has directly established operations in the country. The distinction as to whether or not a loan is considered to be an international capital flow stems from the origin of the capital (Cells I/Ia and III/IIIa). A transaction may be a financial services trade, but not an international capital flow if the source of the capital is domestic (Cells II, IIa). By implication, a country may therefore move to liberalize trade in financial services without touching the capital account and vice-versa. While this does not often happen in practice, the model highlights the fact that the two areas are distinct. Finally, with respect to the between the different "modes of supplying" the loan in Table One and Two (from abroad vs. from an established subsidiary), the key distinction is not between international capital flow vs. financial services trade but whether the given transaction is also considered to be inward foreign investment, as in Cells IIa and IVa.

III. FROM WHENCE IT CAME: SERVICES IN THE WORLD TRADING SYSTEM

When the General Agreement on Tariffs and Trade (GATT) was created in 1947-48, it was designed in large part to address the impediments to merchandise trade which were believed to be responsible for turning the economic downturn of 1929-31 into the Great Depression; namely "beggar-thy-neighbour" economic policies underpinned by high tariff barriers at the border. However, by the end of the 1960's, the Kennedy Round rate reductions were beginning to make tariffs a largely secondary impediment to open trade, especially in the developed world. While the lowering of the tariff walls meant that countries had achieved freer trade from a textbook point-of-view, many other barriers, both subtle and explicit, emerged to hamper market access. In reaction, the center of the debate shifted away from tariffs to the more complex notion of "effective access". The ambiguity of this concept inevitably gave rise to rancorous debates over both the handling of non-tariff measures (NTMs) and the inclusion of the so-called "new issues" on the agenda. Among these "new issues" was trade in services, of which financial services was a de facto component.[1] In 1983, John Jackson explained the process at work and its consequences as follows:

> ⇒ *The receding waters of tariff and other overt protection inevitably uncovers the rocks and shoals of a variety of other barriers. Creating free trade requires attention to a group of interrelated activities such as the flow of capital, the flow of labor, the flow of technology and services, and these in turn revolutionize the methods by which governments have traditionally controlled such matters as fiscal and monetary policy, taxation, environmental regulation (and) product standards.*[2]

While negotiators were understandably concerned with "effective access", the reason they were willing to expend so much time establishing disciplines on services in particular stemmed from the growing importance of these sectors to the national economies of GATT members, especially in the developed world. The United States for example saw the value of its export of services rise from $6.3 billion in 1960 to $36.4 billion in 1978. to $111.1 billion in 1988 to and estimated $260.3 billion in 1998. Moreover, services now accounts for about 80% of US non-farm employment, including 7% in the financial services sector. In terms of content, while travel and transport services accounted for over 50% of the total services exports in 1997 ($135 billion of $239 billion), financial services exports did total some $13.5 billion. On a global basis, exports of services now account for 19% of world trade, totaling some US $1.3 trillion in 1998. Between 1990 and 1997, world services exports grew at an average rate of 8% per year, compared with 7% annually for goods.[3] With respect to trade in financial services specifically, Graph One below presents the data for the years 1987-1996 for six leading OECD economies.

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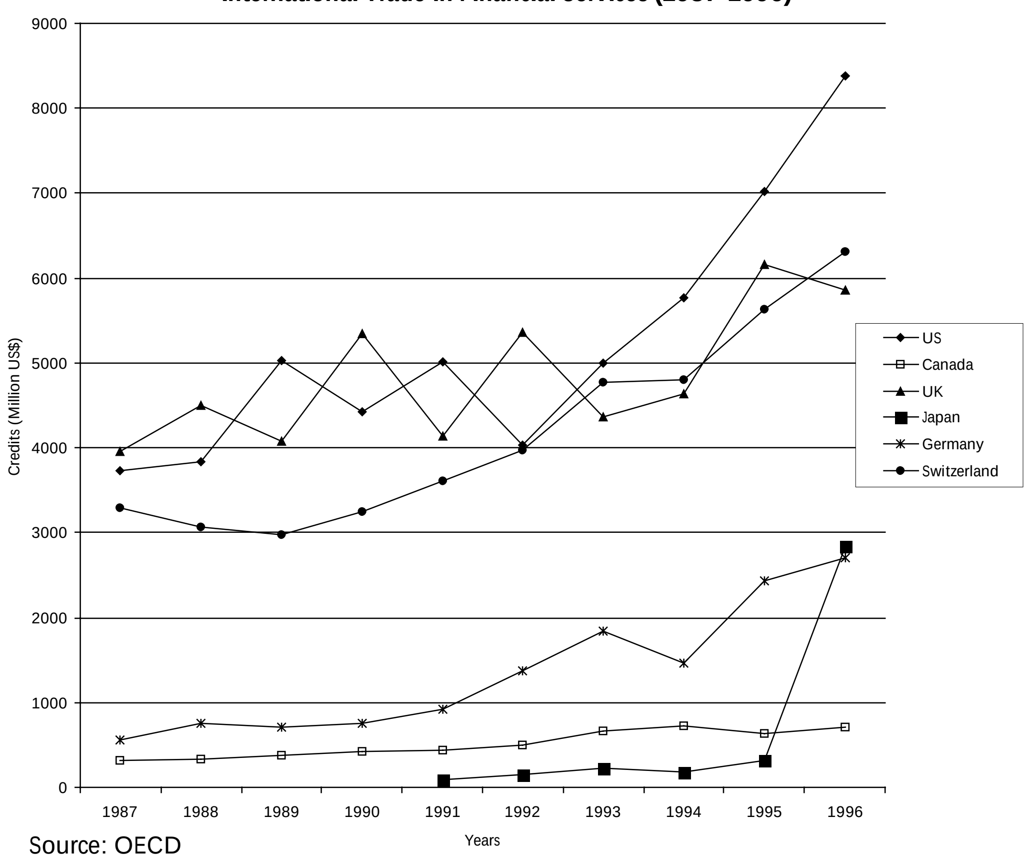
[1] In addition, the "new issues" included such matters as investment, intellectual property rights, government procurement, technical barriers to trade, etc.

[2] Jackson, cited in Michael Hart ([1996] p.74, n.33).

[3] The US statistics are taken from Tables entitled "US International Trade in Goods and Services", "Top Ten Services Exports, 1997", Services Chart 1". All were prepared by the International Trade Administration of the US Department of Commerce. The global statistics are taken from "Trade in Services: Canada in a Global Context", prepared by Industry Canada. It is available at *http://strategis.ic.gc.ca/SSG/sc00195e.html*.

When trade officials began to discuss the possibility of including services on the negotiating agenda, one of the biggest problems was deciding how to proceed. Because the output traded in a services transaction is often less tangible than that of a goods transaction and the restrictions faced are less easily quantifiable, it took sometime to develop a comprehensive framework for negotiations. It was finally decided to use as a model the methodology employed in negotiations on trade in goods and focus for the time being on the most obvious barriers to trade in services: those employed at the border. Thus, the initial aim of the negotiations would be to create rules governing the *cross-border* trade in services (the ability to supply services in the territory of another member). A broadening of the scope to include other "modes of supply" of services has slowly evolved.[4] According to the WTO Framework, these additional methods include: Consumption Abroad (the ability of the consumer to purchase services in the territory of another member); Commercial Presence (the ability to directly establish, operate, and expand); and Presence of Natural Persons (the ability of a foreign service provider to enter the territory of a member and stay temporarily in order to supply a service).

GRAPH ONE
International Trade in Financial Services (1987-1996)



Source: OECD

[4] For a history of the development and evolution of the framework employed for negotiating trade in services in the GATT, see W. Drake and K. Nicolaidis [1992].

