UNITED NATIONS

TD

**United Nations Conference on Trade and Development**

Distr.
GENERAL

TD/B/COM.1/EM.33/3
3 August 2007

Original: ENGLISH

TRADE AND DEVELOPMENT BOARD
Commission on Trade in Goods and Services, and Commodities
Expert Meeting on Trade and Development Implications
of Financial Services and Commodity Exchanges
Geneva, 20–21 September 2007
Item 4 of the provisional agenda

# TRADE AND DEVELOPMENT IMPLICATIONS OF FINANCIAL SERVICES

**Note by the UNCTAD secretariat***

**Executive summary**

A well-working financial services (FS) sector can leverage economic development by improving productivity, facilitating domestic and international transactions, broadening availability of credit for small and medium-sized enterprises (SMEs) and households, mobilizing and channelling domestic savings, attracting foreign direct investment (FDI) and enhancing efficiency. The FS sector is also closely linked to trade. For FS reform and liberalization to generate pro-development outcomes, it needs to be supported by appropriately paced and sequenced policies (e.g. macroeconomic, prudential, regulatory and supervisory policies). For many developing countries (DCs), this remains a challenge, further compounded by weak regulations and institutions, and difficulties in properly managing capital-account liberalization. Given the costs and risks associated with pre-mature FS liberalization, caution is warranted in liberalizing the sector.

* This document was submitted on the above-mentioned date as a result of processing delays.

## I. INTRODUCTION

1. This note has as its scope the global financial services (FS) market and emerging trends; the importance of FS for economic development, including universal access (UA); the significance and elements of an effective regulatory and institutional framework; development issues arising from FS liberalization including through the General Agreement on Trade in Services (GATS) and regional negotiations; and areas of potential export interest for developing countries (DCs).

2. Three main activities in an increasingly diverse FS sector are banking, securities and insurance. There are several definitions of FS. The World Trade Organization's (WTO's) definition (annex on FS) lists activities under the headings insurance and insurance-related, and banking and other FS.[*]

3. The FS sector comprises the following aspects: *products* of the financial sector (e.g. loans, insurance, derivates); *suppliers* of FS (e.g. credit institutes, investment banks, funds (pension, mutual, hedge), insurance companies); *services* offered by the suppliers (e.g. provisions of credit, asset/risk management, investment banking, brokerage, ratings); *policies* affecting the FS sector and its suppliers (e.g. trade, investment, monetary, industrial, or competition policy); and *policymakers* (e.g. Governments, central banks, supervisory and other authorities at the national and international level, such as the Basel Committee on Banking Supervision, International Monetary Fund (IMF), International Association of Insurance Supervisors, International Organization of Securities Commissions, and WTO.

## II. FS AND DEVELOPMENT

4. A modern and efficient FS sector is key for economic development. FS are a central infrastructural sector. Through their strong backward and forward linkages with the overall economy, FS can leverage economic development by improving productivity, facilitating domestic and international transactions, broadening the availability of credit for SMEs and households, mobilizing and channelling domestic savings, facilitating firm entry and competition, attracting FDI and enhancing efficiency. The sector is also closely linked to trade (access to international financial networks is needed to obtain letters of credit and insurance) as well as supply of other services sectors.

5. Liberalization of trade in FS removes barriers to trade in FS. Liberalization of the financial system (so-called "financial liberalization") can be split into the liberalization of the domestic financial system and the current and capital account liberalization, which can entail wide repercussions on the stability of the economy and growth prospects.

