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Editors' Summary

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Editors' Summary

IT HAS ALMOST BECOME A CLICHÉ to say that financial services have become “globalized,” but it is true. By any relevant measure—volume of foreign exchange transactions, amount of cross-border financial flows, or amount of cross-border investment and merger activity among financial firms—finance and financial services have become global activities. This third volume of the *Brookings-Wharton Papers on Financial Services* explores various dimensions of this ongoing process through papers that examine global trends in the banking and reinsurance industries and securities markets, the challenges these trends pose for national regulations, the evolution of global accounting standards, the alleged impacts of global hedge funds on capital flows in and out of emerging markets, and the erosion of legal barriers to the establishment of foreign financial service firms around the world.

Together, these papers offer the reader a view of a sector that is increasingly globally interdependent. Firms, markets, trading activity, and even the distribution of retail financial products are all becoming more global. However, this movement is not always direct and is not without problems. It places new pressures on regulators and policymakers to understand both the movement toward globalization and the factors that cause it.

Globalization, however, is manifested not only in finance but also in the increasing interdependence among nations in the trade in goods and services. Secretary of the Treasury Lawrence Summers opened this year's

conference, held in October 1999, with a broad-ranging address on the economic and political challenges facing this nation as a result of globalization. Summers analogizes the economic optimism of the late 1990s, at least in the United States, with similar feelings in the late 1920s. He warns America not to make the same mistakes the world made in the 1930s, when the world economy spiraled out of control, laying the seeds for the rise of fascism and the Second World War that was required to end it. Instead, he urges America to continue advancing open-market policies here and elsewhere around the world, to continue America's commitment to the multilateral development banks, and to invest at least some of the budget savings from the end of the cold war in helping other countries to move rapidly from the third world to the first.

The first three formal papers in the volume provide a view of the consolidation process. The first is a comprehensive study of large bank mergers—concentrating on those involving banks in different countries—by several experts from the Federal Reserve System (Allen Berger, Robert DeYoung, and Hesna Genay) and Gregory Udell.

Such mergers have been much in the news in recent years. Within the United States alone, the domestic banking industry is being transformed by a series of large consolidations. The marriage of NationsBank with Bank of America and the conglomerate combination of Travelers and Citibank are just two examples. Among cross-border transactions, the takeover of Bankers Trust by Deutsche Bank has signaled that even the largest U.S. financial institutions are now in play in the international merger arena.

In Europe, consolidation in banking across borders is being driven largely by the introduction of the euro, which has exposed inter-country differences in costs and prices and thereby distinguished the weak from the strong. In fact, the volume of cross-border merger and acquisition (M&A) activity now exceeds within-country mergers among insurers and securities firms.

Meanwhile, in Japan, one mega-consolidation—involving Fuji Bank, Dai-Ichi Kangyo Bank, and the Industrial Bank of Japan—has produced the world's first trillion-dollar institution, measured by asset size. The combination of Sumitomo Bank and Sakura Bank has formed another financial giant, with other large mergers likely to follow.

Berger and his colleagues focus much of their paper on the causes of this worldwide wave of banking consolidation, concentrating on which of the two main hypotheses about the efficiency of cross-border mergers in particular is best supported by the available empirical evidence. These competing theories are known as “home field advantage” and “global advantage.”

Under the home field advantage hypothesis, domestically owned banks are more efficient than banks from other countries. The authors note that this result has been found in previous studies. It has been argued that this advantage can arise because it is expensive to monitor operations and to acquire local customers from a distance. In addition, the home field advantage may be due to the difficulties of overcoming differences in language, regulatory structures, and other country-specific characteristics.

The alternative global advantage hypothesis rests on the view that international banks have superior managerial efficiency and other best practices that they spread to acquired institutions in other countries. In the process of diversifying risks of the entire organization, therefore, these large banks are able to overcome any disadvantages favoring home field institutions.

To assess which of these two views is most accurate, the authors examine the performance of both foreign-owned and domestically owned banks in five countries—France, Germany, Spain, the United Kingdom, and the United States. In the process, they distinguish between the particular national owners of the foreign banks, so that they can investigate whether banks from specific countries are more efficient than the others.

