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10 International Trade in Banking Services

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10.1 Introduction

The international or "tradable" nature of banking services (and of financial services more generally) has been well established. It is difficult to identify any class of services for which an international demand or a capacity for international supply has been more clearly demonstrated. Foreign banking institutions are prominent in most financial centers of the developed world. "International banking" has become almost a cliché. But despite the apparent ease with which banking operations have crossed national boundaries in recent years, there remain important obstacles to efforts by banks to serve customers in foreign markets. Increasingly, these obstacles are becoming a focus for international debate and dispute.

Obstacles to international trade in banking services arise for the most part because of the special nature of banking services and the importance that all nations place on the regulation of banking operations. In every country, banking operations are subject to special regulations and restrictions. These regulations and restrictions are almost always intended to ensure the stability of national banking systems, to provide national authorities with effective instruments for economic management, or generally to encourage thrift and other social virtues. That these policies sometimes hinder the establishment of foreign banking operations or restrict the scope of such operations once they have been

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established is usually an unintended (although not always deeply regretted by domestic banking institutions) side effect.

Having grown up in response to particular national circumstances, policies toward banking operations vary widely from one nation to another. There is no international consensus about what are and are not legitimate activities for banks, about the mechanisms required for adequate supervision of banks, or about the roles that banks are supposed to play in the larger economy. Under the circumstances, it is not surprising that there is no consensus about the rules under which banks from different countries should be allowed to compete with each other within national markets.

International trade in services seems to have been identified as the next frontier for trade liberalization—especially by U.S. policymakers—and trade in banking services is likely to be an important topic for discussion whenever a new round of trade talks gets started. In this paper, I consider several aspects of trade in banking services and note the possibilities for and the problems facing expanded international trade in banking services. To the extent that this paper has a unifying theme, it is the question of whether trade in banking services really should be made a priority item in a larger effort to expand opportunities for trade in services. My tentative conclusion is that—at least for the major industrialized countries—the game is just not worth the candle. To identify progress in this area as an essential requirement for the upcoming round of trade negotiations is to risk the failure of the talks. But much more important, to succeed in facilitating expanded trade in banking services may be to accomplish something we may one day regret.

In part, this conclusion arises from consideration of the obstacles to be overcome. Painstaking negotiations will be required to reconcile legitimate national needs to regulate banking with the demands of freer and fairer international trade. In the process, many important interests will be threatened and a great deal of political capital will have to be expended—capital that might be more fruitfully employed in seeking improved trading opportunities in other areas. These problems are, I think, well understood and do not need elaboration here.

My reluctance to make a big issue out of trade in banking services stems also from some uncertainty about whether more international trade in banking services is unambiguously a "good thing." Raising a question like this among economists may seem a bit odd. Our instinct is to urge freer trade in all areas. But as I began to think about trade in banking services, I found myself becoming less sure that my instincts were right in this case.

None of us believes, after all, in completely "free" banking at the national level. We may argue about what constitutes an appropriate degree of bank regulation or what regulatory mechanisms are most effective, but we all recognize a need for some regulation. If we do not want "free" banking at the national level, maybe we should not want "freer" banking at the international level. Pertinent in this regard is the current debate over whether and under what conditions to allow increased interstate banking in the United States. To be sure, many of the arguments against interstate banking reflect little more than a desire in some quarters for *intra*national protectionism. But behind all of this smoke, there do lie some serious questions about the consequences of more interstate banking. It is difficult, for example, not to harbor at least the suspicion that the Continental Illinois debacle might have been considerably harder to deal with if the banks involved had been truly national. If there is a case for limiting interstate banking, maybe there is also a case for limiting international banking.

Obviously, there are no simple answers to these questions. In this paper, I try to lay out the potential benefits of increased international trade in banking services and to note on what conditions the existence of these benefits seems to depend. I also try to describe some of the difficulties and potential dangers that may lie in the international supply of banking services. While I hope that my analysis is correct, I will be satisfied if others' efforts to correct my mistakes bring forth some new thinking on this subject.

10.2 The Issues

My first task is to establish some reasonably concrete notion of what is at issue when we are talking about increased international trade in banking services. I should stress that I am not offering a judgment here on which aspects of trade in banking services most urgently require international discussion. Rather, I am simply noting which aspects of trade in banking services seem to be on the agenda for the upcoming trade round. The first step in this discussion is distinctly positive, not normative. (For a broader survey of important policy issues relevant to international banking—mostly issues that will *not* be addressed in the course of trade talks—see Pecchioli 1983.)

For the most part, we are *not* talking about lending to, deposit-taking from, or foreign exchange services for large corporations, sophisticated managers of large portfolios, state enterprises, or national entities. These consumers of banking services generally have access to services from any large bank in the world. They can avail themselves of these services in the home country headquarters of whatever bank they may choose. The most important barriers that banks face in this kind of business are those imposed on them by their home country regulatory authorities. It is evident that banks in many countries have developed successful strategies (too successful in some eyes) for attracting and carrying on this sort of business. Barriers to trade in these banking services do not seem to have generated much concern. To the extent that there is a public policy problem here, it is probably the other way around: how to limit these activities to levels considered safe.

Neither, more generally, are we talking about those services that are often classified as constituting truly "international" banking—that is, services supplied to foreign residents from offices in a bank's home country. Sometimes these operations can be hindered by restrictions on the customer's ability to do business with a foreign bank. If a firm is required, for example, to buy its foreign exchange from or to hold its foreign currency balances at its central bank, it may have that much less business to transact at some foreign bank. As a practical matter, though, these kinds of restraints do not seem to have become a serious issue for debate. The range and volume of services affected do not seem to be large, and one hears few complaints about these restraints. These sorts of restrictions are sometimes a reflection of economic or balance-of-payments problems, and a country imposing them may not be the most attractive place for banks to look for new customers anyway. Moreover, attempts to limit the opportunities for potential customers to deal with foreign banks sometimes foster a whole new demand for foreign banking services as the restricted customer goes through complicated maneuvers to keep his assets abroad and beyond the reach of the authorities of his country.

What people really seem to mean when they are talking about increased trade in banking services is what is often called "multinational" banking—services that require a local presence by a foreign bank: lending to small and medium-sized firms, mortgage lending, retail deposit-taking, consumer finance, and a host of so-called non-asset-based services such as securities underwriting, local-currency bond trading, foreign exchange services for small and medium-sized firms, brokering, custody services, cash letters, lockboxes, and funds collection and disbursal services. These are not services that can easily be supplied to, say, German residents from a banking office in New York. To offer these services, a bank needs to have an operation (as bankers and generals like to say) "on the ground" in the market to be served. (For a general discussion of this issue, see U.S. Government 1984. For a sampling of the debate over how best to gain access for U.S. banks to foreign markets, see U.S. Senate 1984.)

10.3 Obstacles to Trade in Banking Services

The requirement for a local presence brings a foreign bank face to face with the domestic banking policies of the host country, and this is where the trouble begins. In the past, national policies have explicitly prohibited the establishment of foreign-controlled banking institutions. As recently as 1984, for example, establishment of foreign banks' branches and subsidiaries was either prohibited by law or not permitted by prevailing policy in Australia, New Zealand, Iceland, and Sweden (OECD 1984). These absolute bars to entry have been relaxed in the past few years, however, and today only Iceland among the OECD (Organization for Economic Cooperation and Development) countries continues to prohibit all foreign-controlled banking operations. (A number of OECD countries require that foreign-controlled banking entities take on a particular legal form, usually that of a locally incorporated subsidiary.)

The "right of establishment" (to use the current jargon) remains a thorny issue in negotiations between industrialized and developing countries (U.S. Government 1984). The latter sometimes see (probably quite correctly) financial services as a growth industry. Further, they see (also probably correctly) a network of financial institutions as an important part of the infrastructure necessary for economic development. As a result, some developing nations have adopted classic infant-industry strategies with respect to financial services, excluding foreign banks from their domestic markets in hopes of encouraging the development of the local industry. Among industrialized and financially sophisticated countries, though, the simple right of establishment is usually not a major problem.

The real problems in relations among the industrialized countries arise from policies that have the effect—intentionally or otherwise—of discriminating against operations of foreign-controlled banking institutions. This discrimination can take many forms. Foreign-controlled banks may, for example, be prohibited from engaging in certain lines of business or serving particular customers. The most common restrictions of this sort are regulations preventing foreign banks from underwriting bond issues or managing or participating in securities issues and measures that deny foreign banks access to government deposits. Foreign banks are sometimes limited to a specified share of the national banking market. In Canada, for example, foreign-controlled banks may not hold more than 16 percent of all domestic bank assets. Branches of foreign banks must in some instances meet special capital-adequacy criteria. Foreign-controlled banking entities are also faced with a variety of "nuisance" obstacles to efficient operations. Sometimes these take the form of immigration policies that hinder the use of home-country nationals or requirements that host-country nationals be included in the institution's management or on its board. Sometimes foreign banks do not enjoy the same access to government-controlled communications and information transfer services as do domestic banks.