6. In many DCs, the FS sector has been characterized by isolation from global financial networks, high levels of government intervention, restrictive regulations posing barriers to new firms and products, limited product differentiation and shallow domestic markets. During early development phases, relatively closed banking sectors have served several countries quite well (e.g. India, China). Subsequently, with economies becoming more complex, their FS system also became gradually more open to trade and FDI. To improve the performance of their FS sector, a growing number of DCs and countries with economies in transition have undertaken programmes of regulatory and policy reforms. They aim to

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[*] The United Nations Central Product Classification (CPC) provides a detailed classification of financial services.

increase the number and diversity of firms and products, enhance access to credit, reduce risk and enhance the stability of the financial system.[†]

7. Greater competition, including by foreign entry, can increase efficiency (through lower prices and increased product differentiation) and can encourage transfer of management skills and technologies. Foreign firms can help re-capitalize failing domestic firms. In both Asia and Latin America, limited availability of capital from domestic sources and an inefficient domestic banking structure were important motivations for opening up banking systems. More recently, opening securities exchanges to foreigners has increased inward capital flows, catalyzing economic growth. African FS remain generally weak[‡] (e.g. in the United Republic of Tanzania, only 6 per cent of the population has access to banking) but some of the privatization programmes (1980s/1990s) improved the prevailing situation.

8. While at theoretical level, there are numerous arguments for liberalization of FS trade, debates about relative virtues of openness and protection in FS also face concerns that need to be addressed. Clearly, the FS sector is unique, both in terms of its fundamental importance for a country's economic development and in its broader nature (e.g. potential for imperfect competition and market failures such as information asymmetry). These characteristics suggest caution when considering liberalization of trade in FS. More specifically, concerns expressed are as follows:[§]

(a) One concern relates to the role which foreign FS providers would play in the domestic economy. Following from the strategic function of FS for countries' economic social development, the suggestion is to avoid that the domestic FS system is dominated by foreign providers, possibly allowing for abuse of market dominance. This approach appears even more valid in situations where large banks (i.e. concentrated economic power in few consolidated banks) effectively obtain a certain degree of political power.

(b) Another concern relates to effects, which foreign FS providers will have on national providers. Entry of foreign firms can lead to a decline in profits of existing firms and lower profit margins create pressure to reduce costs, potentially leading to financial distress among individual domestic firms. Foreign firms can bid lucrative corporate business away from domestic banks. Case studies showed that foreign entry significantly reduced the profitability of domestic banks and their non-interest income.[**] Entry of more foreign firms would also aggravate problems of "overbanking"/"overinsuring". The pressure which domestic financial firms would face would depend, among others, on the degree of pre-existing structural problems, including the extent to which the financial system is undercapitalized.

(c) Some Governments wish to maintain a certain national presence in the domestic market or to provide temporary support to national suppliers. As described in the infant industry debate, national competitors are sometimes much less advanced compared to foreign

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[†] See UNCTAD Assessment Studies, e.g. Jordan, Kenya.

[‡] The financial markets of many African countries are very small and likely to be relatively unattractive for foreign banks. Jansen, Vennes, "Liberalizing financial services trade in Africa: Going regional and multilateral", WTO staff working paper, March 2006.

[§] Claessens, Jansen, *The Internationalization of Financial Services, Issues and Lessons for Developing Countries,* Kluwer Law, 2000; Singh, *Capital Account Liberalization, Free Long-Term Capital Flows, Financial Crises and Economic Development*; "Opening Markets in Financial Services and the Role of the GATS", WTO Special Study; Myriam Vander Stichele, "Critical Issues in the Financial Industry", SOMO Financial Sector Report, 2004; Boyd/Smith, "Intermediation and the equilibrium allocation of investment capital: implications for economic development", Journal of Monetary Economics, 1992.

[**] The role of foreign banks in domestic banking systems, in Classen/Jansen.

FS providers entering the market. In certain FS segments domestic providers simply cannot compete (e.g. investment banking). There is, therefore, a need to encourage infant FS in DCs, including by allowing for learning by doing that will ultimately reduce local cost of production and improve quality of output. Sometimes, local suppliers are particularly drained – for example, when burdened by a large portfolio of non-performing loans – or they are impeded by their small size. Frequently, foreign companies do not face these detrimental factors. This might suggest that domestic firms need time to adjust to new/unequal competition and, accordingly, trade liberalization could be phased in over time.

