FINANCIAL SERVICES LIBERALISATION AND INTERNATIONAL INTEGRATION IN SOUTH EASTERN EUROPE

ABSTRACT: The first part of this paper analyses the regulatory framework for international trade in financial services within the auspices of the World Trade Organisation (WTO), with special attention paid to the open issues including the scope of prudential measures and capital mobility limitations. The process of the international integration of the South Eastern Europe (SEE) countries is mainly dictated by their goal of EU integration. With regard to the services’ sectors, a major liberalisation step on the way is WTO accession. Of the countries in the region only Serbia, Bosnia and Herzegovina and Montenegro are still not WTO members and in order to become members significant liberalisation commitments will be demanded of them. For this reason the second part of the paper deals with concrete financial liberalisation commitments undertaken by the original WTO members in SEE and the newly WTO-acceded SEE member countries. The last part of the paper provides a quantitative analysis of these commitments by means of the measurement of liberalisation indices in the banking sectors in SEE countries. This is to provide a general idea of the scope of liberalisation that may be required from a SEE country in order to achieve WTO membership on the road to EU integration.

KEY WORDS: financial services, liberalisation, international integration, WTO, trade in services, regulation of financial sector

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Ivana Prica*

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* Faculty of Economics, University of Belgrade
Introduction

The relationship between the depth of the financial system and economic growth, investment, poverty, and other indicators of the level of development of a country, is a long established fact in economic theory. Only in the last ten years, however, did the theory and empirical analysis clearly define the causal relationship between financial development and economic growth. Just as the development of the financial system is a significant determinant of a country’s overall level of development, so is the successful financial reform a significant determinant of the success of the transition process. Financial reform consists of several elements, one of which is financial liberalisation. This paper will deal with some of the issues of financial liberalisation, in the light of the international integration processes and the WTO accession in particular, in the transition countries in South and East Europe (SEE).

All sectors of a modern economy fundamentally depend on the financial services sector. A healthy and stable financial sector, supported by a strong macroeconomic policy and a prudential system, is a basis for achieving the sustainable development of an economy in transition. According to many studies financial reform based on deepening the financial sector may be a source of growth itself (see analysis in Claessens [2005]). Liberalisation, or internationalisation of this sector based on international disciplines, is an integral part of this reform. This paper tries to give some answers to the question of how far a transition country in the SEE region should go.

1. International Regulatory Framework for Trade in Financial Services

1.1. Regulatory framework for trade in services

The last decade saw a major boost in global trade in services, mainly due to the introduction of new technologies facilitating the supply of services (e.g. satellite communication), the opening of services’ monopolies in many countries (e.g. voice telephony) and gradual liberalisation of previously restricted sectors like banking and insurance, combined with changes in consumer preferences therein. Services now account for close to 70% of production and employment in the OECD area OECD [2001], while estimates show that total measurable trade

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1 See: Francois and Schuknecht [1999], or Fink, Mattoo and Rathindran [2001]. An overview of the empirical results is provided in Claessens, [2005].
in services represents close to a fifth of total trade in goods and services (WTO [2001]). This boost in services’ activities on an international level demanded regulation through multilateral disciplines similar to GATT (General Agreement on Tariffs and Trade).

The General Agreement on Trade in Services (GATS) was negotiated during the Uruguay Round (1986-1994) and is one of the major achievements of those negotiations. The reason is that the GATS is the first and only set of multilateral legally-enforceable rules that govern international trade in services. Similar to the GATT, GATS encompasses the following three elements: general rules and disciplines, Annexes to regulate sector specificities, and the Schedule of Specific Commitments that show specific obligations a particular Member has undertaken in the particular services’ sector in order to facilitate market access therein. Unlike GATT, GATS has a specific fourth element - a list of MFN exemptions. This list shows the sectors in which the Member is temporarily not going to apply the Most-Favoured Nation (MFN) principle of non-discrimination (these are temporary withdrawals of the MFN principles).

As in the case of trade in goods, measures restricting trade in services actually decrease the real GDP level. Due to the specificities of the modes of supply of the services, liberalisation of particular service sectors demands a liberal and transparent domestic regulatory framework that enables higher mobility of production factors, service providers and consumers. Thus the scope of the impact of international trade rules on domestic regulation of services is far higher than in the goods sector.

Goods and services fundamentally differ in more than one way. As opposed to goods, many services are not tangible, visible, or continuous and their production and consumption processes more often than not run simultaneously. It is this aspect of services that crucially determines the mode of trade in services and the reason that international trade in services often cannot occur without allowing for mobility of production factors – capital and labour. It is the former of these that will be further discussed in this paper and in particular in the section titled Open Issues further below.
The generally accepted definition of trade in services, as provided in Article 1, Paragraph 2 of the GATS, recognises this specific aspect of services and defines trade in services by way of four service supply modes:

- **Mode 1: Cross-border Supply** - where services are delivered across the country border, the service provider is resident abroad while the consumer remains in the home country (for example, when financial credit is extended or insurance policy purchased from a bank/insurance company located abroad);
- **Mode 2: Consumption Abroad** - this is where the consumer travels into the country in which the services are delivered by the foreign services supplier (for example, tourism; education in a foreign country; or repair of a ship in a foreign country, when it is only the service consumer’s property that travels abroad);
- **Mode 3: Commercial Presence** - where a service supplier of one country supplies a service in another country by establishing, through foreign investment, a commercial presence in that country (e.g., commercial presence of foreign banks or insurance companies);
- **Mode 4: Presence of Natural Persons** - this applies to the temporary movement of individuals (which are natural, not legal persons as is the case in the previous mode) and arises where a service is delivered in a foreign market: these individuals may be independent service providers (such as medical doctors), or employed with a service-supply company.