The authors find results that, on the surface, seem to support the home field advantage thesis. Based on data for 1992–97, domestic banks in the countries they examine have both more efficient cost structures and more efficient profit structures than do foreign banks. Nonetheless, on digging deeper into the data, they find significant differences among banks located in particular countries. While domestic banks may be more efficient than foreign-owned banks from *most* countries, in several cases both types of institutions are about equally efficient, and banks from one country—the United States—dominate as the most efficient producers in whatever country they are located.

The authors believe that their results, subject to the usual caveats about the limitations of available data, have several important implications for future global banking. First, the finding that foreign banks are, on average,

less efficient than domestic banks implies that efficiency considerations may limit the global consolidation of the financial services industry. Second, at the same time, some highly efficient global financial institutions from certain countries (notably the United States) may nonetheless be quite successful in expanding their global reach. Third, a goal for future research is to locate the source of the efficiency advantage of U.S. institutions in particular. Does it flow from factors relating solely to the institutions and markets themselves, or have changes in policies—such as recent moves to deregulate interest rates or limits on domestic geographic activities—been a significant factor? If policy considerations prove to be important, then the efficiency gains from the Single Market Program in the European Union (EU) may facilitate further global expansion of EU-based financial institutions in particular and make the U.S. advantages short-lived.

The banking industry is not the only financial industry experiencing a wave of consolidation. A similar trend has been under way throughout the 1990s in the insurance and reinsurance markets. The reinsurance market is global in nature to an even greater degree than any other segment of the financial sector. These firms assume a large volume of the low-probability, high-consequence risks that primary insurers may not want or be able to assume themselves and thus are part of a network of firms that backstop primary insurers worldwide. In the next paper in this volume, David Cummins and Mary Weiss seek to explain the driving forces behind mergers in the reinsurance industry during the 1992–97 period, in particular, based on a sample of 130 reinsurers.

The authors begin their analysis of the industry by outlining some propositions basic to insurance. One is the law of large numbers, which insurers rely on to ensure that the total value of claims by their policyholders in any single period is reasonably predictable. The law of large numbers works, however, only if the risks in the pool are independent of one another. Markets where this is true and where the risks posed by each policyholder are not large—as is the case with auto insurance in the United States, for example—are said to be *locally insurable*.

But what about markets where there are relatively few insurers, each with sizable risks (even though they may be independent)? The risk posed by oil spills is an example: the probabilities of individual spills may be uncorrelated, but there are not many oil tankers and the losses their spills

may cause can be substantial. Such markets nonetheless may be *globally insurable*, provided the insurer or reinsurer is able to assemble a sufficiently large pool of policyholders to bring the premiums into a reasonable range. Similarly, risks may also be globally reinsurable where losses are locally dependent but globally independent. Examples here are the markets for insurance coverage for tornadoes or similar natural disasters where geographic diversification across countries permits diversification of risk.

A third category consists of events that are neither locally nor globally insurable: high-consequence occurrences with low frequency where the individual risks are highly dependent. Examples include large hurricanes or earthquakes, which can cause massive losses to many individuals and businesses simultaneously. The authors argue that the reinsurance industry as a whole may not have the capital to withstand losses from such very large natural catastrophes. However, it may be possible for capital markets to handle such risks through securities linked to catastrophes. The authors call these risks *globally diversifiable*.

A final category of *globally undiversifiable* or *cataclysmic* risks consists of events that are so severe that even the capital markets may not be able to bear them. The best example is a severe earthquake in Tokyo, which could cause losses exceeding \$3 trillion, or as much as 70 percent of the gross domestic product of Japan.

Building on these propositions, the authors proceed to test a series of hypotheses about the causes of recent mergers among global reinsurers. They begin with the causes implied by what is known as Borch's theorem (named after its developer Karl Borch), which holds that the market for reinsurance is most efficient when all reinsurers hold a proportionate share of the market portfolio of insurance risk. This theorem implies that, as the reinsurance industry consolidates resources in a fewer number of firms, the industry comes closer to operating as a single firm and thus should be better able to withstand catastrophic losses.