(d) Also, UA-related concerns are prevalent. On the one hand, there is the concern that foreign FS providers would engage in cherry-picking and cream-skimming.[††] They will operate only in very profitable market segments and not serve all sectors of the economy and local market, leaving aside, for example, retail banking in rural areas. In parallel, there is the concern that internationalization –through lower profit margins and pressure to cut costs – would result in closing/streamlining branches, relying on automatic service provision and reducing services to the poor. Facing increasing competition, (domestic) FS providers tend to target their focus on most profitable clients, including big firms and the rich.

(e) Structural concerns relate to the fear that opening to foreign FS providers may lead to capital flows abroad and that liberalization of FS trade worsens a country's balance-of-payments position. Foreign FS providers are more likely to invest domestic savings abroad rather than in the local economy, and in so doing may exacerbate difficulties regarding domestic savings. Regarding potential benefits of portfolio–equity flows, openness to foreign providers might also increase the probability of capital flight and volatility accompanying such benefits. Foreign providers are said to be better equipped for shifting capital abroad, possibly lacking commitment to the domestic economy; domestic providers in turn might have a sense of patriotism, thus withstanding incentives for moving money abroad.

(f) Concerns also relate to the difficulty of properly managing the liberalization process: experiences with liberalization are mixed, and premature liberalization has proven to cause considerable costs. This is compounded by difficulties of – and lack of experience in – regulating international FS markets/transactions. In many DCs, weaknesses of institutions and domestic regulatory frameworks make it difficult to monitor more complex financial institutions.

9. The above concerns have been put forward, inducing countries to pursue a policy of selective economic openness for FS trade liberalization. On the other hand, there is the argument that the economic and regulatory concerns suggesting caution with internationalization are weak. The arguments include:

(a) The specificity of the FS sector – while indeed existing – does not justify a move away from the overall liberalization paradigm;

(b) Infant industry protection has thus far not led to efficient and competitive FS;

(c) Weaknesses of the domestic financial system are best improved through importing foreign know-how and allowing foreign banks to establish; and

(d) In terms of policy choices, protection (barriers to foreign competitors) is never the best alternative.[‡‡]

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[††] Cherry-picking would also arise on the human resources side, with foreign companies hiring the best managers and personnel away from local employers.

[‡‡] "Internationalization of Financial Services: A Trade-Policy Perspective", in Claessen/Jansen.

10. It is clear that for FS reform and liberalization to generate pro-development outcomes, it needs to be supported by appropriate policies, including macroeconomic, prudential, regulatory and supervisory frameworks and adjustment policies. For many DCs, designing and implementing such policies remain a challenge, further compounded by difficulties of properly managing capital-account liberalization.

## III. GLOBAL MARKET TRENDS

### A. Economic data[§§]

11. In 2006, total global value of all quoted FS companies grew by 26 per cent to $10.7 trillion. Emerging markets were important drivers of growth, representing 29 per cent of increase in total market value over the previous five years. They account for 21 per cent of the total market value of global FS and contribute nearly $688 billion of the $2.2 trillion overall growth in value.[***]

12. World FS exports were $200 billion in 2005, and grew at an average annual rate of 14 per cent from 2000 to 2005. Accounting for 90 per cent of all exports in 2005, developed countries dominated this fast growing market. DCs account for only 10 per cent of global FS exports (about $18 billion), and their segment of the global market grew at an average annual rate of only 5 per cent from 2000 to 2005. DCs' FS exports grow at an annual rate significantly below the average rate for all commercial services, and well below the high rates of dynamic export sectors (construction, computer, information, personal, cultural/recreational service). FS exports accounted for only 4 per cent of DCs' commercial services exports in 2005, far behind the share occupied by travel and transportation (42 and 28 per cent, respectively). For DCs, FS account for roughly 7 per cent of commercial services imports. Their commercial services trade increased roughly fivefold from 1990 to 2005 (figure 1). DCs' FS imports underwent particularly rapid and high growth, outpacing their exports of FS.

13. In terms of FS trade, developed countries are net exporters, their exports nearly doubled (from $97 billion to $182 billion from 2000 to 2005), contributing over 10 per cent of their total commercial services exports in 2005. The United Kingdom is the largest exporter of FS, followed by the United States, Luxembourg and Switzerland. Although developing country (DC) trading volumes are smaller, some (e.g. Hong Kong, China; Singapore; Taiwan Province of China; Brazil; South Africa; India; Republic of Korea) are active in FS (figure 3).