The level of foreign trade in services liberalisation is weighed against the restrictions of Market Access (MA) or National Treatment (NT) for each of the four service supply modes and for every service sector. The concrete liberalisation commitments of a WTO member country, defined against this framework, are entered into that country’s Schedule of Specific Commitments. As in the trade in goods, where every country has its Schedule of Concessions as an integral part of GATT (defining the maximum tariffs to which it commits), every country also has its Schedule of Specific Commitments (hereinafter: the Schedule) related to GATS, through which it commits to a particular level of liberalisation in trade in services.

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2 Estimates show that of the total world trade in services in 1997, around 40% was allocated to two modes of supply, viz. cross-border transactions and commercial presence modes; while the remaining 20% share consisted mainly of consumption abroad, and services supplied through natural persons were found to be statistically insignificant; see Karsenty [1999].
1.2. Specific provisions regarding financial services

The basic GATS rules outlined above apply equally to trade in financial and other service sectors. However, recognizing the particularity of this sector, both as basic input for all other sectors and its importance for the financial viability and stability of an economy, specific rules were developed to regulate just this sector. As a result, this “to date, WTO GATS which sets rules for international trade in financial services and thus affects the financial sector and its stability, remains the only multilaterally agreed, binding, and legally enforceable framework related to the financial sector”\(^3\). That is why in this paper we have performed both descriptive and empirical comparative analyses of the degree of liberalisation in the financial services sector that countries in this region have committed to. To begin with, we shall describe the mechanisms and outline the basic provisions of this regulatory framework with respect to financial services.

GATS rules that apply specifically to financial services are found in several documents. These are:

- **GATS Articles XI, XII and footnote 8 to Article XVI.**
  
  *Article XI* provides that 1) *payments and current transactions* shall be allowed in relation to service sectors and modes of supply where the country has undertaken commitments in its Schedule, and 2) that the country will not impose restrictions on *capital transactions* that may be inconsistent with the country’s specific commitments\(^4\).

  *Article XII* provides that the country may temporarily maintain restrictions on payments and transfers related to its specific commitments in the event of serious balance-of-payments (BOP) and external financial difficulties, or threat thereof. These are to be applied only under certain conditions (to be reviewed by the WTO Committee on BOP Restrictions) and in accordance with the IMF Articles of Agreement.

  *Footnote 8 to Article XVI* (MA) further provides that if a country has undertaken Market Access (MA) commitment in its Schedule under modes 1 or 3 and if a capital transaction is an essential part of that service, such capital transaction shall be allowed\(^5\).

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\(^3\) Kireyev [2002], p. 3.

\(^4\) Exceptions are to be allowed only under the auspices of the IMF.

\(^5\) Although this applies to all services, it is of particular importance for the financial services sector since undertaking MA commitments in this sector for modes 1 and 3 is often not feasible without allowing the underlying capital transaction.
• **Annex on Financial Services** (hereinafter: the Annex) further defines the scope of the application of GATS in the financial services sector. The Annex defines which governmental services and measures shall not be subject to GATS rules. It provides that GATS rules do not apply to: (a) the activities of the Central Bank (hereinafter: CB) or other monetary authority in relation to monetary or foreign exchange policy not subject to GATS, and (b) the activities of any public entity performed for the account, with the guarantee or using the financial resources of the Government, unless it allows that those activities be provided by a financial service supplier(s) in competition with such public entities.

The Annex also provides that prudential measures do not fall under the GATS disciplines (“prudential carve-out”)\(^6\). However, these measures may not be used as a means for avoiding commitments undertaken under GATS. Furthermore, the Annex offers definition and classification of financial services (this classification extends the one previously provided by WTO [1991]).

• **Second and Fifth Protocol** are results of the subsequent rounds of negotiations in financial services and provide for inclusion of new financial services as well as a higher level of commitments of member countries (these came to force as of September 1, 1996 and March 1, 1999, respectively).

• **Understanding on Commitments in Financial Services** (hereinafter: the Understanding) provides further levels of commitments in the financial services sector. Although its application is not mandatory, most newly acceded members were hard pressed and accepted it\(^7\), as did most of the SECE (South East and Central European) countries that were original members. The Understanding offers a wide array of provisions that present significant liberalisation commitments on behalf of the signatories thereof. It is divided into four sections: A, B, C and D. Part A of the Understanding provides that countries shall not undertake any new measures that are contrary to the provisions contained therein. Parts B and C specify MA and NT commitments respectively, while part D supplies the definitions.

In part B the Understanding relates to MA commitments and states that the monopoly rights must be listed in the schedule, and also provides that the countries shall endeavour to eliminate them or further reduce their scope.

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\(^6\) This provision is quite vague in many aspects, as shall be discussed in more length below. However, it provides appropriate procedures for recognition of prudential measures of member countries.

\(^7\) Due to the wide scope of the Understanding it is usual that countries apply it partially, this fact being entered in their Schedule.
This provision also applies to other governmental services as defined in the Annex on Financial Services and summarised above under (b) (i.e. not including monetary authority). Part B further provides that modes 1 and 2 shall be allowed for the provision of the following services:

- Insurance of goods in international transit,
- Insurance of goods, the vehicle that transports the goods and the liabilities arising therefrom, in commercial aviation and maritime shipping, and
- Reinsurance, retrocession and the services auxiliary to insurance.

It also provides that mode 1 shall be allowed for provision and transfer of financial information, financial data processing etc., as well as advisory, intermediation and other auxiliary financial services, while mode 2 shall be allowed for all banking and other financial services (this includes all financial services except for insurance).

With regard to mode 3, the Understanding provides that the country shall allow financial services providers of another member to establish their commercial presence and to expand within its territory including purchase of existing enterprises (allowing for adequate terms, conditions and procedures for authorization thereof). The established commercial presence of another member shall be allowed to provide new financial services, as well as the transfer and processing of financial information and transfer (importation) of equipment necessary for business operations of a financial services supplier.