Cummins and Weiss find that the evidence supports Borch's theorem, at least during the period they examine. They estimate that the accessible capacity of the industry—the proportion of claims that reinsurers can collectively cover for losses reaching as high as the total premiums and equity capital of all reinsurers—rose from 82 to 92 percent over the period. Furthermore, they estimate a significant decline in the number of possible insolvencies among reinsurers resulting from catastrophic losses of various magnitudes.

The authors also find that consolidation has been motivated by a search for improved operating efficiency. Larger insurers are more efficient than smaller ones, suggesting that as the average size of firms in the industry increases due to consolidation, the resulting firms are better diversified and more efficient. A related conclusion is that acquirers tend to be both more strongly capitalized and more efficient than targets. This implies that the consolidation process has, in effect, removed the weaker firms from the industry, thereby enhancing its ability as a whole to absorb large losses. In short, the consolidation among reinsurers has increased the capacity of the industry and improved its performance.

Nonetheless, the authors conclude that the reinsurance market is still incapable of handling truly catastrophic events, such as a hurricane on the East Coast or an earthquake in California, each causing \$100 billion in damage. For these events, the authors argue that a securitized catastrophic risk market must develop. In the future, they foresee a role for both a stronger reinsurance industry and the capital markets in handling insurance coverage for such catastrophic events.

Yet another financial arena where consolidation has been taking place is in the securities trading market. Alberto Cybo-Ottone, Carmine Di Noia, and Maurizio Murgia tackle this subject in the next paper. Using a data set of approximately 100 deals among European exchanges in particular, the authors seek to explain the reasons for the recent alliances on the continent and then project the outlook for consolidation of exchanges there and elsewhere in the future.

The authors' main finding is that deals between exchanges are more often announced than implemented. Yet the pace of announcements has picked up over the last part of the 1990s, most likely spurred by the development of the single European currency, the euro. One possible reason why the pace of implemented alliances, mergers, or shared-technology agreements has lagged behind the formal announcements is that the claimed network effects of consolidated exchanges do not seem as significant as is widely believed. The authors suggest that this is because exchanges can buy their "scale" directly by outsourcing technology.

Until recently, the combinations of European exchanges have been almost all domestic—that is, within national borders—and confined to the consolidation of cash and derivatives markets. The relatively few cross-

border deals have been contracts or joint ventures that lead to a common trading platform rather than full-scale mergers. Further, fully 80 percent of the cross-border arrangements announced during 1990–93 were later abandoned. The authors speculate that noneconomic factors may have been a main driving force behind the combination of exchanges in Europe so far. Although they concede that many of these exchanges are quite small in size, and some of the mergers or alliances can clearly produce some efficiency gains, they view the relatively slow speed of actual consolidation as the result of political factors both within EU countries and within the individual exchanges themselves.

Key factors holding back the numbers of fully implemented exchange alliances are the governance and ownership structures of most exchanges. These tend to be member-owned and thus slow to embrace technological change, especially electronic trading. As a result, the authors project that substantial further change will not occur until the exchanges are demutualized or privatized (in the case of government ownership). At the same time, the authors believe that because many investors will continue to display a home-country bias in their investment patterns, there will continue to be a role for many existing exchanges, although their market shares may and probably will decline.

Looking ahead, the authors assert that only those exchanges that can maintain their reputations will survive. Exchanges earn their reputations by having efficient execution and an acceptable level of regulation either self-imposed or through a public entity, so as to give investors confidence of the integrity of the market. They also must have advanced technology allowing direct access by institutional and individual investors during long trading hours as well as provide safe and efficient systems of clearing and settlement.

Even so, existing exchanges are likely to find it in their interest to form networks or loose alliances with other exchanges in other locales. Such ventures will enable the exchanges to retain their identities and at the same time to enhance liquidity for investors.

Consolidation of the financial industry, across sectors and countries, is presenting regulators with new challenges. Moreover, continuing rapid technological advances—in both the hardware that speeds communication and financial software that leads to ever more complex financial instru-

ments and trading strategies—further complicate the lives of regulatory officials. In the next paper, Charles Calomiris and Robert Litan explore the implications of these various developments for regulators.