IV. WHY ARE FINANCIAL SERVICES DIFFERENT?

While a unified methodology to approaching trade in services did emerge, political and economic considerations made it impossible to apply to a small number of specific sectors. One of these was trade in financial services. Although there are arguably many reasons for viewing financial services as different from tourism or air transport services, the core reason is very simple: the banking system is a fundamental support to the rest of the economy. When the other sub-parts of the financial sector are included, most transactions in a market economy rely in some way or another on the financial system. Two characteristics stand out: 1) the depth and breadth of the regulatory framework under which financial institutions operate is much greater than that applied other sectors; 2) while economies as a whole are increasingly globalized, the regulation of the financial sector remains almost exclusively in the national realm.

Because of both the central role of the financial sector in the economy and the dominant position of nation-states in regulating such activities, governments have, on the whole, been extremely reticent to negotiate substantive disciplines in this area. All fear agreeing to something that could potentially result in greater financial instability. At the same time though, national policy-makers recognize that the pressures of globalization necessitate greater competitiveness, efficiency and economies of scale in their financial sectors. Thus, the central challenge which governments face in this area is to reconcile greater openness with adequate stability in the financial sector. No other area on the trade agenda is potentially so important.

V. TILLING THE VIRGIN SOIL: SOME CASE STUDIES

In the early-mid-1980's, the multilateral trading system was in trouble. A deep global recession combined with a disastrous 1982 ministerial meeting that brought the "GATT close to serious breakdown"(Croome [1995] p.14) and a general upswing in protectionism made the prospects for maintaining the current level of openness in the system look bleak. Because it was almost impossible to realistically contemplate further liberalization or the adoption binding comprehensive rules covering the "new areas", the United States was deeply pessimistic about the prospects for progress at the GATT. In response, U.S. trade policy shifted increasingly toward a bilateralist path. The first concentrate manifestation of this policy was the Free Trade Agreement signed with Israel in April 1985. It included Articles on "Trade-Related Performance Requirements" (Investment), Intellectual Property, Government Procurement as well as Trade in Services. However, these were extremely rudimentary and therefore lacked the rigor to be effective.

First Steps: The Canada-United States Free Trade Agreement (CUSFTA)

The true birth of the modern comprehensive free trade agreement came with the Canada-United States FTA. The two countries were (and are) by far each others largest trading partners, making it the largest such relationship in the world. While this made the agreement very important, what made the CUSFTA truly revolutionary were the approaches that the two parties adopted to deal with the barriers between them. When negotiations began in 1986, Canada and the United States already had relatively low tariffs vis-a-vis each other. Therefore, the negotiation of tariff phase-outs, while important, was not central to the talks. Non-tariff measures, trade remedy laws, and structural/regulatory impediments constituted the largest sources of bilateral trade disputes. In response, a variety of groundbreaking provisions were included to help deal with these issues.[5] In doing so, the negotiators constructed a new paradigm for trade agreements that went well beyond the traditional border barriers and into the organization of the parties' national economies. Subsequently, it would become the prototype for the NAFTA and many other agreements Americas that followed.

Despite a basic consensus on the agenda, a number of sectors proved to be particularly controversial in the CUSFTA negotiations. One of these was financial services. Given the centrality of financial services to each party's economy as well as its tremendous political sensitivity (particularly in Canada), the negotiators agreed that a different approach was required. This resulted in the creation of separate specific chapter (Chapter 17) on financial services that was totally distinct from the main Services chapter. As will be seen below, the treatment of financial services as a unique area has been repeated in the comprehensive agreements to follow. And for good reason.

When the Canada-United States Free Trade negotiations began in the mid-1980's, the existing regulatory restrictions in the two countries' financial sectors consisted largely of ownership/

[5] These included: Chapter 13 (Government Procurement); Chapter 14 (Services); Chapter 15 (Temporary Entry of Business Persons); Chapter 16 (Investment); Chapter 17 (Financial Services); Chapter 18 (Institutional Provisions); and Chapter 19 (Provisions on the Binational Dispute Settlement Process).

types-of-activity measures and barriers to market entry.[6] Because of the relatively liberal and highly sophisticated nature of the two systems, Ottawa and Washington were open to considering rules in the CUSFTA governing the cross-border trade in financial services that provided not only for “standstill”, but also “rollback”. Be that as it may, this area proved (to no one’s surprise) to be one of the most sensitive and difficult of the entire negotiation. Moreover, Canada and the United States both knew that in negotiating disciplines on trade in financial services they were entering uncharted territory and chose to proceed with extreme caution.

Although the financial systems of Canada and the United States were characterized by a degree of stability and sophistication, the two systems were very different in many ways. (See Table Three). Canada, with its centralized structure and fears of American domination had long used basic entry, establishment and ownership restrictions that were designed to ensure a stable Canadian-owned system. The United States, on the other hand, had a more de-centralized market structure where the many banks often faced geographic restrictions on their operations and firewalls were maintained between the banking, securities and insurance sub-sectors. Given these divergent structures, the exchange of demands for greater cross-border liberalization struck at the heart of each country’s most important barriers. Canada sought a complete exemption from the provisions of the *Glass Steagall Act*[7] and the unfettered right to engage in inter-state branching for its financial institutions. The United States sought the full-scale liberalization of market entry conditions in Canada, including the elimination of ownership restrictions and capital ceilings.

Given their risk-averse nature on this matter, the parties opted to use a “positive list” approach for Chapter 17. In other words, only what is specifically listed in the Chapter is covered. All else is excluded. From their initial positions, each side made some gains, but the overall extent of liberalization achieved was relatively little.

In its list of commitments (Article 1702), the United States permitted Canada to lock-in its existing rights in the U.S. market, including the right to engage in commercial banking and an exemption from many inter-state banking restrictions. In effect, the U.S. agreed to permanently drop its "forthcoming review" of Canadian banking activities in the United States (Lipsey and York [1988] p. 90). The CUSFTA also gave Canadian banks, which are chartered and operating in the United States, the right to underwrite and deal in <u>Canadian</u> government securities.[8] This includes those of the federal government, provincial governments and crown (government-owned) corporations. Lastly, the U.S. committed to provide Canada with national treatment when making future changes to *Glass-Steagall*.

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[6] In the post-World War II period, governments used one or a number of six major policy mechanisms to achieve their regulatory objectives. These were: 1) interest rate controls; 2) securities markets regulations; 3) quantitative investment restrictions; 4) ownership and types-of-activities restrictions (i.e. fire walls); 5) market entry restrictions on foreign financial institutions; and 6) capital controls. The combination of instruments chosen by each country stemmed from their distinct national experiences, the structure of their economies and financial sectors as well as the problems that they were seeking to address. While these mechanisms worked well for the first two decades after 1945 (and continued to function with diminishing effectiveness for the next two), after the mid-1980’s many policy-makers began to actively eliminate them. See Edey and Hviding ([1995] pp. 5-10).

[7] The *Glass-Steagall Act* of 1933 established a firewall between commercial banks and securities firms. Following the 1929 stock market crash, some 9000 banks failed; many as a direct result of losses stemming from unregulated participation in the securities field. Although gaps permitting specific activities by banks in this area have appeared in recent years the law remains on the books. See Baer and Mote, ([1992] p. 503).

[8] While this was an important achievement because it broke through the *Glass Steagall* barriers separating the activities of banks and securities firms, it was, in a sense, the achievement of reciprocity because U.S. banks have always had the right to underwrite and deal in United States Government Securities sold in Canada.

