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Trade Note 31

Financial Services Liberalization and Trade Agreements in Latin America and the Caribbean*

International trade in financial services has emerged as the result of intense global integration trends and the widespread use of information technology. Nowadays, it represents an increasingly important dimension of domestic financial system activities. Countries have achieved trade liberalization of financial services in three main ways: (i) unilaterally, by opening their financial systems to international competition in the context of autonomous domestic reform efforts; (ii) at the multilateral level under the auspices of the WTO's *General Agreement on Trade in Services* (GATS); and (iii) on a reciprocal or preferential basis by concluding bilateral or plurilateral *preferential trade agreements* (PTAs). This note analyzes the trade liberalization of financial services via PTAs that was undertaken by countries in the Latin America and Caribbean Region (LCR).

Regional integration and financial services liberalization in Latin America and the Caribbean

Since the 1990s, the world economy has witnessed an unprecedented proliferation of PTAs. Almost every WTO Member is party to at least one PTA, and LCR has been particularly active in this regard with a different level of economic integration, ranging from *free trade agreements* (FTAs) to custom unions and common markets. North-South

agreements take the form of FTAs, while some South-South agreements aim for a higher level of economic – and potentially political – integration at a sub-regional level via the establishment of customs unions and common markets. The four main South-South PTAs in LCR are the *Southern Cone Common Market* (MERCOSUR, established in 1991), the *Andean Community* (CAN, established in 1969), the *Caribbean Community and Common Market* (CARICOM, established in 1973) and the *Central America Common Market* (CACM, originally established in 1960 and reinstated in 1991).

Financial services are typically covered via provisions included in a separate, self-contained chapter. This chapter is, for analytical purposes, the principal vehicle for influencing the operations of the domestic financial system although, strictly speaking, it does not fully capture all such activitiesⁱ. The coverage of financial services by PTAs in LCR follows 3 main approaches:

- *no coverage* because of the specific exclusion of services in general, or of financial services in particular, from the scope of a particular trade agreementⁱⁱ
- *direct coverage* via the introduction of dedicated provisions in a separate chapter or

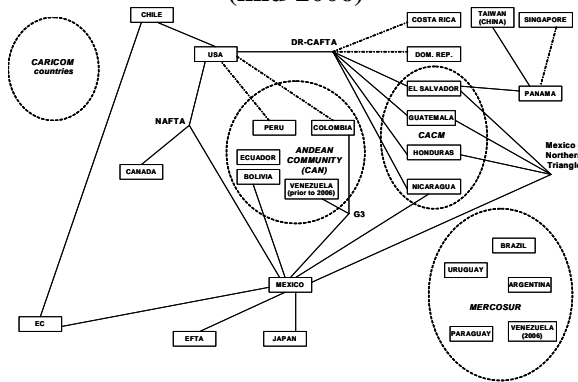


annex dealing exclusively with financial services

- *indirect coverage* via ‘horizontal’ provisions of a more generic character covering services and/or investment that partly apply to financial services as well.

As can be seen in Figure 1, the proliferation of PTAs in recent years has contributed to greater financial services liberalization commitments for many LCR countries and led to an increasingly complex regional ‘commitments map’ (or financial services ‘spaghetti bowl’). Most progress in financial services rule-making and market opening has been achieved via FTAs; by contrast, LCR countries that have relied on the multilateral framework and on sub-regional customs unions have not made much progress to-date.

Figure 1: ‘Map’ of Financial Services-Related Trade Commitments in LCR (mid-2006)



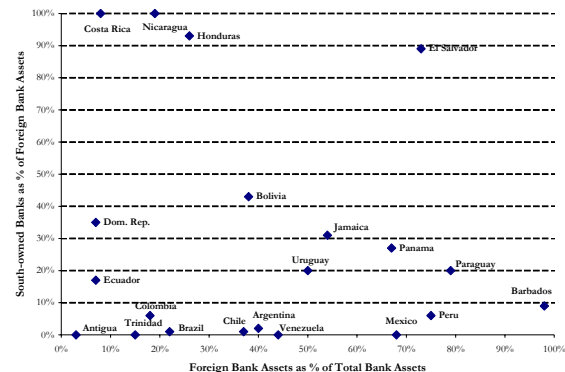
Source: Own analysis, SICE database.
 Note: Lines indicate the existence of a financial services chapter/Annex in a PTA between the relevant countries (dashed lines indicate that the agreement has not yet been ratified or implemented), while the ovals indicate the presence of a trade agreement for the creation of a common market or customs union.

The inclusion of financial services in LCR PTAs depends greatly on whether it is a North-South or South-South agreement. Unsurprisingly, developed countries in North-South agreements have been the main proponents of including financial services.

Most LCR countries are net importers of financial services and have few – if any – perceived ‘offensive’ interests linked to a “*demandeur*” or domestic constituency, both of which lessen the scope for striking reciprocal bargains within the sector.