The authors begin by providing an overview of the recent financial landscape in the United States, in particular. They note that competition, coupled with technological advances, have been inducing both federal regulators and the states to gradually erode the legal segmentations that once separated banking from other financial (and commercial) activities. Congress finally took a more definitive step in 1999 when it enacted the Gramm-Leach-Bliley Act that removed the remaining barriers but preserved the distinction between banking and commerce.

The globalization of finance, meanwhile, is reflected in a number of trends: more extensive cross-border flows in short- and long-term capital and the broader global reach of financial service firms themselves. As a result, financial institutions have been growing in size.

These changes in the financial structure pose a series of challenges to the way financial institutions, especially banks, are regulated. First, as institutions become active in a broader range of activities, interest has grown in consolidating financial supervision in a single agency. A number of European countries and Japan already have moved in this direction. So has the United States, but less aggressively. Under the new financial modernization legislation, the Federal Reserve has been given the equivalent of backstop consolidated regulatory authority, but not frontline responsibility for regulating and supervising nonbanking affiliates of banks.

Second, the increasing complexity of financial entities and activities is complicating financial supervision. The near failure of Long-Term Capital Management, a highly leveraged hedge fund, underscores this development. The consolidation of financial services adds further complications. Some “mega” institutions may now be so large as to be “too big to fail”—or, more precisely, too big for regulators to risk letting creditors take a loss for fear of sparking a run on many institutions of similar, or smaller, size.

Third, the globalization of finance highlights the growing mismatch between the limited authority of national regulators and the global reach of financial institutions. Central banks of developed countries—through the Basel Committee—have been wrestling with this trend for more than twenty years, establishing minimum capital standards for banks in the late 1980s that attempted to tie bank capital to the risks of banking activi-

ties. In the early stages of the Asian financial crisis, the Basel Committee urged the extension of its standards to emerging-market countries.

Calomiris and Litan also summarize the various global efforts at regulating nonbank financial services, which are not yet as well developed as those for banks. The International Organization of Securities Commissions (IOSCO) is perhaps the furthest along, having also specified minimum capital rules for securities firms in member countries. IOSCO also has been pushing the development of global accounting standards by the International Accounting Standards Committee (a subject explored in depth in the next paper by Günther Gebhardt). The International Association of Insurance Supervisors is the most recently formed global financial body and is in the early stages of outlining ways in which national regulators can exchange information about individual insurers and supervisory best practices.

The authors discuss several questions that financial regulators in the United States and the European Union may confront in the near future. One is whether the current tendency toward placing regulation and supervision in a single consolidated entity really is appropriate. Calomiris and Litan are skeptical, suggesting that supervision of the banking operations in a financial conglomerate does not necessarily require extensive oversight of its affiliates, so long as regulators enforce bank capital standards and police inter-affiliate financial transactions. The authors also cite some benefits to continuing regulatory competition, at least with respect to non-prudential matters, which they believe has enabled the financial regulatory system in the United States to be much more accommodating of market-driven changes than otherwise would have been the case.

European regulators face a different question: since consolidated regulation already is emerging on a national level, will financial regulation and supervision at some point be consolidated at the EU level as well? The authors speculate that the answer to this question will be yes, given the inevitable movement toward EU-wide financial institutions. In addition, despite the theoretical advantages of vesting consolidated authority in an institution other than the central bank, the authors believe that the European Central Bank is likely to assume this authority since it is the only pan-European international financial organization already in place.

Finally, Calomiris and Litan discuss the changes in the bank capital standards proposed by the Basel Committee in June 1999, the flaws they

perceive in the proposal, and the direction they believe the committee should take instead. The June 1999 proposal seeks to correct several flaws in the preexisting standards, which assign risk weights to different types of loans and off-balance-sheet commitments and then require that banks back a fixed percentage of total risk-weighted assets with two different types of capital (pure equity and a mixture of equity and subordinated debt).

In advancing its proposed changes, the Basel Committee recognized that the existing risk weights have encouraged too much lending to emerging-market governments and banks, that they have failed adequately to discriminate among the risks of other types of loans, and that the current standards take inadequate account of private sector information in setting the risk weights. To address these problems, the committee proposes a more elaborate system of risk weights, one that relies heavily on the ratings of private credit rating agencies to assign loans to various risk buckets.