Restrictions are sometimes placed on the advertising of foreign-controlled entities. In the U.K., for example, advertising by banks based outside the European Community must include a warning about the absence of deposit insurance and of possible transfer and exchange risks. Even the names of foreign-controlled institutions are sometimes subject to regulation. The names of foreign banks operating in Switzerland must not give the impression that the bank is Swiss, and in the Netherlands certain conditions must be met before an institution based outside the European Community can use the word "bank" in its name. (These examples of restrictions on foreign banking operations are drawn from OECD 1984; Walter 1985; U.S. Government 1984; and U.S. Treasury 1984.)

In the industrialized and financially sophisticated world, foreign banks are generally permitted to establish representative offices as they please. At most, permission of the host government is required, and this permission is generally granted. These representative offices can be active in marketing a bank's services and in prospecting for customers. They cannot actually conduct business—cannot make loans, cannot take deposits.

A full accounting of all the restrictions facing foreign banks is beyond the scope of this paper. In 1984, the OECD compiled a summary of regulations affecting the establishment and operations of foreign-controlled banks within the OECD area (OECD 1984). Even this summary required 84 pages. Moreover, any list of such regulations will be out of date almost before it is printed. Since publication of the OECD volume, Japan, New Zealand, Australia, Sweden, Germany, the Netherlands, France, and the U.K. have all altered policies to reduce obstacles to foreign banking operations. (Personal communication, U.S. Treasury Department). Despite these movements toward liberalization, there seems little reason to alter the conclusion reached by Ingo Walter in his recent study of barriers to trade in banking and financial service: "Foreign-based financial institutions operate in one of the most restrictive environments in international trade" (Walter 1985).

Any agreement on principles for trade in banking services will almost certainly include the requirement that "national treatment" be extended to foreign banking entities, making them subject to the same rules as domestic banks. The only alternative basis for agreement, "reciprocity"—country A allows banks headquartered in country B to carry on only those operations that country B permits to banks headquartered in country A—would produce a regulatory nightmare with foreign banks in a major financial center subject to a variety of different limitations. Neither would reciprocity do much to advance trade in banking services. Banks operating in foreign markets would be restricted to offering only those services allowed to domestic banks in *both* home and host countries, very likely fewer services than could be offered by domestic banks in either country. The general stance of the U.S. government in international negotiations on trade in banking services is to seek national rather than reciprocal treatment of U.S. banks abroad (U.S. Senate 1984).

But in some cases, national treatment can be as much of an obstacle to trade in banking services as it is a principle for allowing freer trade. Canadian banking rules provide a particularly neat example of how national treatment can place a foreign bank at a disadvantage. In order that all banking institutions may be unambiguously subject to Canadian law and to facilitate oversight of banks by supervisory authorities, the Canadian Bank Act requires that all banking entities operating in Canada be locally incorporated. This effectively prohibits the establishment of branches in Canada by foreign banks. Foreign banks may operate in Canada, however, through locally incorporated subsidiaries. These subsidiaries, so-called schedule B or "closely-held" banks, are subject to the same regulations as domestic schedule B banks. These subsidiaries are invariably smaller than major Canadian domestic banks, and they have no legal claim on the resources of the foreign parent bank beyond their initial capitalization (although a "comfort letter" from the foreign parent is required). As a result, they are generally seen as poorer credit risks than large Canadian banks and must therefore pay higher rates for deposits than do large Canadian banks. Before the Bank Act came into force in 1980, foreign banks conducted business in Canada through special, nonbank financial companies, operating under a different set of regulations than did domestic banks. There were many disadvantages to this arrangement as far as the foreign banks were concerned, but they were able to fund their operations by issuing commercial paper in the name of their parent banks. After 1980, however, the new schedule B subsidiaries had to issue certificates of deposit in their own names, and subsidiaries of the larger U.S. banks found themselves paying about 25 basic points more for funds than previously. In the view of some foreign bankers, the extension of national treatment to their Canadian operations did more harm than good.

10.4 Why Trade in Banking Services Has Become an Issue

Foreign banks have been well represented for a number of years in most (although by no means all) major financial centers of the industrialized world. In the past, foreign banks usually did not compete with domestic banks for domestic business. The foreign banks traditionally concentrated their efforts on serving the multinational companies headquartered in their home countries that they had "followed" abroad. Often (as with U.S. banks in London in the 1970s) they took advantage of less burdensome regulations abroad, offering services to their traditional customers at home or in third countries through a foreign office where banking regulations allowed types of operations prohibited at home. In an important sense, the establishment of a London branch of a U.S. bank during the mid-1970s probably represented more an export of British banking services to the United States than an export of U.S. banking services to the U.K. The London branch of the U.S. bank was, after all, staffed mostly by Englishmen whose salaries were paid largely by U.S. corporations using the branch to gain access to the Eurodollar market. When foreign banks did serve local customers, it was usually in some transaction that involved the bank's home country or its financial markets—matters in which the foreign bank would be recognized as having particular expertise. Domestic and foreign banks usually found themselves in direct competition only in providing banking services for customers in third countries.

This specialization by foreign banks reflected in part their previous customer relationships. Banking, it is widely said, is a personal business, and foreign banks naturally concentrated their attention on the customers with whom they had had the closest contact. It also reflected the fact that, even in the absence of overt discrimination, foreign banks were generally at a disadvantage in serving local markets. Without the branch networks, the established customer relationships, and the familiarity with local markets that domestic banks enjoyed, foreign banks found themselves without secure local currency deposit bases. To fund their local-currency business, foreign banks had to rely primarily on the interbank market. In general, it was more expensive for foreign banks to borrow local-currency funds from domestic banks than it was for the domestic banks to raise funds directly through deposit taking. Thus, foreign banks found themselves at a disadvantage vis-à-vis domestic banks. This dependence on the interbank market for funding also encouraged a certain competitive restraint on the part of the foreign banks: If you try too aggressively to win the clients that are the bread and butter of a domestic bank, you may find your access to funds at its interbank window suddenly terminated.

In recent years, though, this situation has begun to change. As foreign banks have gained confidence and experience in dealing with host-country firms, they have gradually begun to see opportunities for attracting more local business. Stronger local deposit bases have improved their competitive position in the local market; and to attract these deposits, the foreign banks have sought more aggressively to serve local customers. At the same time, changing economic conditions have brought new opportunities for banks to offer non-asset-based services. The booming demand for foreign exchange services in the late 1970s and early 1980s, for example, opened a major new market in which a foreign bank could serve just as well as a domestic one. Local-currency funding was much less important in these new lines of business, and therefore the disadvantage faced by foreign banks was less.

A worldwide trend toward financial market deregulation and financial market innovation has also produced a variety of new possibilities for banks, and subsequently a variety of new financial instruments and services. New markets have opened in which domestic banks have no long-standing position. Indeed, in some cases a foreign bank with experience at offering a particular service in its home country might find itself with an advantage over domestic banks in a market where such activity is emerging for the first time.

A growing "internationalization" of all business activity also has contributed to eroding barriers to operations by foreign banks. Firms in all countries are making increasing use of foreign financial markets. It is no longer unusual, for example, for a U.S. firm to borrow Swiss francs and convert them to dollars to fund a U.S. investment program, knowingly assuming a foreign exchange risk in return for a lower interest rate. As firms become more comfortable with the idea of borrowing foreign currencies, foreign banks without local-currency funding will find their positions strengthened.

Another result of deregulation has been an increased emphasis on retail banking as a growth strategy. Services to retail depositors and borrowers have traditionally been among the most heavily regulated services provided by banks, and deregulation has therefore opened a particularly rich set of opportunities in this area. In the United States, and in other industrialized countries as well, retail customers are becoming more aggressive, demanding a wider variety of banking services at finer prices. Many see retail financial services as a major growth industry, and the ability of foreign banks to provide these kinds of services is particularly at issue.

Finally, technological progress in telecommunications and data processing may have brought new possibilities for economies of scale. This may be encouraging efforts by banking institutions to grow, and foreign markets may in some cases provide the most attractive opportunities for growth.