With regard to mode 4 the Understanding provides that temporary entry shall be allowed to the necessary personnel.

Part C of the Understanding relates to NT commitments and provides that the established commercial presence of another member shall have access on a NT basis to publicly-operated payment and clearing systems, official funding and available refinancing facilities (not including the lender of last resort facilities), as well as to membership of any professional bodies, associations etc.

### 1.3. Open issues

The above regulatory framework is in no way perfect, but several issues are of particular importance for the further analysis of the commitments undertaken towards liberalisation of the financial services sector. These are: a) Distinction

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8 Part D defines “commercial presence” to include wholly or partly-owned subsidiaries, joint ventures, partnerships, sole proprietorships, franchising operations, branches, agencies, representative offices or other organizations.

9 Part D defines new financial service as a service of a financial nature, related to existing and new products or the manner of their delivery, that is not supplied on the member’s territory but is supplied in the territory of another member.
between modes of supply, b) Scope of prudential measures, and c) Capital mobility issues.

a) *Distinction between modes of supply.* One of the main issues regarding the definitions and disciplines defined in GATS is the unclear distinction between modes 1 and 2. This issue was identified and analysed in the WTO forums and also in the document WTO [2001a] which examines different specificities of the financial services sector. The distinction between the two modes of supply is particularly unclear in the case of the financial services sector. While mode 1 occurs when the consumer is in the domestic territory and mode 2 when he goes abroad (in both cases the service provider is abroad) now it is often the case that the physical presence of the service consumer is no longer necessary for the service provision due to modern telecommunication technology. It is often hard to tell how the particular service was provided, i.e. by which mode? This presents problems both for scheduling the commitments in the acceding countries and for the understanding of commitments already undertaken by members in further negotiations. This issue was discussed as early as the negotiations on financial services which ended in December 1997 (see details in annexes to WTO [2001a]). It was recognised that the proposed solution to this problem should not interfere with the commitments already undertaken. The proposed partial solution discussed was the adoption of a non-binding headnote, and a member that feels that such an explanation is necessary may include the note in its Schedule. Models of such a headnote can be found in the attachments to the WTO [2001a]. However, the issue of distinction between the modes of supply may also be found with regard to modes 1 and 3. One study (Kono and Schuknect [1998]) finds that in the financial services sector the most important modes of supply are modes 1 and 3, and in some cases the distinction between the two is quite vague. For example, a foreign bank credit that was arranged over the phone presents mode 1 of supply, while the same credit arranged through the domestic branch\(^{10}\) or subsidiary of a foreign bank shall be deemed mode 3.

b) *Scope of prudential measures.* By virtue of the Annex on Financial Services prudential measures are allowed (so-called “prudential carve-out”) and are not subject to GATS disciplines, provided they shall not be used as a means of avoiding commitments under GATS and the country’s Schedule. The WTO legal documents do not provide a precise definition and explanation of

\(^{10}\) Branches in this paper, as in the WTO definitions, are dependent legal entities of a parent company situated abroad.
what prudential measures are comprised of. From the information available it could be surmised that they include not only measures to ensure stability and integrity of the financial system, but also measures to protect investors, depositors, etc.\(^\text{11}\). No further explanation is offered, which is fine since this should not be the subject of the WTO\(^\text{12}\) but of other international fora, such as the Bank for International Settlements (BIS), the IMF or the International Organisation of Securities Commissions (IOSCO).

However, while prudential measures are not included in the countries’ Schedule still the extent of their restrictiveness may significantly undermine the level of commitment (i.e. liberalisation) of individual members. This imposes significant reservations regarding the quality of information available in the Schedule with regard to financial services. For example, quite stringent licensing procedures for new entry to the market that may be defended for prudential reasons on the grounds of market instability may be a significant impediment to new entry. To our knowledge this is still an open issue that requires defining disciplines and means to measure the degree of restrictiveness of the underlying prudential measures. Still, in theory\(^\text{13}\) under a dispute settlement mechanism any measure can be challenged as a disguised MA or NT limitation (thus in breach of section 2 (a) of the Annex).

c) **Capital mobility issues.** With regard to the financial services sector, capital mobility issues, namely capital and current transactions,\(^\text{14}\) are of particular importance. It goes without saying that without opening current accounts mode 1 is generally not feasible. That may be the reason many SEE countries keep this mode of supply closed. Regarding capital transactions these generally have an impact on all modes of supply. This has been discussed in more detail in Kireyev [2002], who has developed a table for measurement of the strength of the influence of capital transactions on particular types of services in the financial services sector, and for all 4 modes of supply\(^\text{15}\). This table shows that capital transactions are generally of minor influence in all types of insurance services for modes 1 and 2 (except for mode 1 in life insurance services where it is of strong significance). Regarding banking and securities trading the capital flows have a major significance for all types of services for modes 1 and 2 (except for financial leasing in mode 1). Commercial presence, i.e.

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\(^{11}\) See GATS Annex on Financial Services, section 2 (a).

\(^{12}\) See for example: Key [2003], page 12.

\(^{13}\) In practice no such or similar dispute has ever been undertaken.

\(^{14}\) It should be mentioned that the distinction between the two is not provided in any WTO document.

\(^{15}\) Kireyev [2002], p.13.
mode 3, in most cases does not have such strong significance\(^\text{16}\). Thus in most cases the liberalisation of financial services is not feasible without liberalising the capital and current account. Consequently, the existing capital mobility limitations should be directly or indirectly listed in the country’s Schedule in as far as they impact financial sector commitments. This we shall examine further in the following section.