TABLE THREE

THE CANADIAN AND UNITED STATES FINANCIAL SYSTEMS AT THE OPENING OF THE FTA NEGOTIATIONS

	Canada	United States
Nature of the Financial System	Centralized within each of the traditional sub-areas in the financial services sector. Eg. Banking dominated by the "big six" institutions.	De-centralized - Many different sizes types of firms.
Regulatory Approach	Governed by the "four pillars" approach that separated banks, securities firms, trust companies and insurance firms. Authority split: Banks were under federal authority; Securities were under provincial authority; Insurance and Trust were mixed.	No unified philosophy existed. In banking, regulatory responsibility split between federal and state levels depending on its charter. Securities industry was regulated by the SEC, a federal body. Insurance was largely regulated at the state level.
Number of Commercial Banks	66	13,000 (approx.)
Restrictions on Foreign Banks	Canada had two types of banks: "Schedule I" and "Schedule II" institutions. Foreign firms were effectively barred from receiving the "Schedule I" (full service institution) designation and thus were all classified as "Schedule II" banks.[9] A key mechanism, beyond Canada's investment screening rules, for guaranteeing that this bar was maintained was the so-called "10/25 rule". It prevented any single individual or firm (resident or non-resident) from acquiring more than 10% of the shares in a Canadian-controlled chartered bank and prevented non-residents as a group from holding more than 25% of the equity in such a financial institution. In addition to restrictions on types of activities, Schedule II banks also faced a ceiling of 16% of the total assets in the system.	The United States operated on a national treatment basis (In other words, they subjected foreign-owned banks chartered in the U.S. to the same restrictions as domestic-owned institutions). However, Canadian-owned banks did have some subsidiaries in more than one state. Prior to 1978, foreign banks were not subject to most inter-state banking rules. When the law was changed certain accommodations were made for the existing operations of these firms. Foreign-owned banks were permitted to open, subject to examination of the licensing state.
Banks permitted to engage in securities activities?	No	No
Banks permitted to offer insurance services?	No	No

Source: Complied by the author from the following sources: Chant ([1997] pp.15-16 and [1992] pp.174-176); Barth, Nolle and Rice ([1997) Tables 3-4); Kryzanowski and Roberts ([1992] pp.1-58); Baer and Mote ([1992] pp.555-594); Fayerweather ([1973] pp.171-172).

With respect to Canada's commitments (Article 1703), the United States not only locked-in its existing rights in the Canadian market, but succeeded in achieving modest gains as well. First, Canada granted the United States exemptions from two important provisions. First, U.S. financial service providers were exempted from the 16% capital ceiling applied to foreign

[9] "Schedule I" institutions were domestically-owned, widely-held, control most of the assets in the Canadian banking system, and permitted to offer all types of banking services. "Schedule II" institutions were predominantly foreign-owned and barred from branching, deposit taking as well as other activities.

firms[10] (See Table Three). Second, U.S. firms were exempted from the 25% limit on foreign ownership of a Canadian financial institution, as established in the so-called "10/25 rule" (See Table Three). The US had been seeking to blunt the effect of this law ever since it was introduced in 1967. However, the status quo in the Canadian banking sector after the granting of this exemption was largely unchanged. The 10% ceiling on individual ownership remained firmly in place. Moreover, Ottawa retained the right to review applications by U.S. firms to establish in the country. Be that as it may, Washington was able to extract a commitment from Ottawa to further liberalize its domestic regime, without offering a similar pledge in return. In subsequent years, Canada has followed through on this commitment. However, foreign ownership of "Schedule One" banks remains off limits.

In short, the CUSFTA financial services chapter consisted mainly of binding the status quo with some very modest changes. While far from optimal, it was no small achievement given that clear disciplines on trade in financial services had never before been established.[11]

A More Complicated Equation, A More Ambitious Agenda: The NAFTA

From a distance, the NAFTA financial services negotiations appear to have largely been a continuation of those in the CUSFTA: i.e. to trilateralize the bilateral agreement. However, given Mexico's turbulent financial history as well as its distinct social, political, and economic norms and structures, the negotiations had a much different dynamic. In addition, the NAFTA negotiations occurred at the same time as the Mexican financial sector was undergoing its most dramatic re-structuring in decades. The entire banking system was being re-privatized, regulations were being liberalized, and foreign investors were being permitted to participate in the financial sector for the first time in decades. Beyond these specific factors, the negotiations were more complex because Canada, Mexico and the United States not only sought to codify the status quo in the financial services area but to achieve a degree of liberalization as well. Thus, the NAFTA negotiations, like its predecessor, would venture into uncharted territory.

"(H)asta finales de los ochenta", as Catherine Mansell Carstens notes, *"el sector financiero mexicano era un claro ejemplo de represión financiera"*("until the end of the 1980's, the Mexican Financial Sector was a clear example of financial repression") Mansell Carstens ([1995] p. 17). Although the most visible reforms in the process of opening the system did date from 1990 onward, the origins of the contemporary financial sector can be found in the fallout from the 1982 debt crisis. On September 1, 1982, the Mexican Government adopted full exchange controls and nationalized the country's banks (with the exception of Banco Obrero and Citibank[12]) in an effort to stave off a system-wide collapse (Lustig ([1992] p. 25). For the next six years, the government largely ran the country's financial system. Nevertheless, Mexico's policy-makers did not seek to

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[10] The Canadian government revised the asset ceiling for non-US foreign firms downward to coincident with the entry into force of CUSFTA on January 1, 1989. See Kryzanowski and Roberts ([1992] p. 34).

[11] As a point clarification, the European Community moved to establish a common financial framework by means of the First Banking Coordination Directive of 1977 and the Second Banking Coordination Directive of 1988. However, these did not deal with trade in financial services per se. Moreover, the EC and its successor the EU have not sought to address these issues by means of a chapter in a free trade agreement. Its model of integration has been very different.

[12] See Wethington ([1994] p. 24). Banco Obrero and Citibank were also excluded from the process of rationalization which followed. See Peñaloza Webb ([1995] p. 14).

merely re-privatize the banks after stabilization had been achieved. They sought to dramatically re-shape the financial sector as part of their broader plan for re-making the Mexican economy.

The restructuring process began after the election of President Miguel de la Madrid in December 1982. The first step would be the forced consolidation of the banking sector. While a total of 58 banks were nationalized, after two phases of *racionalización* (1983 and 1985), only 18 banks remained.[13] In addition, the de la Madrid and Salinas administrations phased out most of the long-standing post-World War II style regulatory restrictions. (See Footnote 13). This process began with the dismantling of a number of firewalls between banks and securities firms in 1985 and ended with the complete elimination of capital controls in 1991.[14] Although the government began to actively prepare the way for re-privatization in 1988, a key moment came in June 1990 when the government approved *La Ley de Grupos Financieros* (The Financial Group Law), which permitted the existence of so-called *universal banks*. To ensure an orderly transition, the government set forth new rules on acquisitions and ownership by non-Mexican individuals. It was stipulated that total foreign participation in a Mexican financial institution was limited a maximum of 30% of the equity capital. Ownership of shares by a single foreign individual was limited to 10%. The limit for foreign institutional investors was 15%. Previously, foreign firms had been effectively frozen out of the Mexican financial services market. The actual process of re-privatizing the 18 Mexican banks got underway in June 1991 and lasted until July 1992, raising a total of $12.35 billion dollars (Adams [1997] pp. 24-25 and Wethington [1994] p. 26).

The architects of Mexico's economic restructuring after the debt crisis were a group of U.S.-trained economists and planners known as "the technocrats". Under the direction of Carlos Salinas de Gotari (first as Director of Planning and then as President), this group devised a plan that they believed would lead to the long-term stabilization and development of the country's economy. A key part of their approach was trade liberalization. This would be pursued unilaterally, multilaterally (through the GATT, which Mexico joined in 1986) and, most important of all, bilaterally with the United States.

The Heads of State of Mexico, the United States and Canada announced their intention to negotiate the North American Free Trade Agreement on February 5, 1991, some five months before the first bank re-privatization. In the financial services area, two distinct sets of negotiating objectives emerged. The United States and Canada sought to maintain the largely restrictive regime that they had established between themselves in the CUSFTA while pushing Mexico to grant the maximum possible degree of market access. Mexico, on the other hand, viewed the financial services negotiations as part of its broader banking and financial reform process. Although liberalizing its rules on international trade in financial services was seen as a way of encouraging capital inflows, maintaining stability in the banking system was felt to be the key. Therefore, although Mexico was willing to make binding market access commitments, it insisted on the establishment of a complex timetable to allow for a gradual introduction of foreign competition.[15]

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[13] The first total comes from Adams Jr. ([1997] pp. 12-14). The second total and dates of the rationalization comes from Peñaloza Webb ([1995] pp. 12-14).