The last few years, then, have seen an erosion in the "natural" barriers to foreign bank operations. As these barriers have declined, what are perceived as "unnatural" barriers—barriers arising from government policies—have loomed relatively larger. This has happened at a time when the incentives for expansion by banks into foreign markets are also growing. The not very surprising result is intense new interest in how national policies do or do not hinder trade in banking services. (For an indication of interest within the banking community in improving access of U.S. banks to foreign markets, see U.S. Senate 1981.)

10.5 What Really Is Being Exported

What is at issue, then, in the debate over international trade in banking services is the right of foreign banks to compete for customers in the domestic market of the host country. To what extent, though, does the provision of these services really constitute an export?

A visit to the foreign branch of any major U.S. bank will reveal an office staffed overwhelmingly by natives of the host country. Sometimes this staffing pattern is required by local immigration laws; in many OECD countries, obtaining work permits for foreign personnel can be difficult. (Restrictions on foreign workers can form very effective barriers to foreign competition in many service industries, and these rules will almost certainly become an important focus for discussion whenever talks on service trade are begun in earnest. It may turn out that the real key to agreement on rules for trade in services will be agreement on policies towards foreign workers.) But the use of native staff is also simple good business. Language, cultural affinity, and direct experience with prevailing local conditions are important elements in successful banking relationships, and it is in native staff that these qualities are often most easily found.

Funding, the other principal input to the production of banking services, is generally procured locally as well. Foreign banking operations generally rely only minimally on funding from the parent bank, turning instead to the local interbank market and, when possible, to local deposits for raising funds, particularly local-currency funds. The other inputs to this production process—facilities, communications, data processing, and so on—are also generally purchased locally.

Banking services are not like automobiles or textiles. Export either of the latter, and you employ more workers and raise incomes in the exporting country. To the extent that other inputs also are produced in the exporting country, you increase employment and income that much more. Export banking services in the sense described above, though, and you mostly generate jobs for foreigners, pay interest to foreign depositors, and pay foreign suppliers for most of your other inputs. What the home country gets is some remitted profits and a modestly increased demand for supervisory and headquarters personnel. For those who see increased exports of services as an important way of increasing employment and income, banking services may turn out to be a disappointment.

The other side of the coin is that the importation of banking services is unlikely to have a major impact on employment of importing country nationals in the banking sector. If a foreign bank captures a significant share of the domestic market, workers displaced from a domestic bank are likely to find opportunities to move across the street, going to work for the newly arrived foreign bank. Indeed, if some local workers do not move across the street, the chances of a foreign bank's gaining a share of the local market are probably small. Neither will the capture of some share of the market by foreign banks affect the demand for local deposits or for other inputs to the banking process. If anything, the arrival of a foreign bank is likely to increase demand for these inputs. A fear that increased imports will leave some local resources underutilized (a reasonable concern, at least in political terms, in the case of merchandise imports) is probably not justified in the case of banking services. Those who see international trade in banking services as a potential threat to local employment or local income are probably worrying unduly.

What are really being traded in the case of banking services, it would seem, are managerial services, technical know-how, networks of contacts, certain analytical and information services, and the name of the parent institution. The only local resource that may be left underutilized by an increase in foreign banking activity is local bank management. (Similarly, the home-country resource most likely to be more in demand as a result of increased trade in banking services is bank management. A cynic might see in this an explanation for the vehemence with which senior bank executives sometimes approach questions concerning international trade in banking services.) What is being exported and imported are not really banking services at all, but the technical and managerial structure necessary for the local production of banking services and the capital necessary to establish a branch or subsidiary to deliver banking services.

This leads to my first general observation. Discussions of rules for international trade in banking services would seem to have much more in common with discussions about rules for international direct investment than with discussions about merchandise trade. Perhaps the inclusion of banking services in a round of negotiations aimed at liberalizing other, more traditional forms of trade is not the best idea.

This line of argument also raises a suggestion for empirical work. As far as I can tell, no one has a good idea about how much "trade" there really is in banking services. We do not have a clear picture of the value of services provided to banking customers by foreign banks. Neither do we have any idea what fraction of the value of these services is accounted for by returns to factors of production located in the foreign bank's home country. I suspect that the truly "traded" component of banking services is small, that most of what may appear as the provision of banking services by a foreign bank is really local production. I suspect, therefore, that there is much less to trade in banking services than may at first meet the eye. It would be interesting to see some careful empirical work in this area.

10.6 The Benefits of Freer Trade in Banking Services

To argue that the direct employment and income effects of trade in banking services are small is not to argue that trade in banking services is an unimportant or an uninteresting issue. The centrality of the banking function to the operation of the wider economy is such that questions about how the banking system operates and by whom it is operated are always important. There is also a particular analytic attraction in the question of trade in banking service. Precisely because the direct employment implications of such trade are relatively minor, some of the more emotional arguments for and against freer trade are minimized. This gives more leeway for the more fundamental analysis of the type that economists prefer. I now turn to more traditional arguments about the benefits of trade in banking services.

Traditionally, two sorts of gains arise from freer international trade:

1. Increased opportunities for trade can promote more intense competition within national markets and can lead to more efficient production of the traded good or service.
2. Each trading nation gains by specializing in the production of the goods or services for which it enjoys a comparative advantage.

Dealing with the first of these benefits is relatively simple. Lack of competition in the banking sector, as in any other sector, can allow inefficient providers to survive, reducing the range of services available to customers, and raise the prices of services that are provided. The experience of countries that have deregulated their banking sectors so as to allow more competition provides ample proof of these points. Increased competition has forced some banks out of business and forced survivors to offer a broader range of customer services at lower prices. This is undoubtedly a benefit to customers.

What is not clear is whether the presence of foreign banks is necessary to foster more intense competition. Most obstacles to competition in banking services arise from local regulations that prohibit entry into the banking sector, fix interest rates, or otherwise restrict competition. It seems likely that important gains in this direction could be achieved simply by adjusting national policies. Indeed, if these policies are not adjusted, allowing foreign banks to operate in domestic markets will probably do little to encourage competition; newly arrived foreign banks will sink into the same comfortable noncompetitive life enjoyed by domestic banks. Where restrictive regulations have been relaxed, more intense competition seems to have arisen even without a surge of activity by foreign banks. Thus, it would seem that allowing international trade in banking services is neither necessary nor sufficient to bring about the undoubted benefits arising from more competition in the banking sector.

The issue of comparative advantage in banking services is more difficult. If banks in one country can produce banking services more efficiently, in terms of the other goods and services produced in that economy, then can banks in another country, and if this efficiency can be "exported"—that is, if it persists when a bank from the first country offers services in the domestic market of the second—there will be welfare gains to be had by allowing banks from the first country to supply banking services in the second. If there is no substantial difference in the relative costs of producing banking services in the two countries, or if differences cannot be transferred to another market, then there is little to be gained from trade. We have, then, two kinds of questions to answer:

1. What factors can bestow on a bank (or banks based in a particular country) greater relative efficiency in providing banking services?
2. Can this efficiency be "exported"?

Let us consider a number of possible sources for banking efficiency. (In the rest of this discussion, I will sometimes make points in terms of absolute rather than strictly comparative advantage. I do this for convenience of presentation. All of these points could be made—more clumsily—in terms of comparative advantage without altering the nature of the results. For a survey of studies on what constitutes advantage in the international supply of banking services, see Aliber 1984. For a more general discussion of comparative advantage in services trade, see Deardorff, 1984.)

The availability of sufficient numbers of well trained and disciplined clerical workers at a relatively low wage will undoubtedly give a country a strong advantage in producing banking services. Such workers are important inputs to the production of banking services, and a plentiful supply of them will reduce the cost of producing such services. But this workforce is not exportable. As we have already noted, clerical staff in the branches and subsidiaries of foreign banks are generally hired in local labor markets. Thus, being headquartered in a country endowed with the kind of workforce necessary for banking is not likely to bestow any particular international advantage on a bank. Thus, there seems little reason to expect gains from trade to arise because of differing labor force characteristics in different countries.

The efficiency of bank operations can vary, of course, with the quality of bank management. At any given time, there will be a group of banks, not necessarily all in the same countries, that will be able to offer better or cheaper services than can other banks by virtue of their simply being better run than other banks. To the degree that this managerial talent reflects expertise in dealing in particular financial markets, it will not be transferable to markets in other countries. But to the extent that it is embodied in personnel policies, operating procedures, data-processing operations, or other techniques not unique to particular markets, it may be "exportable." Freer international banking may give rise to welfare gains if customers are able to avail themselves of higher-quality services when from time to time they are offered by foreign banks.