2. Commitments in Financial Services in SEE Countries

2.1. Structure of commitments pertaining to financial services

It is common knowledge that the new WTO members usually make a much higher level of commitment compared to the original members\(^\text{17}\). This is a consequence not only of the way the negotiations for accession are structured but also of the WTO principle of progressive liberalisation. In the financial services sector in particular there was a pronounced increase of commitments in all members regarding the scope of sectoral coverage and the level of commitments due to the post-Uruguay rounds of negotiations that were dedicated exclusively to the financial services. The level of commitment in financial services in SECE countries, as concluded in Mattoo 1999\(^\text{18}\), is much higher compared to other members: “5 out of the 7 (SECE) countries, accounting for 79 per cent of regional participant’s GDP, already represent the most liberal markets as far as commercial presence is concerned”\(^\text{18}\). This part of the paper shall examine these findings further in the pool of SEE countries, and also by including two acceding countries, Montenegro and Serbia.

We have analysed commitments in financial services in 7 WTO member countries, in South and East Europe (SEE): Albania, Bulgaria, Croatia, Hungary, Macedonia, Romania and Slovenia. In the first stage, a preliminary analysis of the structure of WTO commitments pertaining to the financial sector was carried out. Results of this analysis are summarised in Table 1 below.

Table 1 shows that MFN exemptions are not present except in the case of Hungary. As already mentioned in the first part of our paper, exemptions from the Most Favoured Nation Treatment (MFN exemptions) are temporarily allowed\(^\text{19}\), have

\(^{16}\) The establishment of commercial presence, of course, requires inflow of capital (FDI), but such a transaction is not normally forbidden.

\(^{17}\) This information can even be found on the WTO site, [www.wto.org](http://www.wto.org).

\(^{18}\) Mattoo [1999], p. 17

\(^{19}\) According to GATS Article II.
to be scheduled in the List of MFN Exemptions of a member country, and are to be eliminated within a certain period of time. However, in the sectors and within the scope of the application of such an exemption, the member country cannot make any commitments in its Schedule.

Table 1. Structure of WTO commitments in SEE: MFN exemptions and horizontal limitations relevant for the financial services sector

<table>
<thead>
<tr>
<th>Country</th>
<th>WTO membership date</th>
<th>MFN exemptions in fin. services sector</th>
<th>Horizontal limitations pertaining to fin. services</th>
</tr>
</thead>
<tbody>
<tr>
<td>Albania</td>
<td>September 8, 2000</td>
<td>None</td>
<td>- for mode 4, and - for capital mobility</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>December 1, 1996</td>
<td>None</td>
<td>- for mode 4, and - for capital mobility</td>
</tr>
<tr>
<td>Croatia</td>
<td>November 30, 2000</td>
<td>None</td>
<td>- for mode 4, and - for mode 3</td>
</tr>
<tr>
<td>Hungary</td>
<td>January 1, 1995</td>
<td>Reciprocity condition</td>
<td>- for mode 4</td>
</tr>
<tr>
<td>Macedonia, FYR</td>
<td>April 4, 2003</td>
<td>None</td>
<td>- for mode 4</td>
</tr>
<tr>
<td>Romania</td>
<td>January 1, 1995</td>
<td>None</td>
<td>- for mode 4, and - for mode 3</td>
</tr>
<tr>
<td>Slovenia</td>
<td>July 30, 1995</td>
<td>None</td>
<td>- for mode 4, and - for mode 3</td>
</tr>
</tbody>
</table>

Hungary kept the MFN exemption that provides a reciprocity condition for the commercial presence (mode 3) of other WTO members. The original much stricter formulation of this exemption that was adopted upon its membership was subsequently watered down. Today it provides that Hungary may invoke the reciprocity condition for commitments under mode 3. It follows that the reciprocity condition is in fact subject to the discretionary decision making which is considered to be a very restrictive limitation in itself. If in the meantime “autonomous liberalisation” occurred and this limitation was relaxed still

20 According to GATS Annex on Article II (MFN) Exemptions.
21 Many countries in fact apply a more liberal regime than the one actually bound in their Schedule. If a more liberal regulatory regime is adopted in a particular economy after the date of adoption of the country’s Schedule, for many reasons most members do not change their Schedule. In WTO this is often referred to as “autonomous liberalisation”.
Hungary did not bind itself to such liberalisation in its Schedule. Therefore in our analysis we shall take this limitation in consideration.

Analysis of the horizontal limitations of SEE countries pertaining to financial services reveals three types of limitations:

- Mode 4 limitations with regard to movement of persons (e.g. residency requirements for managers or Board members etc.) which are present in every observed country. These, as well as all other limitations on mode 4 will not be the subject of further analysis as they were not considered to be representative indications for liberalisation of the financial services sector;
- Mode 3 limitations are present in 3 countries in our pool, requiring a certain form of legal entry etc. These will be subject of further analysis;
- Some countries have listed their limitations on capital movement (current and capital transactions) in the horizontal section. These will also be analysed in more detail.

To conclude the first stage, further analysis shall take into account one MFN exemption of Hungary, mode 3 limitations in the horizontal section as well as the current and capital transactions limitations listed horizontally. Mode 4 limitations and residency or other requirements upon employees that may be scheduled under mode 3 will not be the subject of further analysis.

2.2. Descriptive analysis of WTO commitments in financial services

Following the analysis of the structure of commitments in the financial services sector, the second stage in our analysis is to explore further the depth of commitments in the sector. For this purpose, in accordance with the classification set out in the GATS Annex on financial services (see www.wto.org), commitments were analysed separately for the following financial services sub-sectors:

- Insurance and insurance related services, i.e. sub-sectors (i) to (iv) according to part 5 (a) of the Annex;
- Banking services, which comprise sub-sectors (v) to (ix) in 5.(a) of the Annex;
- Other financial services (securities, money broking asset management etc), or sub-sectors (x) to (xvi) of Annex 5.(a).