[14] First part: Lustig (1992] p. 108); Second part: Schwartz ([1997] p. 156).

[15] For a more-detailed discussion of negotiating objectives, see Wethington ([1994] pp. 6-16).

As with the CUSFTA, the NAFTA financial services negotiations proved to be very contentious and resulted in the creation of a separate Chapter (Chapter 14). Nevertheless, it departed from the pattern of its predecessor in at least one fundamentally important way: the NAFTA Chapter was based on a "negative list" rather than a "positive list" approach. Where previously no rights or recourse had existed in the financial services area unless specifically designated, the parties were now required to list all provisions which they sought to exempt. This, in turn, meant it was possible to create a Chapter based on a common set of principles that all Parties would apply equally.

Specifically, Chapter 14 was based on two principles: 1) the right of establishment and the ability to provide services across borders; and 2) national treatment. Thus, the baseline from which the Agreement worked was that financial service providers in the three NAFTA countries were free to establish banking, securities, and insurance operations in any other NAFTA country. When receiving such investment, the host country was obliged to treat foreign firms no less favourably than it treats its domestic firms. In addition, residents of NAFTA countries would be able to purchase financial services from providers domiciled in another NAFTA country. Finally, the countries would not impose new restrictions on the cross-border provision of financial services.[16] While in terms of broader trade policy, these principles are not new, their use in this context is significant because they placed financial services squarely within a GATT-type framework for the first time. Although the distinctiveness of the financial services area is rightly preserved by virtue of it being addressed in a special chapter, the degree of uniqueness, and thus the basis for future justifications of special and differential treatment, has been reduced.

As noted above, the "negative list" approach of Chapter 14 required that all exemptions which the countries wanted had to be written into the Agreement. Accordingly, it is the reservations lodged by each country (rather than the principles) that illuminate the true degree of liberalization on trade in financial services. Annex VII of the NAFTA contains three country-specific schedules where these exemptions are set forth. In terms of results, the schedules reflect the negotiating objectives of each party to a significant degree.

Canada, which acted to maintain the status quo throughout the negotiations, made no new access commitments on trade in financial services. Therefore, the net effect of the Canadian Schedule was, without putting it as such, to extend the same commitments to Mexico as it had made to the United States in the CUSFTA. The "trilateralization of CUSFTA" approach was also adopted by the United States during the negotiations, with two key exceptions. The first of these pertained (once again) to the issue of banks in the securities business. Because 14 of the 18 Mexican banks had been purchased by integrated financial groups (Adams [1997] p. 25) when they had been re-privatized, the potential for conflicts with *Glass Steagall* was be great should they be permitted to operate without restrictions in the U.S.. Therefore, in its Schedule, the United States agreed that if a Mexican financial group, which owned a subsidiary bank or operated a branch or agency in the U.S. on January 1, 1992, acquires a Mexican securities firm with a U.S. subsidiary, they may continue to operate the subsidiary for five years on the condition that they do not expand through acquisition in the United States and restrict transactions between the U.S. firm and its affiliates. While the precedent this commitment set was important, it had little practical effect. The second key exception pertained to the provision in the CUSFTA under which Canadian banks had gained the right to underwrite and deal in Canadian

[16] These principles are set forth in "Chapter 14: Financial Services" [1993] and in Wethington ([1994] p .50).

government securities in the United States. Washington unwilling to extend this same right to Mexican financial institutions similarly domiciled in the United States.

TABLE FOUR

MAXIMUM INDIVIDUAL CAPITAL LIMITS IN MEXICAN FINANCIAL INSTITUTIONS

Type of Financial Institution	Maximum Individual Capital to be Authorized (Percentage of the Aggregate Capital of All Institutions of the Same Type)
Commercial Banks	1.5%
Securities Firms	4.0%
Insurance Companies:	
Casualty	1.5%
Life and Health	1.5%

Source: Compiled by the author from Mexican Annex VII (B)

As noted above, the NAFTA financial services negotiations focused principally on the degree of liberalization which Mexico was willing to undertake and the transition process for implementation. Given the minimalist approaches of Canada and the United States, Mexico's Schedule in Annex VII established the parameters for new liberalization in the area of trade in financial services in North America. While the main text of Chapter 14 grants Canadian and U.S. firms the right to acquire 100% of any Mexican financial institution (and vice-versa), this was effectively prevented for an extended period of time. Section B of Mexico Schedule establishes a two-phase process for liberalization. Phase One, known as the "Transition Period", runs from 1995 through 2000. During this period, a number of limitations on the establishment and operation of financial institutions are in force. The first of these set capital maximums which individual Canadian and U.S. firms were permitted to hold in specific sectors. (See Table Four). In addition, Mexico imposed steadily increasing market share limitations on aggregate foreign participation. (See Table Five).

TABLE FIVE

MEXICAN AGGREGATE MARKET SHARE LIMITATIONS

Type of Financial Institution	Percentage of Total Capital	
	Initial Limit	Final Limit
Commercial Banks	8%	15%
Securities Firms	10%	20%
Insurance Companies[17]	6%	12%

Source: Compiled by the author from Mexican Annex VII (B)

The effect of these measures ensured that the structure of the Mexican financial sector was not radically altered immediately after the implementation of the NAFTA. For example, due to the percentages for commercial banks, no foreign firm or group of firms could hope to acquire any of

[17] The transition period for insurance begins in 1994 and ends in 1999.

the country's three largest commercial banks. (Banamex, Bancomer and Serfin together represented some 50% of the Mexico's commercial banking assets).[18]

After the end of the "Transition Period", what could be informally designated as Phase Two would begin. While all limitations set forth in Tables Four and Five would be eliminated in the year 2000, a number of restrictions would remain. Some would end in 2004 and some would continue in perpetuity. The first of these pertained to the aggregate capital limitations. If, at any point during the first four years after the transition period, the total market share for Canadian and U.S. firms reaches 25% in the commercial banking sub-sector and 30% in the securities sub-sector, Mexico reserves the right to establish a one-time ceiling at those levels. The restrictions may not continue after 2004 and may not be kept in place for a period exceeding three years. Another limitation that remained in the commercial banking sector pertained to individual capital limits. Mexico, in essence, would review all proposed acquisitions of commercial banks or their assets and reject any which would give the acquirer control of more than 4% of the total assets in the banking system. This restriction will not be lifted after 2004.

Chapter 14 represented an important step forward in the broader process of liberalization in the area of trade in financial services. Although negotiated as a one-off agreement, the NAFTA included a mechanism for discussing further progress should the will to do so be there. Accordingly, the signatories are required to meet to "consult on further liberalization" no later than January 1, 2000.

In the final analysis, Mexico largely succeeded in achieving the measured liberalization that it had sought on trade in financial services in the NAFTA. In the banking sector, on which it placed the most importance, Mexico offered sufficient liberalization to encourage inflows of U.S. and Canadian capital, while protecting the countries three largest banks from foreign takeover. From a broader perspective, Chapter 14, like much the NAFTA, was an excellent example of the application of the principles of the "new regionalism". This concept holds that the benefits of international trade and integration agreements, like the NAFTA, go far beyond the traditional Vinerian model of trade creation vs. trade diversion. Among the most important of these additional benefits is that such agreements serve as mechanisms through which domestic policy reforms may be strengthened and "locked in".[19] A key assumption of this approach is that the consistent application of sound economic policies over time is the only way to ensure future growth and development. President Salinas and the Mexican negotiating team shared this assumption and thus, sought to limit the scope of flexibility of future Mexican administrations in the area of economic policy. Chapter 14, for example, mandates that Mexico must maintain a specified degree openness to foreign participation in the financial sector. To make this effective, the NAFTA offers the sticks of international pressure from the United States and Canada and a binding dispute settlement mechanism. This ensures that a policy reversal can not be effected without great cost.