Conversely, the inclusion of financial services in most North-South agreements likely reflects the fact that the majority of foreign financial institutions in LCR countries are headquartered in developed countries (see Figure 2), as well as the relative (and asymmetric) bargaining powers between the negotiating counterparts. In fact, only two LCR countries have tended to include financial services chapters in South-South agreements – Mexico (primarily in the immediate post-NAFTA periodⁱⁱⁱ) and Panama (which is an offshore financial center and a net exporter of financial services).

Figure 2: Foreign Bank Penetration in Selected LCR Countries



Source: Own analysis based on Van Horen N. (2006).
 Note: A foreign bank is defined to have at least 50 percent foreign ownership. Figures reported represent averages over 2000-2004 in each country. South-owned banks are foreign banks headquartered in a developing country.

Templates, rules and disciplines for financial services in PTAs

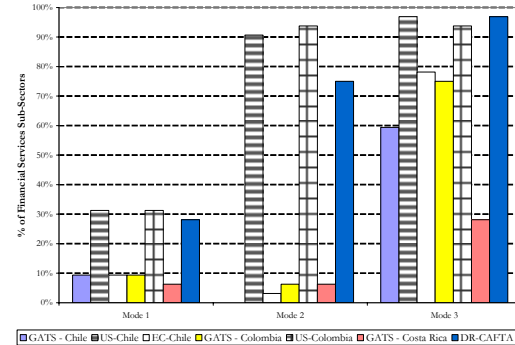
PTAs that have developed disciplines on services in general (including financial services) have traditionally followed two ‘architectural’ models or templates: one



based on the GATS and the other based on the NAFTA. While the liberalization of financial services under the GATS is based on a hybrid list approach, NAFTA-type PTAs use a negative-list or top-down approach. The latter approach obliges countries to list all non-conforming measures, otherwise they are deemed to be fully and automatically liberalized (the so-called “list it or lose it”). The choice of modality used to negotiate and schedule liberalization commitments can be an important contributor to the actual level and quality of liberalization attained (see below). NAFTA- and GATS- type agreements also have important differences in terms of scope and coverage – for example, in their treatment of cross-border trade and of non-regulated financial institutions. While the vast majority of PTAs that were negotiated by LCR countries have followed the NAFTA model, the financial services chapters of recent agreements (e.g. US-Chile FTA) have tended to mix elements of the two architectural templates.

The rules and disciplines contained in PTAs with regards to financial services have two objectives: (1) to liberalize trade in financial services through the removal of discriminatory and market access-impeding measures affecting foreign financial services suppliers; (2) to promote better regulatory practices (e.g. on transparency), while also allowing countries to regulate their financial services markets on prudential grounds. In addition to *market access*, *national treatment* and *most favored nation* obligations, important financial services-related provisions cover *prudential safeguards*, *dispute settlement* and *transparency*, as well as *standstill* (‘freezing’ of existing regulatory regime thus preventing backsliding), *ratcheting* (i.e. automatic lock-in of new liberalization measures) and *denial of benefits* (rules of origin).

Figure 3: Market Access Commitments – Proportion of Financial Services Committed by Chile, Colombia and Costa Rica in the GATS and Subsequent FTAs



Source: Authors’ interpretation based on WTO and USTR information, Contreras P. and Yi S. (December 2003), Contreras P. (2005), Saez R. (2006), Arbeláez M. A., Flórez A. and Salazar N. (August 2006) and Echandi R. (2006).

Note: Three levels of market access commitments are applied in the above analysis by financial services sub-sector and mode: none (value of zero), partial (value of 0.5) and full commitment (value of 1). Mode 4 commitments, as well as all national treatment commitments and horizontal restrictions, are excluded. All pre-commitments to liberalize additional sub-sectors and/or modes in future years are included.

Have recent PTAs led to increased financial services liberalization commitments for relevant LCR countries compared to those made under GATS?

An analysis of market access and national treatment commitments scheduled in the financial services chapters has been undertaken for a sample of LCR countries that have recently participated in PTAs (Chile-US and Chile-EU FTAs, Colombia-US FTA and Costa Rica in the DR-CAFTA). Results provide evidence of significant additional liberalization commitments when compared to the GATS. This is not unusual given the time elapsed and the (unilateral) market opening undertaken by these countries since the mid-1990s. Additional commitments tend to span all financial sub-sectors, including those that were not well covered in the first GATS round, such as insurance, securities-related and other financial services. The same is



true in modal terms, with significant new commitments particularly in mode 2 (consumption abroad). Commitments are in general more extensive across all modes for FTAs involving the US, particularly for mode 2. By contrast, mode 1 commitments (cross-border trade), while better than what has been harvested to date under the GATS, remain relatively more timid (see Figure 3).

Have recent PTAs led to actual liberalization of financial services as opposed to merely binding the status quo?