Results of this analysis are presented in Tables 2 and 3.
Since banking services will be the subject of further quantitative analysis, they are analysed separately, according to sub-sectors (v) acceptance of deposits and other repayable funds from the public and (vi) lending of all types including consumer credit, mortgage credit, factoring and financing of commercial transactions. These are summarised in Table 3.

The level of commitment in the tables was sorted and outlined in the following manner:\textsuperscript{22}

- No commitment, entry “no c.,” is the situation where the country has not undertaken any commitment (“unbound” entry in the Schedule) or the limitations are such that in effect there is almost no market access (which are often referred to as “almost no c.”);
- Full commitment, entry “full c.,” is the situation where the country applies no (or practically no) limitations for market access. In case of mode 3 this includes branching\textsuperscript{23}, otherwise the situation may be categorised as “almost full c.”;
- In between the two extremes are conditions where there are some limitations. In such cases we would usually summarily state the most stringent of the limitations applicable. For example, in mode 3 the most usual limitation is “legal form of entry” which means that the country requires a certain type of domestic legal incorporation (e.g. joint-stock company) in order to achieve domestic market access through mode 3 (this also implies that no branches are allowed).

The results of the descriptive analysis presented in the Tables 2 and 3 show that the original members have a lower level of commitment as compared to the newly acceded member countries. This hypothesis will be tested further in the quantitative analysis of the banking sector.

The analysis also shows that the level of commitment is higher in the case of banking compared to insurance and other financial services. This is fully in line with the findings of OECD [2003], which concludes that in all SEE countries “financial services are dominated by the banking sector”.

Limitations on capital mobility are present in every country in the pool. In some countries, like Albania and Bulgaria, they are listed horizontally, while

\textsuperscript{22} This categorisation was developed in accordance with WTO [2001b].
\textsuperscript{23} See footnote 10.
some countries have listed them in the financial services section of the Schedule (Croatia, Macedonia and Romania). Although Hungary and Slovenia did not enter any capital mobility limitations in their schedules, they keep most of the modes of supply relating to such restrictions closed. This allows them to apply any capital mobility restrictions that may or may not be part of their respective regulatory regime\textsuperscript{24}.

Insurance sectors are more closed than other sectors. Except for an overall acceptance of the insurance-related part of the Understanding (see explanation in the previous section) pertaining to insurance of goods in transit and in maritime and aviation transport, other sub-sectors of life and non-life insurance seem to be mostly closed. The exception is reinsurance and retrocession, which in most cases are kept open.

Securities trading and other financial services seem to be the least developed. Albania even entered that it will take commitments in this sector upon adoption of adequate prudential regulation for mode 1. \textit{Almost all countries in the pool made no commitments for the first two modes}\textsuperscript{25}, while mode 3 was kept fully open only in Albania and Croatia. Bulgaria, Macedonia and Romania have some limitations on mode 3 (legal form of entry) while the cases of Slovenia and Hungary are more complicated.

Regarding mode 3, two of the three original members in our country pool, Slovenia and Hungary, are special cases. As already discussed above, Hungary applies an MFN exemption in financial services, in the form of the reciprocity condition that may be applied to WTO members for market access through commercial presence. In the case of Slovenia, there is a potential discretionary licensing issue. In its Schedule it is listed that, when considering issuing a license the Bank of Slovenia shall take into account “the national economic preferences for certain banking activities”. Discretionary licensing is considered to be a most restrictive measure that is contrary to the spirit and basic principles of WTO. In Slovenia there is also a NT limitation that provides that foreigners may not participate in privatisation of state-owned insurance companies. This restriction is to be removed upon the “adoption of the new Law on Banking.”

\textsuperscript{24} The overall level of commitment in these countries is lower compared to others, but this was not an issue since both countries were original members, who did not go through the process of negotiating accession.

\textsuperscript{25} So, although we find, same as Mattoo [1999], a high level of liberalisation in mode 3, modes 1 and 2 seem to be closed. The same will be found for banking services in the analysis below.
<table>
<thead>
<tr>
<th>Country</th>
<th>Capital mobility</th>
<th>Insurance</th>
<th>Other (securities etc.)</th>
<th>Remarks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Albania</td>
<td>Horizontal limitations for capital outflow, to be</td>
<td>Mode 1 almost no c. for life and non-life except ♦, otherwise full c.</td>
<td>Mode 1 no c. (until development of appropriate prudential regulation, 2010 at the latest),</td>
<td>Although full c. scheduled for securities trade in mode 2, additional</td>
</tr>
<tr>
<td></td>
<td>removed by 2010</td>
<td></td>
<td>otherwise almost full c.</td>
<td>commitment provides ♦.</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>Limitations on current and capital transactions</td>
<td>Significant limitations including on capital movement, except for ♦,</td>
<td>Modes 1 and 2 no c., Mode 3 limitation on legal form of entry</td>
<td>MA and NT limitations on legal form of entry in horizontal section; rather</td>
</tr>
<tr>
<td></td>
<td>scheduled in the horizontal section</td>
<td>exclusive providers of mandatory insurance ♠</td>
<td></td>
<td>limited application of ♦.</td>
</tr>
<tr>
<td>Croatia</td>
<td>Significant limitations scheduled in financial</td>
<td>Mode 1 almost no c. for life and non-life except ♦, otherwise full c. ♠</td>
<td>Mode 1 no c., mode 2 limitations on capital movement, mode 3 full c.</td>
<td>Horizontal limitation on mode 3 branches are not independent, their</td>
</tr>
<tr>
<td></td>
<td>services section</td>
<td></td>
<td></td>
<td>rights are those of the parent company.</td>
</tr>
<tr>
<td>Hungary</td>
<td>Not listed!</td>
<td>Mode 1 almost no c. for life and non-life except ♦, mode 3 MFN exemption</td>
<td>No c. by virtue of MFN exemption (reciprocity condition)</td>
<td>Legal form of entry and no branches horizontally.</td>
</tr>
<tr>
<td>FYR</td>
<td></td>
<td>(reciprocity condition)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Macedonia, FYR</td>
<td>Listed in financial services sector</td>
<td>Mode 1 almost no c. for life and non-life except ♦, mode 2 full c., mode 3</td>
<td>Mode 1 almost no c., mode 2 limitations on capital movement, mode 3 limitation on legal</td>
<td>Mode 3 limitations on legal form of entry scheduled horizontally.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>limitation on legal form of entry, branches allowed from 2008</td>
<td>entry, branches allowed from 2008</td>
<td></td>
</tr>
<tr>
<td>Romania</td>
<td>Some limitations listed</td>
<td>Modes 1 and 2 almost no c., mode 3 only as a joint venture with a</td>
<td>Mode 1 almost no c., mode 2 limitations on capital movement, mode 3 limitations on</td>
<td>Financial leasing was not included in the Schedule at all.</td>
</tr>
<tr>
<td></td>
<td>in financial services sector</td>
<td>domestic person</td>
<td>legal form no branches</td>
<td></td>
</tr>
<tr>
<td>Slovenia</td>
<td></td>
<td>Modes 1 and 2 almost no c. for life and non-life except ♦, mode 3</td>
<td>Modes 1 and 2 almost no c., mode 3 potential discretionary licensing for foreign share</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>limitations on foreign share in new companies, no c. for the existing ♠</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