One might wonder, though, whether gains of this sort are likely to be very significant. Little banking technology is proprietary. Bank officers with detailed knowledge of banking products and internal operating procedures frequently move from bank to bank, and bank personnel frequently go abroad to learn the latest techniques employed by foreign correspondent banks. It seems unlikely that any bank has unique procedures or management secrets that are not known to other banks. Further, most large banks have the size and capital resources necessary to implement good ideas they pick up from the outside. (Among U.S. banks at least, the ability to copy new ideas quickly is striking.) If differences in product lines or management practices persist for extended periods, they are likely to reflect some adaptation to local conditions. When foreign products and management techniques differ systematically from local ones, the advantage must be presumed to lie with local practice. In these circumstances, the products and practices of the foreign bank are unlikely to be exportable, and the gains from freer trade in banking services are again likely to be minimal.

A more likely source of advantage in the provision of banking services lies in differing abilities to attract deposits and to raise capital. These abilities will in turn be strongly influenced by national policies toward bank regulation. Banks in one country might, for example, be perceived as being somewhat safer than banks in other countries. Perhaps this is because they are supervised by a regulatory authority seen as particularly wise, careful, or strong. Perhaps it is because prevailing national banking regulations guarantee particularly prudent behavior. Or perhaps banks headquartered in that country have access to a particularly reliable lender of last resort. Whatever the reason, these banks will be able to raise capital and to attract deposits more cheaply than will banks less favorably situated. As a result, they will have a cost advantage over banks in other countries and should be able to offer loans at lower rates and nonasset services at lower prices. These banks will enjoy a true advantage; and if this advantage can be maintained in an "export" market, there will be gains to allowing such banks to provide services in foreign markets.

Banks' competitive positions can also be affected by reserve requirements and regulatory attitudes about capital adequacy. Banks required to hold large amounts of non-interest-earning reserves are at a disadvantage vis-à-vis banks not required to do so. Banks permitted a low capital/asset ratio should be able to offer finer spreads than a bank forced to operate with a lower gearing ratio. Obviously, competitive advantage in these circumstances is bought with some increase in risk, but other policies—such as strong government guarantees or particularly close supervision—may compensate for these higher risks. In terms of usual trade theory, if two countries have differing endowments of the factors necessary for efficient banking (such as confidence in the banking system or a set of regulatory policies that accommodate banking), and if these endowments are reflected in cross-border operations, then there may be significant gains from trade.

Whether these advantages are exportable will depend on the mechanism by which export is accomplished. If the exporting bank establishes a branch to serve a foreign market, many of the characteristics of the parent bank are exported. The bank's home-country regulations apply to the operation of the branch, home-country authorities oversee its operation, and all the resources of the parent bank stand behind it. To the extent that these characteristics inspire confidence and allow the branch to attract deposits or capital easily, the advantages enjoyed by the parent bank are exportable. Also exportable, in general, are home-country reserve requirements and definitions of capital adequacy. If these are the basis of a competitive advantage, they too can be transferred. What is not entirely clear is the extent to which the foreign branch has access to the lender-of-last-resort facility of the home country central bank. The Concordat concluded among major central banks in 1975 suggests that the central bank of the parent should be responsible for foreign branches. (The text of the Concordat has been published in IMF 1981.) Some doubt remains, however, about whether foreign branches can really count on support of their home-country central banks. Fortunately, these guarantees have never been put to a test. Even if the support of the home country central bank were certain, the export of confidence in the parent bank could never be complete; depositors are understandably hesitant to rely on promises by a foreign central bank that might have to be mediated through a foreign legal system.

If, on the other hand, the mechanism for export of banking services is a foreign subsidiary, export of the parent bank's advantages is more problematic. The subsidiary has no legal recourse to the resources of the parent beyond its initial capitalization. Neither do regulatory authorities in the home country of the parent bank have any direct control or supervision of the subsidiary. Reserve requirements and capital adequacy tests of the host country are operative for the subsidiary. And the central bank Concordat makes the host-country central bank the lender of last resort for the subsidiary. (That home-country central banks can feel little responsibility for foreign subsidiaries was dramatized in 1982 when, in the wake of the Banco Ambrosiano affair, the Bank of Italy refused to extend guarantees to deposits in Banco Ambrosiano's Luxembourg subsidiaries.) I believe that the only things that are exported when a foreign subsidiary is established are the parent bank's ability to raise capital and the parent bank's upper-level management structures. It is hard to see how the establishment of a subsidiary can provide an effective mechanism for the export of other competitive advantages. This leads to my second general observation: If we are seeking welfare gains from trade in banking services, we probably must allow cross-border branching; subsidiaries will probably not do the trick.

While establishing foreign branches may be the only way effectively to export the important qualities of a bank to foreign markets, branches can pose serious difficulties for host countries. The host country can generally exercise no control over and only limited surveillance of the parent bank, and thus has little control over the soundness of a banking institution providing services to its residents. This can be overcome by requiring the formation of a subsidiary clearly separate from the parent bank. But to do so is sometimes to get the worst of everything. By insisting that foreign banks operate as subsidiaries, for example, Canada has gotten American bank managers who may or may not fully understand the Canadian financial markets in which they operate, without any recourse to the substantial assets and reserves of the parent American banks should these managers get into trouble. A fundamental dilemma is posed: The benefits of trade in banking services can be realized only if host-country authorities are willing to relinquish regulatory control and oversight of some banking institutions operating in their territory. Insulation from the dangers of foreign banking practices can be bought only at the price of insulation from the benefits of these practices as well.

10.7 The Dangers of International Trade in Banking Services

Many banks apparently feel that the difficulties of exporting operating efficiencies across national boundaries can be overcome and that successful operation in foreign markets is possible. Why else would banks show such interest in establishing a presence in foreign markets? If banks think they can succeed in foreign markets, why should we not allow them to try their luck? Indeed, since some gains *may* arise from increased trade in banking services, why should we not do everything possible to remove barriers to such trade?

The principal reason for caution in encouraging more trade in banking services is that this trade may erode the safety and stability of the global banking system or, depending on prevailing regulatory policies, the safety and stability of either host- or parent-country domestic banking systems. In every country, regulatory authorities and central banks bear at least some of the risks inherent in banking operations. The decision to commence banking operations in a foreign market may increase the risks borne by regulatory authorities in either the home or the parent country without necessarily imposing any additional costs on the bank wishing to engage in multinational business. If, for example, deposits are fully guaranteed by national authorities, depositors have no reason to demand higher interest rates even if banks take on riskier operations. Similarly, if regulatory authorities do not increase the costs of deposit insurance as banks take on riskier operations (and how are regulators realistically to measure risks?), banks do not face the full extra costs of engaging in riskier business. Thus, moves that may appear profitable to an individual bank, may impose extra risks on the wider society and may result in a hidden loss of overall welfare. In the usual jargon, moral hazard may result in negative externalities when a bank decides to engage in cross-border operations.

Does the entry of a bank into a foreign market increase the riskiness of its operations? Some have argued that by allowing banks to broaden the scope of their operations, by allowing them to enter new lines of business or to extend their operations geographically, we allow banks to diversify their operations and thereby reduce their risks. This argument makes sense only if the quality of bank management is independent of or is positively correlated with the scope of banking activity. I think that it is not unduly uncharitable to say that recent experience has, at the very least, raised some questions about the validity of this proposition. The diversification of bank portfolios away from traditional forms of lending into international lending and a variety of new services does not seem to have brought about any marked reduction in riskiness of major banks. Neither has it made these banks noticeably better able to retain their balance when traditional loans (in, for example, the energy or agricultural sector) go bad.

For some time now, the managements of big banks have faced incentives to grow—often without taking full account of the risks thus incurred. Recent difficulties have complicated the process of growth, but they have probably not altered the underlying incentives. It is still a better and better paid job to run a bigger bank. Incentives to growth may also have been strengthened by recent problems with bad loans: One way to deal with a fixed volume of bad loans is to enlarge the bank enough to absorb them, and foreign markets may appear to be a fruitful field for expansion. The trick, of course, is to avoid taking on more bad loans because the bank is growing too fast. Some have argued that the rush by major banks to establish a presence in new markets either at home or abroad has distracted management attention from the basic business of credit assessment and risk control. The result is at least a perception that major banks are in a more precarious position today than at any time since the Great Depression.

The expansion of banking activities into new markets also places new demands on regulatory authorities. As new financial instruments appear, for example, regulators cannot always clearly identify what constitutes credit exposure for a bank. When a bank moves into a foreign market, domestic regulators may not fully understand the circumstances prevailing in foreign markets or may not have access to information essential for assessing the creditworthiness of foreign borrowers.