While applauding the committee's intentions, Calomiris and Litan nonetheless are critical of the Basel proposal. At the most general level, they attack the very notion of risk weights, contending that even a system based on private credit rating assessments continues to have an element of arbitrariness that does not reflect market assessments. They further argue that the risk bucket approach fails to measure the most important risks posed by bank activities—the risks of their entire *portfolios*. And they claim that the use of private credit ratings for regulatory purposes tends to distort the ratings themselves, which did not prove reliable for the Asian financial crisis.

Instead, the authors join other analysts in recommending that the Basel Committee mandate large banking organizations to back a certain fraction of their total assets (and off-balance-sheet commitments) with subordinated debt. Unlike deposits, which can run at any time, holders of subordinated debt must wait until their bonds mature. Moreover, unlike shareholders who share in both the losses and gains of the bank, holders of subordinated debt earn only a fixed rate of interest and do not gain if the bank is able to achieve greater profitability. For these reasons, the authors contend that subordinated debt can actually be a more effective source of discipline against excessive risk taking than either deposits or equity.

The authors are more circumspect in their recommendations for international prudential standards for nonbanks, however, because of the absence of documented cross-border linkages of the same magnitude as

are present in the banking industry. They conclude with a tentative suggestion favoring the harmonization of international accounting standards or, at the very least, allowing issuers of securities to choose whether to conform to domestic or the emerging global standards.

The subject of international accounting standards is addressed in the next paper, by Günther Gebhardt, who examines the evolution of these standards and outlines their future prospects.

On the surface, it appears obvious that the use of global standards would make it easier for investors around the world to compare and assess the financial performance of companies headquartered in different countries. For this reason, Gebhardt notes that a number of efforts to harmonize European accounting standards have been under way during the past two decades as part of the Single Capital Market Initiative. In his paper, Gebhardt describes in some detail the process by which both national and cross-national standards have been set.

More broadly, accounting bodies from around the world have essentially completed common international accounting standards under the auspices of the International Accounting Standards Committee (IASC). Most countries in the world have since recognized these standards for purposes of accepting listings on national securities exchanges. Canada and the United States, however, so far have been the major holdouts. The U.S. Securities and Exchange Commission (SEC), in particular, continues to study the issue. The SEC appears to be concerned over whether allowing listed companies to use the international standards will lead to a “watering down” of generally accepted accounting principles (GAAP) developed in this country.

But exactly how much difference does it make whether companies use GAAP or some other standards? Gebhardt lays out a number of the conceptual differences between GAAP and the IASC standards. Then he looks at a sample of German companies that register their securities with the SEC in order to be listed in the United States to illustrate the differences between GAAP and German accounting standards in these particular cases. Although there are important differences in line-by-line results, in the aggregate, the two accounting systems produce very similar results for reported income. Gebhardt's examples are consistent with other empirical studies, which show no material differences between home-country net income and GAAP net income in about a third of the companies

sampled. Where there are major differences, some are due not so much to differences in accounting rules but rather to one-time technical adjustments.

Gebhardt also takes a close look at the institutional structure of IASC, seeking to understand why its standards are not yet universally accepted. The IASC board has thirteen part-time country members, drawn heavily from developed countries, and three institutional members. The board is dominated, as expected, by accounting professionals. Gebhardt is critical of the Anglo-Saxon bias of the board membership. Nonetheless, he notes that the IASC standards have been widely accepted outside the United States, including by the European Union.

Gebhardt still finds it discouraging that the SEC has not been more welcoming of the IASC standards for markets in the United States. He speculates that the commission may be taking this position as a way of maintaining the dominance of GAAP, especially as more European companies seem to be listing on U.S. exchanges even though they must comply with GAAP as well as their home-country standards. Gebhardt cautions that there is risk in this strategy, if in fact IASC standards become widely used in Europe and elsewhere. While U.S. financial markets are unrivaled in depth and liquidity, this may change as markets grow deeper in Europe. At some point, therefore, global accounting standards developed outside the United States may become an important competitor with U.S.-based standards.