"No c.” no commitment, meaning market closed (although in effect it may be open, the country did not make any obligation to keep it so)

"Full c.” full commitment, meaning fully open market without any limitations

Mode 1  cross-border supply, consumer stays in home country, service provider is abroad and only the service crosses the border

Mode 2  consumption abroad, consumer travels abroad to purchase the service from the foreign provider there

Mode 3  commercial presence, foreign legal person establishes in home country to provide the service to consumer who stays in the home country

♦ branches allowed; ♦ commitments are entirely or partially based on the Understanding, relating to insurance of goods in international transit, as well as for maritime or aviation transport of goods including the vehicle thereof; ♥ original members; ♠ the country made commitment to liberalise in the future (with adoption of new law etc.) but this liberalisation was not included in the Schedule

N.B: mode 4 limitations were not taken into account and neither were residency requirements for employees that were listed as mode 3 limitations in some Schedules

- separate provision of insurance and banking services was not viewed as limitation since most countries observe that, and so does the EU
<table>
<thead>
<tr>
<th></th>
<th>Acceptance of deposits</th>
<th>Lending of all types</th>
</tr>
</thead>
<tbody>
<tr>
<td>Albania</td>
<td>Mode 1 no c., mode 2 limitations on capital outflow (until 2010 the latest), mode 3 full c.</td>
<td>Mode 1 no c., mode 2 limitations on capital outflow (until 2010 the latest), mode 3 full c.</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>Modes 1 and 2 no c., mode 3 limitation on legal form</td>
<td>Modes 1 and 2 no c., mode 3 limitation on legal form</td>
</tr>
<tr>
<td>Croatia</td>
<td>Mode 1 no c., mode 2 only under license which may be obtained from CB in some cases, mode mobility, mode 3 full c.</td>
<td>Mode 1 full c., mode 2 limitation on capital mobility, mode 3 full c.</td>
</tr>
<tr>
<td>Hungary</td>
<td>Modes 1 and 2 no c., mode 3 limitation on legal form, no branches, state ownership and 25% + 1 vote in one bank, plus reciprocity condition</td>
<td>Modes 1 and 2 no c., mode 3 limitation on legal form, no branches, state ownership and 25% + 1 vote in one bank, plus reciprocity condition</td>
</tr>
<tr>
<td>Macedonia, FYR</td>
<td>Modes 1 and 2 almost no c., mode 3 limitations on legal form, branches allowed from 2008</td>
<td>Modes 1 and 2 almost no c., mode 3 limitations on legal form, branches allowed from 2008</td>
</tr>
<tr>
<td>Romania</td>
<td>Mode 1 full c., mode 2 CB licensing, Mode 3 full c.</td>
<td>Mode 1 full c., mode 2 CB licensing, Mode 3 full c.</td>
</tr>
<tr>
<td>Slovenia</td>
<td>Modes 1 and 2 no c., mode 3 potential discretionary licensing for foreign participation to be liberalised “upon adoption of new Law on banks“</td>
<td>Modes 1 and 2 no c., mode 3 potential discretionary licensing for foreign participation to be liberalised “upon adoption of new Law on banks“</td>
</tr>
</tbody>
</table>

CB - Central Bank of a country; “no c.” and “full c.” have the same meaning as in Table 2 above.
3. Quantitative analysis of SEE countries’ commitments in the banking sector

The commitments in the banking sector were used to calculate the liberalisation indices applying the methodology originally developed in Mattoo [1999] which was adapted for the original use of the analysis performed in this paper, to encompass specific features of the limitations present in the SEE countries. The scope of the analysis is limited to two sub-sectors in banking: (v) acceptance of deposits and other repayable funds from the public and (vi) lending of all types including consumer credit, mortgage credit, factoring and financing of commercial transactions. The scope is further limited to only the first three modes of supply, the same as outlined in Table 3.