The presence of foreign banks in national financial markets may also increase somewhat the "interconnectedness" of the international financial system, making it easier for shocks (and there will inevitably be shocks) to propagate through the system. Perhaps one should not make too much of this point. The Penn Square/Continental Illinois fiasco made it clear that the degree of interconnectedness is already such that the failure of a rather small Oklahoma bank could lead to severe difficulties for a number of foreign banks that had deposited large amounts with Continental. (For a readable and entertaining account of the Penn Square debacle, see Singer 1985. A more traditional account is available in U.S. Senate 1982.) The situation might not have been appreciably worse if large numbers of foreign retail customers had also been at risk.

If there is any difference between the situation we have now and the situation that might prevail if there were a significant increase in trade in banking services, it might lie in the political implications of a bank crisis originating abroad. The non-U.S. banks that found themselves in a difficult spot because of Continental's troubles were large enough and sophisticated enough that they might reasonably have been expected to make informed judgments for themselves about the soundness of the U.S. banks they dealt with. U.S. regulatory authorities guaranteed the large deposits of these banks (a step not required by U.S. banking law) in order to prevent a bad situation from becoming worse, not because they felt any moral or political obligation to protect these foreign banks. Financial authorities outside the United States also might not have felt much obligation to make whole these banks. As long as the losses incurred did not threaten the stability of national banking systems, there was no reason to act to minimize the losses suffered by banks that should have known better than to deposit too much at Continental.

The situation might have been quite different, though, if Continental had had a host of foreign retail customers. These customers could not reasonably have been expected to assess the relative safety of the various banks seeking their deposits. If a bank is allowed to take retail deposits, it is not unreasonable to expect local authorities to make sure it is sound. The burden of assessing the soundness of foreign banks in this situation falls more heavily on local regulatory authorities—who may or may not be up to the job. Perhaps life would be simpler all around if local authorities were responsible for local banks only and were not expected to take on the daunting task of investigating the soundness of every foreign bank that seeks to open up shop in their area of responsibility.

To the extent that one is willing to rely on the terms of the central bank Concordat, which calls for the monetary authorities of the parent country to stand behind deposits in the foreign branches of banks headquartered in its territory, one might come to the mildly ironic conclusion that the most sensible national policy toward trade in banking services would be to seek to attract branches of foreign banks into local markets while discouraging branching of domestic banks into foreign markets. This, of course, is just the opposite of what is generally sought in discussions of trade in banking services. It may be that one of the few things actually being exported when a bank establishes a branch in a foreign country is the guarantee of the home-country regulatory authority to make whole a foreign depositor who might lose money as a result of problems within the multinational bank. The regulatory authority in question may or may not receive compensation for this extension of its contingent liabilities. If it does not, or if these costs are borne by home-country interests, the taxpayers, banking customers, or bank shareholders, country A may be providing deposit insurance for the residents of country B at little or no cost to B.

Another danger inherent in wider trade in banking services is the pressure that might be brought to bear on national regulatory authorities to make banks under their jurisdiction internationally competitive. We have become accustomed to pleas to governments to ease this or that requirement for pollution control or worker safety in order to make some domestic manufacturing industry competitive in world markets. Regulatory competition of this sort is often regrettable, the result being more injured workers or dirtier air. But at least where manufacturing industries are involved, the suffering that results from unwisely waived regulations is usually limited to the constituents of the government that knuckled under to pressure.

Imagine what might happen if trade in banking services became a major item in some countries' balance of payments. Pressures would arise from the banking lobby that local reserve requirements were too high to permit effective competition with foreign banks regulated by more "reasonable" authorities or that local reporting requirements were too burdensome and imposed costs that were pricing domestic banks out of foreign markets. I am not being an alarmist; pressure of this sort is already being brought to bear. In January 1986, the U.S. Federal Reserve proposed the eminently sensible idea of tying bank capital requirements to the riskiness of bank asset portfolios. An official of the American Bankers Association opposed such a step on the grounds that it would "make the industry less competitive with financial institutions that wouldn't have to meet such standards" (Nash 1986).

By giving in to these pressures, regulatory authorities would endanger not only the assets of their own citizens but perhaps the stability of the entire global banking system. One might imagine the result of an international competition among national bank regulators, each trying to make banks in his own country more competitive. The regulators *might* seek to achieve this end by insisting on extremely prudent behavior, enforced by strict regulation. Alternatively, regulators might seek competitiveness through lax regulation, low reserve requirements, and relaxed attitudes towards capital adequacy. Badly regulated banks might drive out well-regulated ones if the near-term cost advantage of being badly regulated were sufficient to allow the former to take markets from the latter. Given the difficulties already facing bank regulators, perhaps it would be better not to allow considerations of international competitiveness to influence regulatory policy. Perhaps it would be better if banking remained a national industry. My third observation, then, is that banks contemplating an expansion into foreign markets may not face the full costs of such an expansion. By deciding to proceed with their plans, they may impose excessive costs on all the rest of us.

10.8 International Trade in Banking Services and the Optimal Size of Banks

Another reason for caution in encouraging increased trade in banking services is that it might lead to banking markets being dominated by fewer, bigger banks. There is no international bank regulator. As bank operations sprawl across the globe, who is to guarantee prudent behavior? The only possible answer seems to be that we must rely on market forces to supply the necessary restraint. Before the Continental affair, U.S. regulators had announced what seemed an appealing policy. They clearly stated their intention to limit deposit insurance to the $100,000 per depositor per bank prescribed by the policies of the Federal Deposit Insurance Corporation. Depositors of larger amounts were presumed to have the resources and the sophistication to form their own judgments about how prudently the banks they placed deposits with operated. By placing these larger depositors at risk, the authorities hoped to impose some market discipline on U.S. banks. Banks with suspect loan portfolios or less than entirely reliable funding arrangements would, the thinking went, find themselves paying a premium for their deposits and thus have an incentive to clean up their acts.

For a policy like this to work, large depositors must believe that they really can lose their money. The catch, as it turned out, was that Continental was just too big to be allowed to fail; U.S. authorities eventually guaranteed all deposits fully. This is not to suggest that U.S. authorities did the wrong thing in the Continental case; they probably had no other choice. (At least at the time they thought that they had no other choice.) But once they had guaranteed all deposits, the previously announced policy was seen to have been a bluff. It seems unlikely that in the next few years any national banking authority will be able credibly to threaten the large depositors of any major bank with the possible loss of funds.

This suggests that if we are trying to design the global banking system for tomorrow, we ought to be seeking ways to produce banking institutions that are big enough to capture the substantial economies of scale that mark the banking business, but are not so large that they cannot fail from time to time. Continental was thought to be too big to be allowed to fail, and there are today plenty of banks bigger than Continental was. If we are going to have to rely on the market to encourage prudent banking behavior in the future (and where else will we have to turn?), we might want to consider how to reduce the size of some of the larger banks, or at least how to slow their growth sufficiently to let growth of the world financial system reduce their relative size. As the costs of information transfer and data processing continue to fall, it may also be that the minimum efficient size for a bank is decreasing. One wonders if there will be a continuing need for the very large financial institutions that we have today. I do not know of any serious efforts to estimate costs functions for the production of banking services. Work of this sort might yield some interesting insights into the optimal size of banking institutions.

What does this have to do with freer trade in banking services? One possible consequence of freer trade in such services is an increasing concentration in the global banking industry. Little is known about market dynamics in the banking industry. I do not really know whether large banks have important competitive advantages over small banks. It is certainly possible, though, that only large banks will have the resources to jump into new markets. And if such banks succeed in capturing a share of foreign markets, it may well be at the expense of smaller banks in the host country. My fourth observation is that freer trade may result in bigger banks controlling more of the total market for banking services—bigger banks whose failure is likely to be less thinkable than was Continental's. Restricting the geographical spread of banks is almost certainly not the ideal way to slow their growth. It may, however, be the most natural and politically feasible way to do so.

10.9 What Kinds of Agreements Are Necessary?

There is no denying the fact that perceived obstacles to trade in banking services are a source of tension today among the developed, financially sophisticated countries of North America, Western Europe, and the Pacific rim. Banks in all of these countries frequently want to do more in foreign markets than host-country policies will allow, and these banks put pressure on their governments to negotiate them a better deal. I wonder, though, how long-lived this kind of pressure will be. We have seen that the principal issues are the right of establishment in foreign markets and the terms under which foreign banks are to be allowed to operate once they are established. We have also seen that for some kinds of business, local establishment seems to be essential. Will this continue to be the case?