[18] See Dobson and Jacquet ([1998 p. 275). On total assets see Adams ([1997] p. 127).

[19] For a good description of the additional benefits of the "new regionalism", including the lock-in of domestic reforms see Whalley [1996] and Fernández [1997].

While Mexico sought to use the NAFTA as a safeguard against future recalcitrant statism on the domestic front, the "lock-in" effect is not a one way street. The net effect of the Agreement was to create an increased level of integration and sense of mutual dependence. In the financial sector, as U.S. and Canadian financial institutions enter and expand in an increasingly open Mexican market, the level of interdependence and thus, the vulnerability to financial crisis in their partner country would grow. From a historical perspective, the NAFTA Financial Services Chapter offers an important case study because it marked the first time that developed countries with histories of largely stable financial systems linked themselves with a developing country with a history of financial instability. By including financial services in the NAFTA, Canada and the United States essentially cast implicit votes of confidence in the probable success and durability of Mexico's financial reform process. While the decision to offer this vote of confidence may turn out to have been wise in the long run, the experience in Mexico since the NAFTA seems to have underscored the need for greater transparency and broader international regulatory cooperation.

President Salinas consistently argued that the future economic development of Mexico depended on securing a free trade agreement with the United States. However, no one could have imagined how soon after its entry into force that the full impact of integration would be felt. On December 20, 1994, the Mexican government devalued its currency. This triggered run on the peso which, in turn, led to a huge hike in interest rates (Weintraub [1997] p. 54). Investors experienced a crisis of confidence in Mexico and unleashed the most serious financial turmoil in Latin America since 1982. Opponents of the NAFTA in the United States took the peso crisis as a confirmation of their position of opposing closer ties with Mexico. After having expended much political capital to pass the Agreement in Congress, the Clinton Administration now took the lead in mobilizing a $52 billion dollar *Exchange Stabilization Fund*, which successfully prevented a total meltdown of the Mexican economy.[20] It is unlikely that such an extensive rescue package would have been mobilized without the linkage provided by NAFTA.[21]

Multilateral Progress - Finally: The WTO Financial Services Agreement (FSA)

In the mid-1980's, when the United States and Canada turned their attention to negotiating of a bilateral free trade agreement and subsequently, the NAFTA with Mexico, they did not abandon the GATT process. In fact, throughout almost the entirety of these sub-regional negotiations, the two countries were among the most active participants in what would come to be known as the Uruguay Round. From the launch of multilateral negotiations in September 1986, trade in financial services was handled within the framework of the broad "Group of Negotiations on Services", rather than separately.[22] Nevertheless, the discussions barely mentioned anything beyond general framework issues until after the 1988 "mid-term review" in Montreal and really

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[20] The United States Government put up $20 billion, the Bank of Canada contributed $1.5 billion and the IMF (of which both countries are members) committed an additional $17.8 billion. In the end, Mexico only $24.9 billion from this fund and payed back the United States Government ahead of schedule. See Schwartz ([1997] p. 161).

[21] On a related point, in its survey of North American business executives, the Bank of Montreal found that some 97% of Mexican respondents and 81% of U.S. respondents believed that trade agreements provide "an incentive to aid trading partners in times of crisis". See Bank of Montreal [1998].

[22] This is not surprising since the Punta del Este Declaration that launched the Round was very vague about the specifics of negotiations on services. It called on countries to "aim to establish a multilateral framework of principles and rules for trade in services, including elaboration of possible disciplines for individual sectors".

only seriously focused on the provisions for specific sectors after the Brussels Ministerial in late 1990. As the foundations of what would become the General Agreement on Trade in Services (GATS) took shape, the negotiations on financial services became more explicitly divided. On one side was the United States, home to the world largest financial services sector, which insisted that other countries (particularly in the developing world) make substantial liberalization commitments in exchange for non-discriminatory access to the U.S. market. On the other side were most other participating countries, both developed and developing, which were unwilling to make far-reaching access commitments. Despite the best efforts of many, the divide remained stubbornly unbridgeable throughout the rest of the negotiations. Finally, on December 14, 1993, in the closing hours of the Uruguay Round, participating countries acknowledged that agreement on trade in financial services was not possible within the existing time frame.[23] Nevertheless, some 76 countries had made offers in one or more financial services fields (Dobson and Jacquet [1998] p .81) and there remained a general will to see the inclusion of financial services provisions in the GATS Agreement. Accordingly, countries agreed to a formula whereby negotiations would continue after the conclusion of the Round.[24]

The formula was a complicated compromise. Throughout the services negotiations, countries had been at odds as to whether the MFN principle should be applied unconditionally. Some countries, particularly the United States, were deeply concerned about the "free-rider" problem. In other words, they worried that their competitors, particularly in the developing world, could retain their relatively closed market conditions and continue enjoy the benefits from protection at home while having open access to less restrictive markets abroad.[25] In the GATS agreement, it was agreed that the MFN clause would be applied on a negative list basis (covers all services except those which are exempted by countries). As the endgame of the financial services negotiations proceeded, the United States (among others) indicated a willingness use the MFN exemption rather than agree to what it viewed as a sub-optimal agreement. In response, other countries would be almost certain to revoke their offers in this area. To get around these difficulties, countries agreed that the negotiations would continue after the conclusion on the Round and would be conducted on an MFN basis.[26] The "Second Annex on Financial Services" established that for a period of 60 days beginning four months after the entry into force of the Agreement, countries were free to improve modify or withdraw their offers. In other words, between May 1 and June 30, 1995, countries were free to withdraw their offers without penalty.

The Uruguay Round Agreements entered into force on January 1, 1995. As the designated negotiating period passed, the dynamic remained largely unchanged the Round. Despite improved improvements to almost 30 offers (counting the EU as one), including a significant improvement in the Japanese offer, the United States continued to argue that the degree of liberalization was insufficient. Accordingly, as the June 30 deadline approached, the U.S. announced the withdrawal of most of its offer and its invocation of an MFN exemption. Despite this action, the talks did not collapse. After securing one-month deadline extension

[23] For a description of the evolution of the services negotiations, including financial services see Croone [1995].

[24] Largely the same formula was applied to the post-Round negotiations on basic telecoms, maritime transport services and professional services.

[25] For a discussion of the "free-rider" issue, see Key ([1997] pp. 3-4).

[26] This description of the formula is contained in Hoekman ([1996] pp. 93-94).

the European Union and Japan moved to try to salvage the process and mold the best offers into an accord. The strategy worked. On July 26, 1995, some 30 countries plus the European Union concluded the Protocol on Financial Services. The signatories agreed to implement the accord on a provisional basis until November 1, 1997, at which time countries would have 60 days to complete a new agreement. Everyone understood that the size of the U.S. market and the clout of U.S. financial services firms necessitated the adherence of Washington to any agreement considered to have global standing. Following the 1995 Protocol, the U.S. and the EU worked diligently behind the scenes try to find common ground. This process continued after the resumption of active negotiations in April 1997. While the negotiations made slow progress throughout the summer and fall the outcome was by no means certain as the talks entered the final 60-day period (after November 1). Nevertheless, on December 12, 1997, almost three years after the entry into force of the Uruguay Round Agreements, a multilateral agreement on trade in financial services was signed by the United States, the European Union and fifty-four other countries. It entered into force on March 1, 1999.[27]

The WTO Financial Services Agreement (FSA)[28] was a landmark not so much for its content, but for the fact that it was concluded at all. The FSA was the first broad international regime ever negotiated in this area and means that trade in financial services is now subject to WTO disciplines on a permanent basis. The combined weight of the signatory countries represented over 95% of the world's trade in financial services. Although many offers merely consisted of an articulation of the then-existing status quo at the national level, expecting substantial liberalization from many countries was politically unfeasible at this time. This is in part due to the fact that the FSA process marked the first time that many of the signatory countries had tackled these issues at an international level.