Nine SEE countries are subject of this study. Other than the above analysed 7 countries, listed in Table 3, the country pool will also include two countries that are in the process of WTO accession: Serbia and Montenegro. Information on limitations applicable for each of the 7 WTO member countries are gathered from their GATS Schedules, in line with the above analysis and in accordance with the model set out in Mattoo [1999].

Regarding Montenegro and Serbia, since they are not members (hence do not have a Schedule) the liberalisation indices were calculated on the basis of their currently applied regulatory regime. On the one hand this means that without changing the current regime these countries cannot have a higher liberalisation index. On the other hand, it is possible and quite probable that during negotiations

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26 While the analysis in Mattoo [1999] was performed on the developing countries worldwide which were WTO members at the time, the focus in this paper is shifted to a single region and its specific limitations pertaining financial services sector. Furthermore, only four of the SEE countries that are analysed in this paper, had been subject of the analysis in Mattoo, as well. Even in those cases, some further liberalisation commitments were adopted, hence the indices had to be re-calculated and have different values now. Explanations of the methodology and issues of applying it to the SEE countries may be found in Prica, I [2009], Financial Services Liberalisation in Serbia and WTO, forthcoming, Ekonomski fakultet, Belgrade.

27 As categorised in the GATS Annex 5(a).

28 Slovenia joined the Euro zone on January 1st. 2007. Prior to that Slovenia was a member of ERM II (which is not the case with Romania, Bulgaria and Hungary). Membership in ERM II and, eventually the Euro zone, has a major influence on capital movement. However, the country’s commitments in the WTO have not been changed, and hence neither did the Slovenian liberalisation index.

29 This is the reason that for countries in the region that are not WTO members we did not calculate the liberalisation indices, or for that matter commented on the financial liberalisation process that may be happening, since that would include defining a fixed regulatory regime, legal documents, assessing them, etc., at the same time as they are being changed.
for accession they may be expected to accept a higher level of liberalisation compared to their current regime, meaning that the WTO membership may result in a higher liberalisation index (effected by the regulatory change, of course). In short, results for Montenegro and Serbia are not directly comparable to those of other countries if the currently applied regime in those countries is significantly different to the commitments in their respective Schedules. As we conclude below, this is only the case with the original members, which is the reason that we have always indicated the original members in our tables.

The liberalisation index created by Mattoo runs in the interval [0,1]. The situation where there are no restrictions on a particular service or mode of supply is considered the situation of full liberalisation and the index value is 1. On the other hand, if no commitments were taken for the studied service and supply mode, the index value is 0. Between these two extremes there are many levels of “partial” liberalisation, defined by particular commitments. Thus, in the case of mode 3 many countries impose restrictions on legal form of entry - e.g., it is required that a domestic entity be founded (no business can be conducted through affiliate offices) and the index value is 0.75.

After we assigned the indices for each of the two types of services and for each of the three supply modes investigated, what we needed was a suitable means (e.g., weighting scheme) to aggregate the data. The weighting scheme, which is supposed to define the relative significance of each of the studied service categories, was calculated based on USA foreign trade data30. The findings of our analysis are shown in Table 4.

The analysis revealed several open issues that were the consequence either of the inadequately articulated Schedules or of the regulatory framework provided by GATS:

- A specific case was presented by Bulgaria which scheduled a possibility of exclusive service providers in banking, for “budgetarily financed public institutions”. However, having in mind Item 1. of the GATS Annex on Financial Services we find that this limitation should not fall under GATS disciplines.
- In the horizontal part of the Croatian Schedule it is listed that branches are “not independent legal entities” and that their rights stem from the rights of

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30 The main reason for deciding on this weighting scheme was the fact that the USA keeps separate statistics for each of the service supply modes. Since the same weighting scheme was used for all countries, the value of the weight does not distort individual countries’ compared data.
the parent company. First of all this is contrary to the WTO definition of a branch. Secondly, this raises the question whether limitations in the Schedule that apply to the parent company also apply to the (domestic) branch. For example, in the case of banking this may imply that domestic branches of foreign banks should observe the capital mobility limitations. That in itself contradicts the fully open mode 3 for banking.

- A particular curiosity is presented by the Hungarian Schedule, complicated by the already discussed MFN exemption. In the top of the financial services section this Schedule states that commitments in modes 1 and 2 apply only to transactions listed in the parts B 3 a) and b) and B 4 a) and b) of the Understanding on commitments in financial services (these are all about the insurance of goods in transit, maritime and aviation transport). This precludes undertaking the commitments in modes 1 and 2 for banking services. For acceptance of deposits and lending services, on the other hand, the Schedule lists no commitments. This is a direct contradiction. Finally we decided, in accordance with the analysis supplied in Mattoo [1999], to accept the MFN exemption as the relevant one, while the commitments listed under modes 1 and 2 we surmised are listed in order to be applied once the MFN exemption is revoked31.

### Table 4. Liberalisation indices for banking

<table>
<thead>
<tr>
<th></th>
<th>Acceptance of Deposits</th>
<th>Lending of all Types</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hungary</td>
<td>0.21</td>
<td>0.19</td>
</tr>
<tr>
<td>Serbia</td>
<td>0.21</td>
<td>0.19</td>
</tr>
<tr>
<td>Slovenia</td>
<td>0.43</td>
<td>0.63</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>0.64</td>
<td>0.56</td>
</tr>
<tr>
<td>Macedonia, FYR</td>
<td>0.64</td>
<td>0.61</td>
</tr>
<tr>
<td>Montenegro</td>
<td>0.79</td>
<td>0.81</td>
</tr>
<tr>
<td>Albania</td>
<td>0.87</td>
<td>0.78</td>
</tr>
<tr>
<td>Croatia</td>
<td>0.85</td>
<td>0.98</td>
</tr>
<tr>
<td>Romania</td>
<td>0.99</td>
<td>0.98</td>
</tr>
</tbody>
</table>