I have no doubt that personal representation in a particular market will always be required. The need for bankers and customers to meet face to face seems unlikely to go away. Almost all developed countries allow the free establishment and unhindered operation of representative offices of foreign banks. These offices can manage customer contacts, negotiate terms of transactions, and generally market the foreign bank's services. They cannot actually book business. If the activities of a foreign representative office are to bear fruit, a foreign customer must ultimately deal with the headquarters of the parent bank or one of its branches in a third country.

There are three kinds of obstacles to these cross-border transactions. The first is regulatory: one of the countries involved in the transaction may have capital controls or currency restrictions that prohibit the external transaction contemplated. The second is practical: communications difficulties, time-zone differences, and so on may hinder the smooth execution of the transaction. The third is legal: a customer with a grievance will have to deal with a foreign legal system.

All indications are that obstacles of the second sort are being rapidly eliminated. Communication and electronic funds transfers are becoming easier and cheaper. Financial market hours are being extended and financial institutions are becoming increasingly willing and able to transact business around the clock. Customers also are becoming increasingly comfortable with the prospect of electronic financial transactions. When a customer uses an automatic teller machine, transfers funds by wire, or takes advantage of automatic funds collection or disbursement services, does it really matter whether the computer handling the transaction is in his own country or not? Indeed, we are told that what seem to be purely domestic transactions will soon actually be international, as, for example, U.S. banks place "back office" data processing functions abroad in low-wage areas.

Obstacles of the first and third types may also be reduced as countries seek to adjust their policies and their laws to encourage foreigners to bring their banking business to institutions headquartered there. It seems possible that before very long all of the functions that now require a local presence by a foreign bank may be adequately handled by a combination of a local representative office and a very good communications link to the bank's headquarters.

If this style of operation should become the norm, much of the difficult debate over appropriate rules for foreign bank establishment, what constitutes truly national treatment for foreign banks, and so on will have been unnecessary. In this possible world of electronic banking, the real issues will be what kinds of national controls on capital movements and foreign exchange transactions are suitable, how international information flows (potentially involving very sensitive information) are to be regulated, who will be responsible for the smooth operation of international interbank clearing systems, and what level of foreign exposure is appropriate for banks in the eyes of their home-country regulators. There is no reason to think that these issues will be any easier to settle than those involved in setting up foreign branches and subsidiaries. My own view is that rules for operating this truly international (as opposed to multinational) banking system will be much more difficult to devise than the rules that would govern simple establishment and operation of foreign bank branches and subsidiaries. But we will have to face these problems anyway. Expending time, energy, and political capital to facilitate foreign establishment of branches and subsidiaries, a style of doing business that already appears somewhat outmoded, may represent a diversion of resources from more important work. My fifth and final observation is that we may be getting ready to negotiate an unnecessary set of agreements.

10.10 Conclusions

My conclusions are really rather simple. For a variety of reasons, I suspect that the next round of trade talks will have a better chance of being productive if the thorny questions of how foreign banks should be allowed to operate in national markets are downplayed. These issues will be contentious, and there is no guarantee that success in making multinational banking more prevalent will make the world a better place. Much better to concentrate attention on questions of restrictions on foreign workers (critical to many service industries), rules for foreign direct investment in service industries, international information flows, and international payments restrictions.

The overall tone of this paper may appear to be anti–free trade. This is certainly not my general view of the world. We have for a long time, though, recognized that banking is not just another industry, and we should at least consider the possibility that our usual approaches to international trade may not be appropriate to the banking industry. More important, I am troubled that economists have not played a larger part in the debate over all aspects of international financial activity, leaving this debate largely to "men of affairs." If nothing else, I hope this paper may provoke some further consideration of this subject by economists, if only to rebut my positions. It might even be that by thinking harder about the place of banking in international trade, we may develop a clearer idea of banking's role in the domestic economy.

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Comment Frances Ruane

Before responding to the papers by André Sapir and Richard Neu,* I would like to begin by making some general remarks about trade in services. This subject has become very topical among trade policy makers in recent years because of both the growth of international trade in services and the repeated suggestions that trade in services may be incorporated within the GATT.[1] It has also merited some discussion among international trade theorists who have been concerned primarily with the conceptual issue of whether the framework which they use to analyze trade in commodities is appropriate for trade in services.[2] If such a framework is appropriate, then the results obtained for trade in commodities and the policy implications for trade negotiations carry through to trade in services.

From a trade theory perspective, one's immediate instinct is to presume that, at least as far as economic aspects are concerned, trade in services is similar to trade in commodities, whatever the legal, institutional, or payment differences between them. This contrasts with the approach taken by Hill who argues strongly that services have two specific characteristics which goods do not have and consequently "goods and services belong in different logical categories" (1977, 336). The two specific characteristics identified and discussed at length by Hill are *nonstorability* and *physical proximity,* which suggest the re-

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*Chapters 9 and 10 in this volume.

1. For an overview of the history of trade negotiations in services, see Malmgren (1985).

2. See, for example, Hindley and Smith (1984), Deardorff (1985), Jones (1985), Markusen (1986a, 1986b), Melvin (1985, 1986a, 1986b), Sampson and Snape (1985), and Sapir (1985).

quirement that production and consumption of each service must coincide *in time* and *in space*, respectively. While these characteristics are common of many services, they are not common to all,[3] and I, for one, am not convinced of the merits of searching for characteristics which are common to all services. What is more important is that we have a framework which allows us to analyze the different channels through which trade in services takes place, especially at a time when we are contemplating negotiations which will affect these channels.[4] Focussing on channels rather than basic characteristics, I have found it helpful to look at services conceptually in terms of whether they are actually tradable or nontradable, and whether or not, for any given economy, foreign-owned factors are required in the production of services. Figure C9–10.1 illustrates.

Box 1 contains those services which are produced using domestic factors only and which are sold only on the domestic market. This category includes what one would consider traditional services, such as restaurants, general retailing, etc. Box 2 contains services that are produced by domestic resources only but that are traded internationally. Examples of such services are life insurance, engineering designs, etc. Box 3 contains services which are nontraded but which require foreign as well as domestic factors in production. Examples of such services are certain types of international banking, and certain types of consultancy. Finally box 4 contains those services which are both traded internationally and which use foreign as well as domestic factors. An example of such a service would be a U.S. bank in Brussels which services loans to Italy.

While in each case I have given examples of services which may fall into a particular box, I wish to stress that I do not believe that one should necessarily attempt to classify whole sections of the service sector in this way; rather in looking at a particular service sector *activity,* it might be helpful to identify it in terms of this classification. In the context of the issues of this conference and both Sapir's and Neu's papers, I found this framework useful in that it allows one to identify, according to the way in which a service is classified, the focus for policies and negotiations. For example, services in box 1 are strictly domestic and are indistinguishable from what trade theorists have called nontraded goods. The prices of such services are determined by the parameters of the production process, the availability of domestic factors of production, domestic consumer tastes and the degree of competitiveness in that sector. Clearly services of this type should not fall within the arena of trade negotiations. By contrast, for policy purposes,

3. Exceptions have been noted, for example, in Bhagwati (1985).
4. This approach is similar to that taken in Melvin (1986a, 1986b).

TYPE OF SERVICES	TYPE OF FACTORS	
	DOMESTIC	DOMESTIC & FOREIGN
NONTRADED	1	3
TRADED	2	4

Fig. C9–10.1 Analysis of services with respect to the tradability of outputs and the ownership of production factors.

services in box 2 should be treated in like manner to commodities, where instead of tariff and quota negotiations, intergovernmental negotiations would take the form of negotiations on barriers to entry, such as domestic regulation. Furthermore, it must be recognized that differences in the methods of payment and the legal status of the services will have implications for such negotiations.

In the case of services in box 3, the service itself is not traded internationally but is produced in the country in which it is to be consumed. Furthermore, there is no necessity in many instances for the foreign-owned factor to physically cross national boundaries; the only requirement is that it combine with local factors to produce the service. Of course in many instances it will move physically but it is the foreign ownership that is the essential component.[5] This feature of service markets is similar analytically to the case of international factor mobility where the foreign factor is used in the nontraded sector; see for example, Jones, Neary, and Ruane (1983). The characteristics of services in box 3 indicate clearly that negotiations in this area are about the use and payment of internationally-owned factors and the nature and extent of competition in the domestic market. GATT negotiators in such areas would find themselves breaking new ground, as the whole area of international factor mobility, use and payment typically lies outside the GATT framework. I will return to this issue below. In the case of box 4, we have the combination of trade at the output and factor level, so that policies appropriate in both box 2 and box 3 may be relevant here.