The FSA consisted of 56 "Schedules of Specific Commitments" embodying the commitments undertaken by the 70 participating member countries. The European Union negotiates as a single entity at the WTO and consequently had one schedule for itself and its member countries. The Schedules themselves were divided into two basic parts: 1) limitations on market access; and 2) limitations on national treatment. Naturally, commitments vary based on the type of activity in question and the mode it is supplied. In addition to the Schedules, the FSA contained 16 "Lists of Article II (MFN) Exemptions" submitted by 16 countries. While the United States, for example, withdrew its broad MFN exemption list when concluding the December 1997 Agreement, it did replace it with a narrow list of exemptions. The FSA became part of the GATS as the "Annex of Financial Services".

As noted above, most trade in financial services currently takes place among the developed OECD countries. However, much of the projected growth in the future will take place in developing countries. Accordingly, the degree of liberalization commitments offered by developing countries was an important focus of the negotiations. Of these countries, those in Latin America were of particular interest to the United States. Since the end of the 1980's, almost

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[27] The chronology of the negotiations was taken from World Trade Organization [1999] and Dobson and Jacquet ([1998] pp. 80-84).

[28] The Agreement covers two basic types of financial services: 1) *insurance and insurance-related services*, which includes life and non-life insurance, reinsurance, insurance intermediation such as brokerage and agency services, and services auxiliary to insurance such as consultancy and actuarial services; and 2) *banking and other financial services*, which includes all the traditional services provided by banks such as acceptance of deposits, lending of all types, and payment and money transmission services. Other financial services include trading in foreign exchange, derivatives and all kinds of securities, securities underwriting, money broking, asset management, settlement and clearing services, provision and transfer of financial information, and advisory and other auxiliary financial services.

every country in the region had implemented a market-based economic reform program. For decades, foreign firms were severely restricted from participating or investing in the financial services sector. However, with the new economic approach the possibilities for liberalization were very real. Beyond the prospect of increased trade in financial services, an important U.S. motivation was arguably to help "lock-in" financial sector reforms undertaken by Latin American nations over the past ten or so years. Table Six offers a comparative examination of the pre-agreement status quo and the FSA commitments undertaken for selected countries in the region. Rather than offering an in depth analysis of the schedule of each signatory country worldwide (which would be a paper on to itself), this Table is designed to serve as a representative overview of the multitude of developing country approaches in the FSA.

TABLE SIX

THE WTO FINANCIAL SERVICES AGREEMENT IN LATIN AMERICA: SELECTED CASES

Country	Pre-Agreement Status Quo (December 1997)	FSA Commitments
Brazil	Foreign participation in the Brazilian financial services sector was restricted by a series of direct and indirect obstacles. Banking: foreigners were permitted to own up to 100% of existing commercial banks. Regulatory approval was given on a case-by-case basis by means of a Presidential Declaration. In addition, the Brazilian Constitution grants Congress the authority to prescribe requirements for foreign bank entry. (No such action had been taken up to the date when the FSA was signed). Securities: foreigners were permitted to control up to 30% of the voting shares (and 49% of the total shares) in an existing Brazilian investment bank. The Brazilian Constitution prevented the establishment of new foreign securities firms or the expansion of existing ones, unless this was deemed to be in “the national interest”. Insurance: regulations vary. A 1996 Presidential Decree gave foreigners the right to own up to 100% of a health insurance firm. Other sub-sector still faced certain investment and establishment restrictions.	Brazil’s schedule largely reiterated the status quo, but did not bind its commitments. Banking: the establishment of new branches and subsidiaries, increases in foreign participation in an existing Brazilian financial institution as well as foreign participation in the privatization of public financial institutions is permitted, subject to approval on a case-by-case basis. (Presidential Decree required). Securities: only legal persons may provide clearing services for securities and derivatives and handle public offerings of securities in a regulated over-the-counter market. Otherwise, foreign securities firms are allowed to offer a range of services, subject to approval on a case-by-case basis. (Presidential Decree required). Insurance: no restrictions are placed on the cross-border supply of freight insurance for exports and auxiliary services - consultancy, actuarial and surveys. Brazil agreed to undertake commitments on workplace accident insurance (then provided by a sole supplier) and on commercial presence in the reinsurance and retrocession markets within two years of the adoption of legislation on these areas in Congress.
Chile	Chile permitted 100% foreign ownership of any and all financial services firms and regulated all parts of the financial sector on a national treatment basis. Banking: Chile required foreign banks to be incorporated in their home countries and to meet Chilean capital requirements. No national or foreign legal person could acquire shares representing more than 10% of a bank’s capital without prior approval from regulators. Leasing services could only be offered through subsidiaries. In response to prudential considerations, the Banking Law was amended December 1997 to allow the Superintendent of Financial Institutions to deny applications for new banking licenses. This same amendment explicitly clarified the criteria for doing so. Securities: Firms were required to enter the securities sub-sector through subsidiaries. Insurance: No entry into the insurance market was permitted through branches.	Chile’s Schedule incorporated all of the principles on which its financial services regime was based: national treatment in entry, ownership, activities and regulation. It did require appropriate registration for banks, securities, and insurance firms and reserved the right to take prudential measures where necessary. However, these measures were applied equally to Chilean and non-Chilean firms alike. Given its already favorable regime, Chile undertook no commitments of note in the Banking, Securities, and Insurance areas. Hence, the FSA had no direct effect on the Chilean regime. Like virtually all countries, Chile wrote down but did not bind its commitments. Finally, for purposes of clarification, it should be noted that no aspect of Chile’s December 1997 Amendment to the Banking Law was discussed in the context of the FSA or included in its FSA Schedule.

TABLE SIX (cont.)