An analysis of individual LCR country experiences is much more difficult to undertake because of insufficient information on the regulatory *status quo* prior to, during and after the implementation of such trade agreements. A review of the existing literature for the aforementioned countries indicates that *de novo* liberalization – which has chiefly taken the form of pre-commitments to future market opening – is relatively modest. Apart from Costa Rica's insurance sector that would have to open for the first time, real liberalization appears to have mostly taken place in the cross-border provision of some insurance services, as well as in asset management and auxiliary financial services. Although there is limited available data on the actual market size of these sub-sectors and modes, anecdotal evidence suggests that they are relatively less important than 'core' banking services. However, the abolition of numerical quotas (e.g. economic needs test) and certain juridical restrictions on forms of entry (e.g. insurance branching^{iv}) might also contribute to further liberalization in other sub-sectors under mode 3.

The above finding is a strong indication that, with a few exceptions, PTAs seem to be primarily used to consolidate and 'lock in' existing unilateral liberalization rather than as means to actively promote further market opening and the process of domestic

regulatory reform. The fact that the LCR countries under review appear to have already largely liberalized their domestic financial systems on a unilateral basis prior to their engagement in PTA negotiations has also contributed to this outcome.

Of course, consolidation of the regulatory *status quo* and the application of certain disciplines in trade agreements remain important because they can limit the arbitrary use (and abuse) of 'policy space' by the authorities. New disciplines such as those on regulatory transparency, as well as the lock-in of the current policy regime via commitments, standstill and ratcheting clauses, enhance predictability, prevent potentially costly policy reversals, and can thus benefit both domestic and foreign financial services providers and local consumers. It is therefore conceivable that a PTA could exert significantly positive impact on the business environment (including for financial services) even if real liberalization commitments remain limited to the *status quo*. However, the issue of policy space is a double-edged sword, and policymakers need to decide on the level of policy flexibility and regulatory discretion (which might not be the current one) that properly balances policy considerations that go beyond trade liberalization objectives *per se*. Linked to this issue is the need for policymakers negotiating the financial services provisions of PTAs to be cognizant of the important nuances in disciplines and commitments that might create unintended consequences or limit policy space beyond what was envisaged. The short time span since the entry into force of most PTAs means that their contribution – whether anticipated or unanticipated – still cannot be fully assessed.

Many de novo liberalization commitments are actually not preferential in nature

An interesting additional finding of the analysis is that many *de novo* liberalization commitments are actually not preferential in



nature. While some commitments (e.g., the abolition of an economic needs test for Chile) are country-specific and benefit the financial services providers of the FTA counterpart, others (e.g., permitting branching or opening up the insurance industry to private providers for Costa Rica) require new 'horizontal' regulations or laws that would presumably apply to the entire industry and could actually benefit financial service providers from third countries. This would seem to suggest that there might not be important first-mover advantages or serious economic distortions created by using PTAs to promote market opening in financial services, although much depends on the specific nature of liberalization commitments *per se*.

Is a GATS- or NAFTA-type 'architectural' model preferable for liberalization purposes?

The answer is unclear – while a simple review of the analyzed FTAs would seem to favor NAFTA-type agreements, this can be largely attributed to the involvement of the US in many of them. In addition, the direction of causality between scheduling approaches and the level of liberalization commitments can run both ways. Finally, as previously mentioned, both models have introduced new features in recent years that borrow from each other, revealing convergence around a hybrid-type approach.

Conclusion

The proliferation of PTAs in LCR, many of which nowadays cover financial services, has potentially important implications for the structure of domestic financial systems and for their contribution to the overall financing of the economy. The aforementioned analysis has yielded some preliminary insights. It shows particularly that LCR countries have used PTAs primarily to consolidate and 'lock in' existing unilateral liberalization rather than as means to actively promote further market

opening and domestic regulatory reforms. It also shows that many *de novo* liberalization commitments are actually not preferential in nature, while there is no architectural model preferable for the liberalization of financial services. More work needs to be done in order to permit the *ex post* evaluation of recent PTAs and support the *ex ante* decision-making process for financial sector policymakers in these countries.

ⁱ Areas relevant to the domestic financial system that are not captured by the financial services chapter include foreign investments in domestic non-financial securities, activities of non-regulated financial institutions (only in NAFTA-type agreements), provisions on payments and capital movements, as well as accounting, data processing, telecoms, legal and taxation services.

ⁱⁱ Some of these FTAs include an obligation to negotiate a financial services chapter some time after the entry into force of the agreement.

ⁱⁱⁱ The NAFTA was the first FTA by a LCR country that included trade in financial services within its scope and devoted a specific self-contained chapter to such trade. Subsequently, Mexico has been a key player in incorporating financial services in its preferential trade agreements; of the twelve PTAs (all are FTAs) entered into by Mexico, seven contain a financial services chapter.

^{iv} However, it should be noted that domestic authorities retain the right to regulate such branches as they deem necessary for prudential purposes, including via the establishment of local capital requirements.



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