Turning now to the papers presented in this session, Richard Neu provides a very detailed qualitative account of the various activities which fall under the heading of international banking. (The difficulties involved in quantitatively measuring the scale of trade in banking services are discussed in St.-Hilaire and Whalley [1986] who provide some

5. This point is particularly important in the case of services. See Deardorff (1985).

estimates of trade in banking services for the United States.) Because he looks at banking in isolation, Neu's paper tends to emphasize the differences rather than the similarities between banking and other economic activities. In fact, as Neu implicitly recognizes in his first general observation, international banking typically involves the use of domestic and foreign-owned factors to produce a nontraded service; in other words, in terms of the framework presented above, international banking services fall primarily into box 3, with some activities in boxes 2 and 4. Apart from some initial capital and a few key personnel, the major foreign-owned factors involved are management services and information, both of which can be combined with domestic factors without leaving the parent headquarters. Once one recognizes this, international banking seems less complex as an activity for analysis and the details in the paper can be seen in a more structured way.

Not surprisingly, a major issue discussed in the paper is whether or not there are welfare gains from increased international banking. Formally, if we accept that international services are primarily in box 3, this question is analogous to the question posed in the international trade literature of whether or not there are gains from increased mobility of sector-specific factors when the sector involved is both nontraded and noncompetitive. This question is difficult to answer since we are quite obviously in a second-best world. However, we can make some general observations about the elements which would determine whether the answer is likely to be positive or negative. In particular, the source of the noncompetitiveness in the domestic market is crucial. For example, if the source of the distortion is government regulations, and the foreign banks are offering no additional services, then it is quite possible that increased foreign banking will reduce welfare. To the extent that new services are offered, there will be an offsetting welfare gain. On the other hand, to the extent that the source of the noncompetitiveness is due to cartelization and that this is reduced or abolished by increased international banking, then there is likely to be a welfare gain. Looking at the experience in the United Kingdom (Llewellyn 1986) and Ireland (McGowan 1986), for example, it seems clear that a considerable portion of the increase in competition in the banking sector in recent years and the pressure for deregulation is due to the growing presence of foreign banks. A further element in determining whether there are welfare gains from international banking is the treatment of taxation of the returns to the internationally-mobile factors. The issue of taxation of factor rewards and profits in international banking is a somewhat surprising omission from Neu's paper.

In his paper, Neu analyzes the welfare gains of increased international banking by reference to banking as a traded service; in other words, he analyzes banking services as if they are box 2–type activities, although he subsequently describes them in terms of box 3 activities.[6] He argues that if foreign banks can produce banking services more efficiently than domestic banks, then there is a potential gain from international trade in banking services; in his opinion, a crucial determinant of whether or not this gain will be transferred to domestic consumers is the organization of the international banking system. In particular, he states, in his second observation, that "we must probably allow cross-border branching; subsidiaries will probably not do the trick." His argument is that unless there is branch banking, the characteristics of the parent bank are not exported, and hence the gains from international banking are not realized. I found his argument unconvincing, as both subsidiaries and branches have equal access to the major foreign-owned factors employed in banking, referred to above. Furthermore, I do not know of any evidence to support the view that subsidiaries have to pay higher interest rates than branches to secure funds, which might support Neu's contention that branches can transfer benefits to domestic consumers that are not transferred by subsidiaries.[7]

However, the issue of whether or not international banking takes places through subsidiaries or branches is extremely important in the context of the optimal size of banks from a global perspective. As Neu points out, one of the major concerns with increased international banking is that the economies of scale involved will most likely result in a few very large banks which governments may find themselves having to bail out if there is a major crisis. Since it is hard to imagine any agency which could effectively or sensibly regulate banks internationally, the only effective method of regulating international banks is good local regulation, and, for this to operate, international banking must operate through subsidiaries. Good regulation would ensure that neither Neu's third observation, that foreign banks may not bear the full costs of their expansions, nor his fourth observation, that international banks may become undesirably large, would be realized in practice.[8] Good regulation benefits both home and host countries as well as the international bank itself, by reducing its monitoring costs.

Unlike Richard Neu, André Sapir attempts to imbed his analysis of telecommunications in the general context of trade in services. In fact,

6. This view of trade in banking services is supported by St.-Hilaire and Whalley who conclude, on the basis of their empirical analysis, that "[s]ervice trade, as it relates to banking, may be an important investment issue, but does not appear to be that important a trade issue" (St.-Hilaire and Whalley 1986, 11).

7. In Ireland, for example, it would appear that foreign banks are able to compete on equal terms with domestic banks (see McGowan 1986).

8. There is also no evidence so far of an international cartel emerging as a result of economies of scale in international banking. In fact, as André Sapir suggests in his paper, it seems likely that lower technology costs will reduce the relative importance of economies of scale in future decades.

using the framework outlined above, it is possible to pinpoint the role which the development of information technology and telecommunications has played in the recent internationalization of the services sector. In effect, many of the services which would typically have fallen into box 1, i.e., strictly local services, have through the development of telecommunications and information technology during the past fifteen years moved into boxes 2, 3, or 4. The analogy here with the effect of the reduced cost of transportation on trade in commodities, as noted by Sapir, is very strong. Furthermore, future developments in telecommunications may well lead to more services moving between boxes. To take an example from the banking area, developments in telecommunications and computers may result in some banking services which are currently undertaken by local subsidiaries and branches being transferred to the bank's headquarters, involving the movement of activities from box 3 to box 2. Such developments will be influenced not only by developments in telecommunications but also by international and national regulatory activities, which may reinforce or counteract the pressures created by technological changes.

In his general discussion of services, in addition to the two characteristics already noted by Hill (1977), André Sapir notes that intangibility is a further characteristic of services, where the intangibility arises from the difficulty of evaluating services ex ante.[9] As a result of this intangibility, Sapir argues, "it is the principles of reputation and qualification that play an overriding role in the selection of suppliers." He goes on to argue, and I agree with him fully, that services characterized by such intangibility are likely to be traded more *intra-* rather than *inter*firm, as the greater the degree of intangibility, the more difficult it is to trade with an "unrelated party." However, he subsequently suggests that if a country with the lowest production cost of a particular service is unable to export that service because it lacks reputation, the principle of comparative advantage might not apply. I have to disagree with his interpretation of this occurrence as a possible violation of comparative advantage, because he is not in essence comparing two identical services. Either one can look at this issue formally in terms of comparative advantage under uncertainty or one can interpret the reputation of a service as an attribute of the service (essentially internalizing the uncertainty) which means that the two services are not identical. Hence, while I agree with Sapir's point that low-cost centres may initially have a problem establishing a reputation for certain services (as indeed Japan and many of the NICs had with manufactured

9. Sapir develops the notion of intangibility from earlier work by Caves (1982) and Shapiro (1982).

products in the past three decades), I would not agree that this should be interpreted as a violation of comparative advantage.

Returning to the crucial role that telecommunications may play in the expansion of international services, I should like to add two related points here in the context of Sapir's paper. First, and this applies to the telecommunications sector as well as other service sectors, changes in technology may quickly render regulatory negotiations obsolete, and regulatory mechanisms may themselves lead to particular technological developments. To view technological developments as random in this context could be dangerously naive, just as presuming that nontariff barriers might not emerge where once there were tariff barriers has proved to be in goods markets. Second, in the telecommunications field technological developments raise very interesting issues about our traditional concepts of natural monopolies. Where once it was common to think of certain industries as being, in some fundamental sense, natural monopolies, we realize that this description may not be appropriate in the longer term. Thus, while the basic infrastructure of telecommunications fits comfortably with our idea of a natural monopoly, the market for the range of services which such a system can facilitate may be more appropriately described as competitive. It seems to me that the phenomenon which André Sapir describes in the telecommunications sector may be much more widespread.

In conclusion, my strong impression from these two papers is that GATT negotiators should be very wary about entering the arena of trade in services. I would, therefore, support the cautionery stance taken in Uruquay, as referred to in André Sapir's introduction. In almost every section of services, negotiators would have to deal, not only with international factor usage, where the factors may or may not move across national boundaries, but also, in many instances with domestic regulation. Rather than attempting to negotiate trade-offs between different countries' discriminatory regulations, time might be better spent attempting to convince governments of the benefits of sensible domestic regulation.