- Original WTO members

31 Annex on Article II Exemptions (i.e. MFN exemptions) provides that the existing limitations be reviewed 5 years after the date of membership. It also states that all exemptions, in principle, shall cease 10 years after the membership date. As in every similar formulation, the issue is what does the term “in principle” mean. Hungary amended its MFN exemption after financial services negotiations that ended in December 1997. This amendment came into force on February 26, 1998. It is not clear if it may be revoked, in principle, in 2008.
The analysis performed in Table 3 and quantified in Table 4 shows that in the banking sector most limitations are present in case of mode 1, followed by mode 2. This indicates the countries’ careful approach towards liberalisation that may endanger the stability of the financial system. For inwards movement of capital these countries mainly keep their markets open (in transition the capital is the most limited resource) – only Bulgaria, Hungary and Serbia keep it closed (or rather decided not to make any commitments in the case of the former two). Regarding cross-border lending (mode 1) only Croatia, Montenegro, Romania and Slovenia have fully liberal regimes.

The highest impact on the liberalisation score is that of mode 3. Albania, Croatia and Romania have the most liberal regimes in this mode, followed by Bulgaria, Macedonia and Montenegro which have minor restrictions. Slovenia and Hungary are the lowest here, joined by Serbia which has discretionary licensing for MA in mode 3.

The liberalisation indices presented in Table 4 show that Serbia is the most restrictive country regarding banking sector openness. Hungary, which, *de facto*, applies a higher level of liberalisation has the same value. Next is Slovenia and then Bulgaria. All of these (except for Serbia which is not yet a WTO member) are original WTO members. Following them is Macedonia which has already committed to future liberalisation in 2008, when it will reach the levels of the rest of the countries in Table 4 that are all (except for Montenegro) new WTO members, which underwent serious negotiations in order to achieve membership status. Montenegro’s quite liberal regime in banking means that the country’s negotiations in this sector need not complicate its WTO membership process nor jeopardise its financial stability since its system is already adapted to the higher liberalisation levels necessary for achieving membership status. Serbia, however, needs to undergo a huge liberalisation process that may have far fetching consequences on its system.

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32 Notwithstanding because it has the highest weight in the calculation of the index.
33 Only because of the MFN exemption is Hungary’s score so low. This limitation is, however, applied only for commercial presence and not to all the countries. On the other hand, Serbia, *de facto*, applies a lower level of liberalisation since its National Bank has not approved a single new banking license in the last two years.
4. Conclusions

Our descriptive and quantitative analysis of the financial services’ liberalisation commitments in the SEE countries shows that:

1. Original members have a far lower level of liberalisation compared to other WTO members. This hypothesis applies in a country pool as small as 7 countries in one region.
2. The level and depth of commitments is correlated to the level of the particular sector development, except for the original members. This is the consequence of the way that Schedules are defined (the so-called “positive listing” approach, for further discussion see McGuire 1998]) which allows that countries may have a more liberal regime than the one in their Schedules. Since their inscription, further liberalisation steps were effected only in those countries that committed to liberalise in their Schedules.
3. Previous discussion leads to the conclusion that the later the country became a WTO member the more realistic the Schedules are as an illustration of the applied regulatory regime.
4. Consequently, the prospective members have to undergo a serious liberalisation in order to fulfil the demands put before them during the accession negotiations. For example, it is usual that the Working Group for negotiating accession of a certain country consists of the neighbouring member-countries who would normally demand that the new member apply at least the same level of liberalisation as they themselves committed to in the Schedule.
5. Therefore it is to be expected that both Serbia and Montenegro will be faced with such a situation. The high level of liberalisation in the Montenegrin financial services sector allows for the possibility that, perhaps with some obligations to future liberalisation, it may accede under the current regime. However in the case of Serbia it is apparent that significant liberalisation will be demanded. Such a change would definitely have a considerable impact on its financial system, with possibly adverse effects on its financial stability or the threat thereof.
6. This brings us to another issue specific to the financial services sector – the relationship between financial liberalisation and financial stability. Without going into this always lively discussion, we will surmise that it necessarily ends up trying to find the answer to the question of how to liberalise in order

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34 As Tables 2 and 3 show several such commitments to future liberalisation exist in our country pool. Such examples are Macedonia which has committed to allow branches of insurance companies by 2008 and Slovenia which has committed to allow cross-border consumer credits after the adoption of the new Law on Foreign Exchange.
to maximise the positive effects and minimise the negative ones (including shocks to the financial system). The main issue regarding financial stability is in fact related to unwanted capital movement (“capital reversals”) and jumps in cross-border capital flows. For that reason it is important to understand the relationship between liberalisation of the financial sector and the capital account\(^{35}\). We find that the WTO framework in fact provides enough flexibility in this respect. Our analysis, where commitments on mode 1 are few and on mode 2 rather cautious\(^{36}\), certainly proves this point.

7. We are of the opinion that the decisive impact on successful financial reform (financial liberalisation being just one aspect thereof) is that of the development of adequate institutional capacities to provide a stabilising effect, both directly and indirectly, through effecting capital mobility. In a transition country it is the state that has to play the crucial role in successful institutional development. The state has to define the regulatory framework and disciplines, form adequate supervision procedures and bodies, and above all enable a transparent financial reform process. It is of vital importance that the state finds the right balance regarding its involvement in this process - to provide enough incentives for sector development and apply enough caution not to endanger the sector stability. It is often perceived that in practice the state has the propensity to over regulate, thus smothering further financial development. This conclusion also stems from our empirical analysis where countries show that only under (outside) pressure are they ready to liberalise.

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\(^{35}\) See Kireyev [2002].

\(^{36}\) Both relate to current and capital transactions as explained in section titled “Open issues”.  

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