One of the most controversial aspects of the Asian financial crisis centered on the role played by hedge funds. Critics of these financial intermediaries—private unregulated investment pools for wealthy individuals and institutional investors (many of which are leveraged)—claim that hedge funds helped to lay the foundation for the crisis by pouring too much money into the region in the first place and then made problems worse by pulling funds out at the first signs of trouble. William Fung, David Hsieh, and Konstantinos Tsatsaronis examine the evidence to assess the accuracy of these assertions.

Fung, Hsieh, and Tsatsaronis begin their study by reviewing the role of hedge funds in the European exchange rate mechanism (ERM) currency crisis of 1992, which the authors find similar to the Asian crisis five years later. The carry trade was involved in both. The term “carry trade” refers to borrowing in a currency with a low interest rate and then lending or invest-

ing the proceeds in another currency with a higher interest rate, without hedging exchange rate movements. This type of trade is profitable so long as exchange rates between the two currencies remain fixed or do not move by more than the interest rate difference.

In the case of the ERM in 1992, it was widely expected at the time that the currencies of countries belonging to the European monetary system were on a continuous path toward convergence to a common currency (the euro). This implied that some high-inflation countries, such as Italy, Portugal, Spain, and the United Kingdom, would have to realign their currencies (that is, allow them to depreciate). Some hedge funds, notably the Quantum Fund led by George Soros, bet heavily that the British pound in particular would be forced to devalue. The authors contend that although speculation by the hedge funds played a role in the departure of the United Kingdom from the ERM, it was not determinative. Foreign exchange trading throughout this period was primarily an interbank activity, and the unwinding of sizable carry positions by commercial and investment banks played as important a role as hedge fund speculation in explaining the withdrawal of the United Kingdom.

Fung, Hsieh, and Tsatsaronis next examine the role of hedge funds in the Asian crisis itself. They point out that capital inflows into the five affected countries—Indonesia, South Korea, Malaysia, the Philippines, and Thailand—jumped sharply from an average of \$30 billion during 1990–94 to \$63 billion in 1995 and \$73 billion in 1996 (the year before the crisis began). They suggest that most of the \$75 billion in additional capital inflows in 1995–96 resulted from carry trades. Yet, according to an earlier study by Barry Eichengreen and colleagues at the International Monetary Fund, hedge funds were not significant contributors to this carry trade activity.

Did the hedge funds nonetheless contribute to the heavy selling of the Asian currencies in middle to late 1997 once the crisis was under way? To answer this question, Fung, Hsieh, and Tsatsaronis examine financial data on twenty-seven large hedge funds (with assets exceeding \$1 billion). Based on a regression analysis of monthly returns reported by these funds, the authors find that, on the whole, the performance of the funds was far more correlated with the Standard & Poor's (S&P) 500 index than with the movements in the values of the Asian currencies. This result provides indirect evidence refuting the view that hedge funds were major sellers of the affected currencies.

Given the fact that hedge funds often change their positions much more frequently than on a monthly basis, the authors also take a closer look at daily and weekly movements in returns for twelve of the largest hedge funds to assess whether changes in the value of the Thai baht—the currency initially implicated in the crisis—played a major role in that currency’s fall. Again, the authors find that movements in the American equities market (as measured by the S&P index) explain most of the variation in returns, leaving little explanatory room for variations in the baht. Furthermore, the authors find that the twelve hedge funds as a whole did not engage in “positive feedback” trading strategies—selling the baht as it was moving down—during the period.

In short, Fung, Hsieh, and Tsatsaronis conclude that, although excessive speculation laid the groundwork for the Asian currency crisis of 1997, hedge funds were not significant culprits. Indeed, as a general proposition, the hedge funds arrived after some lenders already had begun to unwind their positions. To the extent that the funds bet against certain currencies, the amounts involved were small compared to those of other market participants—notably, investment and commercial banks and corporations.

The authors conclude with some thoughts on the policy implications of their findings. They doubt whether off-shore hedge funds in particular can be effectively regulated and even suggest that direct regulation of the funds could be counterproductive by encouraging them to disguise their activities. Nonetheless, they suggest that some degree of monitoring of hedge fund positions and large bank counterparty exposures may offer insights relevant to future problems in the market.