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Comment Gary P. Sampson

While international service transactions (e.g., shipping, telecommunications, patents, finance) have long been the subject of intensive mul-

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tilateral deliberation, in recent years interest in this area has grown. At least one of the reasons for this is mentioned in both papers*: Richard Neu and André Sapir indicate that some—especially policy makers in the United States—consider international service transactions to be the next frontier for trade liberalization. Progress toward an agenda for negotiation, however, has been particularly slow, and both papers contain useful material in helping to understand why. For the purposes of exposition, it is possible to group some of the reasons under two headings. First, various initiatives (notably the United States' initiative at the November 1982 Ministerial Meeting in GATT) have attempted to deal with services as a *sector* rather than as individual activities. Second, the services sector has been raised in the context of "trade liberalization."

Services as a Sector

Dealing with services as a sector throws into sharp relief the problems of dealing with an extremely heterogeneous group of economic activities in a systematic manner. While some services are functionally related (e.g., telecommunications is an input into banking), others such as neurosurgery and the provision of party rental facilities have little in common. Maritime transport and fast food franchising are very different economic activities with very different production functions. Treating services as a sector led to a search for characteristics that would permit what are essentially heterogeneous activities to be dealt with in a common analytical framework—something that is not possible by simply grouping them as "invisible" or "residual" items as has been done on past occasions. Various characteristics have been identified and André Sapir, for example, pays particular attention to the nonstorable nature of services. Because of this, the production and consumption of services must generally take place in the same location at the same time. This leads to an important conclusion—the production and consumption of services frequently requires mobility of the factors producing the services or of the consumers consuming them. In this sense, services and goods are different. A further extension of the conclusion is that controls on international services transactions (or "barriers to trade in services") come from restricting the movement of the factors producing the services and/or the consumers who receive the services. Sapir also addresses a related question: namely, whether the principle of comparative advantage holds for this diverse group of activities in the same way as it holds for goods. After a brief review of the literature Sapir concludes that in this respect there is no difference between services and merchandise trade.

*Chapters 9 and 10 in this volume.

When looking at services (individually or as a sector) it is clear that further complications arise as there is a dearth of systematic quantitative information on international services transactions. The authors make this plain in their case studies of the banking and telecommunication industries. With respect to measuring the value of transactions, Richard Neu raises the very important question of what is in fact being traded when an international service transaction takes place. If the sale of the banking service is done via an "on-ground" presence in the importing country (e.g., through branch banking), there are important conceptual and practical difficulties in measuring the value of the service provided. We do not know, for example, what share of value added (or "retained value") is accounted for by returns to factors of production engaged in the importing and exporting country. At the same time, Neu throws some cold water on the hopes that an international expansion of banking services will create jobs in the exporting country; in his view, exporting banking services may mean that jobs are created by the foreign bank mostly for foreigners.

Liberalizing Trade in Services

The second group of reasons explaining the protracted nature of discussions is that they are taking place in the context of trade liberalization of services activities. For tariff liberalization in goods—as carried out in the postwar GATT rounds of multilateral trade negotiations—life was relatively uncomplicated. *Ad valorem* tariffs can be compared across goods. An important complication arises with the services sector when discussing "trade liberalization" in the traditional GATT sense of an exchange of "concessions." Should such concessions be exchanged across activities (e.g., market access in banking against market access in telecommunications) or should they be within the same service activities? As Richard Neu notes, the idea of exchanging preferential market access for different foreign banks operating in the same market is something that would prove to be unmanagable.

In addition, unlike services, goods pass through customs houses, and tariff barriers are very apparent. As mentioned above, however, international services transactions frequently require the movement of the factors of production and receivers of the services; trade liberalization in services involves changing national rules and procedures. Services include a number of "sensitive" activities with national laws relating to their production and distribution—banking and telecommunications are two examples. For activities of national importance, intergovernmental discussions are sure to be intense and protracted. André Sapir, for example, notes that the governments of the EC and the United States have very different perceptions as to how the telecommunications industry should be structured. The EC assigns a special importance to telecommunication activities, and national regulation has resulted in a state monopoly. The United States government has a different perception and private firms operate in an increasingly competitive market. The U.S. government promotes competition and recent technological developments are such that competition will be further promoted in the United States. The interesting question which Sapir poses is whether with these technological developments it will be possible to contain the monopoly in the EC. Richard Neu also pays particular attention to the sensitive nature of banking and, as he says, since countries have legitimate national needs (in regulating banking) and perceptions about what is in their national interests—painstaking negotiations would be necessary to reconcile these legitimate national needs.

Whether sensitive activities or not, liberalization of services trade involves difficulties. In looking at these, it is useful to consider three groups of services. First, there are services that do not, because of their nature, cross national boundaries. These must be consumed in the importing country by the receiver of the service. André Sapir mentions the PTT in Europe; here for example, local mail delivery services can only be traded internationally if there is international movement of factors of production. Other examples include the construction of roads and other public works such as the provision of municipal sewerage facilities. Fields (the receiver of the service) cannot be shipped abroad to be ploughed. But there can be international transactions in these activities if there is movement in the factors of production; labor or capital must cross the border for the service to be produced in the country of consumption, and must face the national laws relating to foreign investment and the granting of work visas. A further example is the provision of branch-banking services.

Richard Neu gives some interesting insights into what he calls multinational banking (as compared with international banking), which requires an "on-the-ground" presence for the local market to be served. Here, national policies have in some countries explicitly prohibited the establishment of foreign-controlled banking institutions; rights of establishment have not been granted to foreign banks. Neu notes, however, that since the *establishment* rules in most industrialized countries have been liberalized, the real problems in these countries now arise from policies that have the effect of discriminating against the *operation* of foreign-controlled banking institutions. This is the problem of national treatment for foreign banks operating in the domestic market. Richard Neu gives the example of banking services which could potentially be supplied to foreign residents from offices in the bank's home country if there were not national rules which discriminate specifically against foreign operations. Firms in the foreign country may be prohibited from carrying out foreign exchange business, for example, as their potential clients have to conform to national rules and hold and exchange foreign currency with their own central bank.

Thus, where factor movement is important for international service activities, "right of establishment" and "national treatment" emerge as major issues. Restrictions on factor movement are imposed by means of the issuance of work permits and constraints on the behavior of foreign capital. Foreign Investment Review Boards and Departments of Immigration are notoriously sensitive institutions when it comes to deregulation, and progress in this direction can therefore be expected to be slow.

A second class of services includes those that can be produced with or without factor movement. Presumably, a bridge to be constructed in Australia can be equally well designed in Sydney or San Francisco, but the life of the consulting engineer may be considerably simplified if he can visit the site of construction when necessary or perhaps even install an office. So, too, for computer programmers wishing to talk to their clients, and insurance companies hoping to sell insurance to theirs. There are many banking and telecommunication activities that are facilitated through a local presence in the importing country. Thus, in such cases, if there are restrictions on the movement of factors, the provision of the service may not be prohibited—it is just rendered more difficult.

Finally, for an international transaction to take place in some services, it is necessary to have mobility of the receiver of the service. The Taj Mahal cannot be shipped to California to be viewed by Americans any more than Disneyland can be shipped to India. There must be mobility of the receivers. So, too, for university students who study in foreign countries, and aircraft which are shipped internationally for specialized repairs. Here the constraints on trade are again national regulations—tourist visas granted by the government of the country exporting the service and foreign exchange controls for residents of the country of import.

Both papers could be improved if they contained better quantitative material. As noted above, data are hard to find, but they are not nonexistent. There are no statistics in the paper by Richard Neu and some of the quantitative material in the paper by André Sapir could be improved. The market access question for telecommunication products would have been more informative if the author had presented more detailed information on the nature of the goods traded internationally, the direction of trade flows, and the tariff and nontariff barriers confronting such trade. Such information would assist in forming an opinion as to whether trade liberalization in these goods should be a priority matter for any forthcoming trade negotiations.

The authors conclude by offering suggestions as to what all this means for any future trade-liberalizing negotiations in banking and telecommunications. Richard Neu concludes that the next round of trade talks will have a better chance of being productive if the "thorny" question of how foreign banks should be allowed to operate in national markets is downplayed. Based on the evidence, this seems to be a very sensible statement and one wonders to what extent this conclusion applies to a variety of other thorny services activities. André Sapir's conclusions appear no less reasonable. He notes that the focus of future international negotiations will be productive if they are directed toward establishing a greater degree of understanding between governments with regard to their "regulatory philosophies" and toward a "harmonization of national attitudes." He is of the view that such negotiations are best carried out between governments with common economic situations and principles; as far as the EC and the United States are concerned, the appropriate forum is the OECD. There is of course merit in this, but decisions that are taken on the nature of international telecommunication activities in future years will have effects that transcend these economies. The interests of producers *and* consumers of services deserve to be represented in such negotiations, even if their countries are not members of the OECD.

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