Country	Pre-Agreement Status Quo (December 1997)	FSA Commitments
Costa Rica	The Costa Rican financial services sector was relatively open to foreign participation. Banking: Foreigners were permitted to own up to 100% of the shares in any and all commercial banks and were regulated on a national treatment basis. However, they were required to be chartered in Costa Rica and therefore, entry through subsidiaries, not branches. The approval process for applications for bank licenses was based on transparent, clearly defined criteria. In order to receive access to the Central Bank's discount window, private commercial banks, both foreign and domestic, were required to lend between 10 and 17 percent of their short-term assets to state-owned commercial banks and/or open branches in the rural areas of the country. Securities: Any and all securities firms could be up to 100% foreign owned and were regulated on a national treatment basis. No entry through branches was permitted. Insurance: The insurance sector was controlled by the *Instituto Nacional de Seguros (INS)*, a state-owned monopoly. The INS issued retail licenses to providers around the country. Foreigners were restricted in their access to such licenses.	Costa Rica's Schedule largely re-iterated the status quo, but did not bind its commitments. Banking: No restrictions were placed on the commercial presence of foreign banks and their activities in the areas of acceptance of deposits, lending, credit-card services, etc.. In a change to its existing regime, Costa Rica agreed to allow the offering of financial leasing on a cross-border and consumption abroad basis rather than just by firms with commercial presence in the country. The "short-term asset" requirement was not included in the Schedule. Securities: Costa Rica did not distinguish between banking and securities in its schedule, (referring to instead "Banking and other financial services" (excluding insurance)). Therefore, the same liberal approaches that were applied to banks were also applied to securities firms. Insurance: Costa Rica made no commitments on insurance.
Venezuela	By December 1997, Venezuela's financial system was finding a new equilibrium after a number of years of substantial change. Banking: In 1994-95, Venezuela experienced a banking crisis that necessitated nationalization of major financial institutions. As the crisis passed, the government moved to restructure the financial system. In April 1996, a law permitting the operation of universal banks entered into force. Restrictions on foreign investment were reduced and foreigners acquired controlling interest in at least five re-privatized banks. Foreign banks could establish branches or acquire Venezuelan banks provided they received proper certification (following a lengthy approval process) and met Venezuelan capital requirements. They were regulated according to the principle of national treatment. Securities: Securities firms were subject to largely the same rules as banks. Insurance: The insurance market for was opened after the 1994-95 crisis. It was estimated that between 60-70% of the market would be in foreign hands by December 1997. As with banking and securities, investment in the insurance sector was for the most part largely unrestricted, conditional on regulatory approval. However, entry through branches by brokerages was not permitted.	Venezuela's has moved from overt protection to basic openness in its Financial Services Schedules. Banking: Its original 1994 Schedule stated that: "New banking institutions cannot be authorized unless they are 100 per cent Venezuelan owned". However, its 1997 FSA contained no built-in deviations from the application of the national treatment principle in banking. However, at least half the Members of the Board of each bank or financial institution must reside in Venezuela. In addition, reserved the right to request "conditions of reciprocity" for Venezuelan capital in the countries from which foreign capital is originating. Securities: Venezuela lodged no exceptions to the application of the national treatment principle in the Securities area. The same reciprocity and residency requirements as in the banking area applied, with the addition of a requirement that the Administrators of a brokerage house must be Venezuelan residents. Insurance: The approach to national treatment and reciprocity are largely the same in insurance. However, Venezuela reserved the right to ban insurance companies operating in the country from concluding reinsurance contracts with other companies. In addition, he prohibition against brokerage branches was retained. With respect to residency requirements, half the board and half the Vice-Presidents, Directors, etc. of an insurance company had to be domiciled in Venezuela. For brokerages, the President and 3/4 of the executives had to be domiciled in Venezuela.

Source: Compiled by the author from the following sources: 1) the WTO Schedules in their various versions: a) Brazil: GATS/SC/13; b) Chile: GATS/SC/18; c) Colombia: GATS/SC/20; d) Costa Rica: GATS/SC/22; e) Venezuela: GATS/SC/92; 2) Non-Attributable summary of the main improvements in the new financial services commitments. (WTO [1999]).; 3) Global Survey 1997 and Global Survey 1998;: 4) 1998 National Trade Estimate Report on Foreign Trade Barriers; 5) The Economist Intelligence Unit: a) "Venezuela: 1996-1997 ([1997] pp. 24-25); b) "Venezuela: 1998-1999" ([1998] pp. 28-30); 6) CONAPRI [1997]; 7) Bevilaqua and ([1998] p. 3); 8) Selected parts of Dobson and Jacquet [1998]; 9) Discussions with Jamie Granados, Former Director of Trade Negotiations, Costa Rica.

With respect to the NAFTA countries, the results of the WTO Agreement were modest. As noted above, Canada's financial system was relatively closed to foreign participation in banking and relatively open in other sub-sectors. In the FSA, Canada agreed to allow branching directly by foreign financial institutions and to remove a clause from its national legislation requiring foreign bank subsidiaries to seek authorization before opening additional branches. The government's intention to do so was evident when it introduced legislation along these lines in Parliament in February 1997.[29] While the change in branching rules was significant and garnered a great deal of attention, the Canadian government was careful to safeguard the integrity of the current system. As of July 1, 1999, foreign banks may: 1) exist as a fully regulated Schedule II bank; 2) operate as a foreign branch, restricted to dealing with large retail investors and from taking deposits less than US $150,000; or 3) become a lending branch with a capital requirement of US $100,000 or a 3% liability, provided minimal capital requirements are met. Ultimately, nothing in the legislation or in the FSA will affect the dominate positions of the Schedule I banks.[30]

With respect to the United States, it bound its commitments to deal new entrants and activities undertaken by foreign financial services suppliers on an MFN basis in the insurance, banking and securities fields. The U.S. Schedule also committed to the elimination of a variety restrictions existing at the state level. In keeping with recent changes in U.S. law, it also included a commitment to provide market access and national treatment with respect to inter-state banking.[31] While these changes are important, they do not mark a dramatic departure from the pre-existing status quo.

Mexico's approach marked a continuation of the general policy direction established prior to the NAFTA negotiations. In the FSA, it bound its commitment to raise the ceiling for common stock capital from 30% to 40% (and up to 100% of the additional capital) for banks and insurance companies. This ceiling was raised to 49% for foreign exchange houses, investment houses, etc.. Hence, the FSA did have a "lock-in" effect to some degree. The rest of Mexico's Schedule was largely an unbound articulation of the status quo. Because the FSA was establishing an MFN basis for financial services, Mexico obviously did not place its NAFTA commitments in its Schedule.[32]

[29] See Department of Finance Canada [1997].

[30] For the specifics of permissible activities see *Americas Trade* ([1999] pp. 11-12). Canada's final WTO Schedule is GATS/SC/16/Suppl.4.

[31] See the U.S. Schedule: GATS/SC/90 and Non-Attributable Summary (WTO).

[32] See the Mexican Schedule: GATS/SC/56 and Non-Attributable Summary (WTO).

VI. THE END OF THE BEGINNING: CONCLUSIONS AND FUTURE DIRECTIONS

It was scarcely a decade ago that the Canada-United States Free Trade Agreement broke the mold and included provisions on trade in financial services. In the intervening years, the incorporation of such disciplines into free trade agreements has become increasing common. However, this does not mean that trade in financial services as an issue has been "dealt with" and will not slip off the policy agenda in the years ahead. What is more likely to happen is that the nature of the debate will change. While the decade between 1989 and 1999 can be characterized as the "inclusion phase" of disciplines on trade in financial services, the next ten to fifteen years will probably be described as something approximating the "deepening phase". The principle ethos this period will not be to articulate the national status quo in an international agreement while offering only marginal liberalization. It will be to begin to construct common regional and international rules to govern not only trade in financial services, but ultimately integrated financial systems. That said, the "inclusion stage" will continue for those countries that have yet to face the issue, but which will do so in the next few years, even while the main thrust of the global debate moves on. Three principle issues remain to be addressed: in what fora will future negotiations take place, what will be the pace of this process, and what are the possible outcomes.

Rule-making will continue at different levels: global, regional, sub-regional, and bilateral

A multitude of trade negotiations are underway around the world[33] at the bilateral, sub-regional, regional and multilateral levels. While not the case for all, many of these initiatives will include provisions on trade in financial services in their final texts. In their first decade, provisions on trade in financial services have most often appeared in bilateral and sub-regional free trade among a limited number of countries with a harmony of interests agreements (such as the CUSFTA and the NAFTA). The rationale for going the bilateral or sub-regional route remains strong today for many countries, especially those addressing these issues for the first time. In essence, this approach allows one to go farther, faster and to have more control over exceptions.

When the NAFTA provisions were negotiated, they were the most sophisticated in the world and arguably have yet to be surpassed. However, in the medium to long term as further disciplines in other Agreements come on line, these once cutting edge disciplines risk becoming static. A key weakness of many sub-regional FTA's is that they include no internal mechanisms capable of facilitating the modification of parts of the agreement as conditions change.[34] Despite the promise in the NAFTA to "consult on further liberalization" before 2000, no definitive "built-in agenda" exists that obligates the parties to return to the negotiating table.