One of the ways in which the globalization of financial services is manifested is in the increasing cross-border activity of the firms that offer these services. Many nations, however, continue to restrict foreign direct investment by financial service firms. In the last paper in this volume, Pierre Sauv and James Gillespie analyze the prospects for liberalization of these restrictions. The paper was written and presented before the failed World Trade Organization (WTO) ministerial meeting in Seattle in December 1999. However, because the issue of financial services liberalization is part of the built-in agenda incorporated in the Uruguay Round trade agreement of 1995, the subject is likely to continue to be relevant in the immediate future, especially if the next administration is successful in jump-starting a new round of multilateral trade negotiations.

Sauvé and Gillespie observe that the Financial Services Agreement (FSA) concluded in December 1997 ranks as one of the most important achievements of the Uruguay Round, given the importance of financial services and the progress the round made toward reducing barriers to the provision of financial services by foreign firms. In industrial countries, where restrictions on cross-border foreign direct investment (FDI) are not extensive, financial services account for up to 13 percent of the gross domestic product and employ approximately 4 percent of the work force. In developing countries, where FDI restrictions have been more prevalent, financial services are not as well developed, although in several countries, they account for more than 5 percent of total output.

During the Uruguay Round, negotiators established a special framework for services liberalization generally, the General Agreement on Trade in Services (GATS). The financial services talks were pursued under GATS. However, they occurred after the round and thus did not take place in the usual context of multiple-sector and multiple-issue negotiations. The authors credit the hard line taken by the United States in insisting that developing countries in particular commit to relaxing their financial services restrictions. All told, the agreement reached in December 1997 covered 95 percent of global trade in financial services (measured by revenue), with 102 of the 132 WTO member countries making at least some commitments.

The basic structure of the GATS follows the central concepts of the larger WTO system: the principles of nondiscrimination (most-favored-nation status), national treatment, and transparency. The GATS agreement allows countries, however, to protect certain existing discriminatory practices by scheduling exemptions at the time of ratification subject to a ten-year sunset. In addition, the GATS governs domestic regulation of financial services, which it specifies must be administered in a “reasonable, objective, and impartial manner,” free of unnecessary barriers to trade. Financial regulators from the signatory countries obtained a carve out for prudential regulation, which members are free to carry out in order to protect consumers or ensure the stability of national financial systems, so long as such regulation is not used as a means of avoiding scheduled commitments.

The authors observe that thus far it is impossible to provide a quantitative assessment of the benefits of the FSA, largely because of the “positive list” nature of the agreement. Signatories are obligated to notify the

WTO of market restrictions in their scheduled sectors, but not to provide systematic information about their nonscheduled sectors, where many distortions still remain. Nonetheless, researchers have quantified the number of commitments, with the following key results: fifty-two WTO members currently have guaranteed broad market access across all insurance sectors, fifty-nine countries now permit 100 percent foreign ownership of subsidiaries or branches in banking, and forty-four countries do the same in the securities business. As expected, developed countries have scheduled more comprehensive commitments than developing countries.

The FSA commits signatories to future negotiations within five years of ratification of the agreement. Whether progress toward further liberalization occurs still depends, however, on the political will of the countries involved.

Sauvé and Gillespie outline a series of issues that future negotiators will have to address. Within the Organization for Economic Cooperation and Development countries, they suggest the greatest challenges will be to adapt the FSA and the GATS to the continuing changes in e-commerce, clarifying the boundaries of the prudential carve out negotiated at the insistence of the financial regulatory officials, proclaiming rights of nonestablishment (so that financial firms need not maintain a physical presence in order to deliver their services in a country), and limiting the role of emergency safeguards (temporary protection).

For developing countries, the authors suggest that the next negotiating round should concentrate on the removal of classic barriers to entry and establishment of firms as well as discriminatory post-establishment restrictions. Unlike short-term capital flows, which many emerging countries have seen as destabilizing, foreign direct investment is much “stickier” and has demonstrated advantages for destination countries by transferring valuable first-world skills and technology to both the private sector and regulators. Accordingly, the authors argue that declining barriers will add to potential real growth in these developing countries and benefit both the investing and host countries.