The transition from the CUSFTA to the NAFTA tells us something very important about the transition. Being the vanguard agreement in the financial services area, the CUSFTA contained

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[33] The most active region is the Americas where negotiations in progress include: Intra-regional: Free Trade Area for the Americas (FTAA); Andean Community-Brazil; Andean Community-Panama; CACM-Chile; CACM-Panama; Chile-Panama; Costa Rica-Trinidad & Tobago; Mexico-Belize; Mexico-Ecuador; Mexico-Northern Triangle (El Salvador, Guatemala, Honduras); Mexico-Panama; Mexico-Peru; Mexico-Trinidad & Tobago; Mexico-Uruguay; Extra-regional: APEC; MERCOSUR-European Union; Mexico-European Union; Chile-European Union; CARICOM-European Union (Lomé Convention renewal); Canada-EFTA; Chile-South Korea.

[34] In another sense, this can also viewed as one of the main strengths of the model since it permits the "lock-in effect" to work over time.

no provisions for future modification. Thus, the improvements in the NAFTA financial services regime were made possible because the whole bilateral Agreement was re-negotiated to facilitate the inclusion of Mexico. If sub-regional agreements based on the "inclusion phase" model are to eventually be deepened, a new set of comprehensive negotiations is required that includes the all signatories to such agreements is required. While not designed as a successor to sub-regional, the Free Trade Area for the Americas (FTAA) process underway in the Western Hemisphere could serve this purpose[35]. To date though, the modalities of services negotiations have not been fully determined. Therefore, it is unclear what form a financial services agreement may take.[36] Such talks could eventually begin across the Pacific as well under the auspices of APEC.

On a global level, financial services will return to negotiating table by January 1, 2000 as part of the WTO “built-in agenda”.[37] Moreover, it is widely believed that countries will take the contents of the “built in agenda” as a base and launch a comprehensive “Millennium Round” of trade negotiations at their November 1999 meeting in the United States. Financial services will stay on the agenda at the WTO, if only because of the evolutionary character of its negotiating processes where each successive round builds on the legacy of the last.

Progress will be very slow

The financial services industry is changing rapidly on many levels. From the decline in from the increase in cross-border bank mergers to the decline in traditional banking, to the rise of the mutual fund, to the emergence electronic banking, market forces and technology are remaking the landscape of this sector. Governments have a necessary role in regulating the financial industry. However, the task of doing this effectively and efficiently is becoming increasingly difficult. As the pace of change accelerates, one would expect governments to redouble their efforts to respond to the changing realties. Nevertheless, a number of factors mitigate against this.

The first of these, as noted above, is the natural reticence of governments to make major decisions affecting their financial systems without first analyzing all possible ramifications. With all government approaching financial services liberalization with a cautious disposition, advances in the deepening process can not help but take a long time.

The second factor is related point one above. It is generally more efficient to negotiate an agreement between two parties than among many parties. While one-off bilateral FTAs can be negotiated in as little as a few months, regional bilateral agreements take much longer. The FTAA is scheduled to be completed by 2005. Drawing on the experience of the Uruguay Round, a new multilateral Round would no doubt take much longer. Moreover, the application of the "single undertaking" principle ("nothing is agreed until everything is agreed") that progress on

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[35] While existing sub-regional agreements are seen as building blocks for the FTAA, their integrity will be preserved and they will continue to operate after the Hemispheric Agreement enters into force.

[36] While a hemispheric harmonization at the NAFTA level seems unlikely, mechanisms may be devised that allow countries to improve upon and expand disciplines that currently exist in sub-regional agreements. This would depend on the adoption of something like a hemispheric Article XXIV. An optimal Agreement on trade in financial services would include a mechanism for "built-in" future negotiations.

[37] For an examination of the “built-in agenda”, see *Integration and Trade in the Americas: Periodic Note*, July 1997, Annex II.

liberalization of financial services is subject to the overall negotiating clock. In addition, the Uruguay Round approach of continuing the clock for the same negotiations in selected areas after the rest of the Round concludes sets a potentially dangerous precedent for future negotiations, despite the fact that things worked out well this time. If this is an option countries may seek to deflect the pressure to compromise that the single undertaking principle encourages and refuse to deal with sensitive issues until they are isolated in a post-negotiation negotiation. Therefore, if one is going to effectively include a "built-in" agenda process, a decent interval of time needs to separate one negotiation from the next.

A third and very important factor public skepticism about further liberalization of trade in financial services. This stems from three basic sources. The first is general skepticism in certain quarters about trade liberalization in general. The second is a lack of understanding about what trade in financial services is as opposed to capital flows. The global economic crisis of 1997-1999 illuminated downsides inherent in capital mobility and the set of a backlash in many countries against a further liberalization of the current account. Unfortunately, the two have become intermingled in the public mind. The third source of skepticism arises from concerns about what liberalization will mean for the health and stability of the financial system. These factors can only be countered with a vigorous presentation of the case for the liberalization coupled with the inclusion in agreements of workable measures to address the stability and integrity concerns.

The Beginnings of an International Regulatory Framework

Integration is a multi-layered process. New sets of rules are required to underpin and ensure the workability of the initial ones. As such, in the years ahead, when countries agree to further liberalize international trade in financial services, it is also probable that they will move to establish the rudiments of a cross-border regulatory regime. This stems from the fact that as financial services firms are permitted to operate with greater freedom across borders and face greater competition in their home markets, governments will seek ways to ensure that the same level of stability exists in the system after integration as before. Given the complexity of the questions involved and the applicability of such rules well beyond the confines of international trade in financial services, it is unlikely that such a regime would be negotiated directly in the context of an FTA. What is more likely to happen, at least initially, is that countries will agree to adhere to existing international agreements by reference.

The most likely candidate for such inclusion is the *Basle Capital Accord*. When it was signed in 1988, the Basle Accord established, for the first time, a common capital adequacy standard[38] for internationally active banks. Although it was an Agreement among the G-10 countries[39], those outside this group have been encouraged to adopt its standards. In September 1998[40] the Basle Committee on Banking Supervision began a wide-ranging review of the Accord which is likely to

[38] It established an 8% minimum capital ratio

[39] The G-10 comprises Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom, and the United States. See the Basle Capital Accord, July 1988.

[40] See "Basle Reform" ([1998] p. 2).

eventually result in its modernization. The regime has been attacked in recent years by the banking sector as outmoded due to simplistic models for calculating risk. Despite this, the Basle Accord remains central to ensuring bank soundness on an international level and has an unparalleled credibility among regulators. When, in future trade agreements, governments authorize greater foreign participation in the banking sector, they will demand greater transparency in return. In other words, countries will seek ways to ensure that foreign banks establishing in their territory or investing in existing financial institutions are sound, particularly if such institutions have access to a national lender-of-last-resort. Therefore, whether reformed or not, the Basle capital adequacy provisions are likely to be included.

One effect of an increasingly frequent incorporation of the Basle Standards may be to facilitate a closer relationship between the WTO and Bank for International Settlements (under whose auspices the Accord was negotiated), particularly at the technical level.

Another candidate for possible inclusion by reference may be the *United Nations Convention on International Bills of Exchange and International Promissory Notes* of 1988. This Agreement marked the culmination of a long-standing effort to harmonize international payment law. As such, countries may seek to include such provisions in free trade agreements in order to ensure a reciprocal environment of predictability. However, although it was regarded as a milestone when it was concluded, to date, only five countries have signed the Convention and two have ratified it. Therefore, more countries will have to come on board before it can achieve the critical mass necessary to become a standard.[41]

The years ahead will be challenging for those seeking to build on the rudiments of liberalization of trade in financial services that has been achieved to date. However, the continuous integration of the global financial system and more generally, the global economy will necessitate that this process moves forth. The challenge for policy-makers is to be both responsive to change, yet prudent. Liberalization done well can bring tremendous benefits to an economy. Liberalization done poorly can have devastating consequences.

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[41] The countries who have signed are: Canada, Russia, and the United States. Those who have ratified are: Guinea and Mexico. See "Status of Conventions and Model Laws " ([1999] p. 8). For a good overview of the Convention and its provisions see Cheng ([1994] pp. 261-281).

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