14. DCs' performance in FS trade varies considerably by region and country. Countries in East Asia and the Pacific, Latin America and the Caribbean account for the major share of DCs' FS trade. Figure 2 shows moderate growth in their exports and imports (1996–2004). But figure 2 also indicates relatively limited growth in the volume of FS trade in Africa and South Asia over the same period.

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[§§] Data and discussion refer to Mode 1/cross-border FS trade. All trade data presented are from UNCTAD Globstat 2007, Table 5.2 Trade in services by sector and country, analysed for individual countries and aggregated into country groups according to geographical and UNCTAD criteria. Financial and insurance services flows in Table 5.2 were summed to generate the total FS trade data and they include available figures only.

[***] Mercer Oliver Wyman, "State of the Financial Services Industry, 2007", Source: DataStream financial services index.

**Figure 1: Trends in DCs' services trade (1990-2005)**

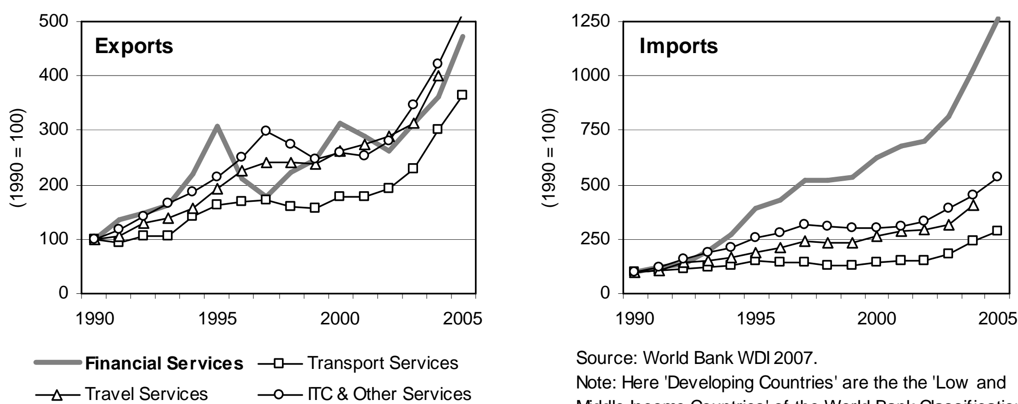
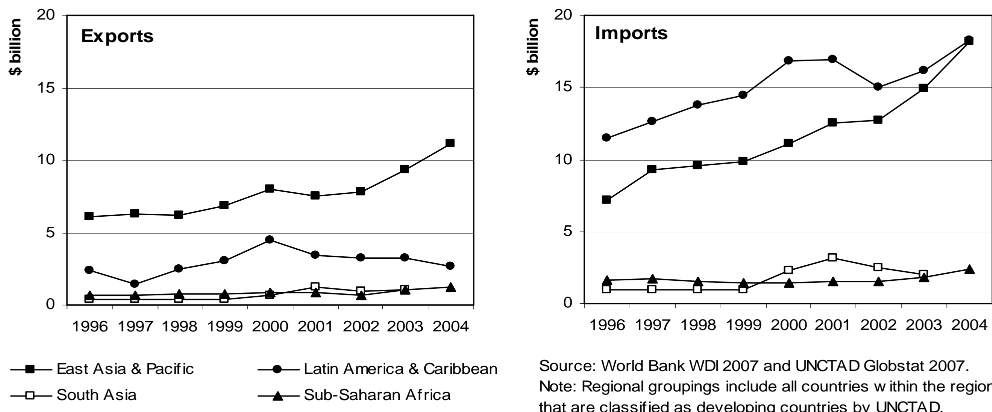



**Figure 2. Regional trends in FS trade (1996–2004)**




15. Data at the country level indicate that some DCs have emerged as important exporters of FS. Figure 3 provides a ranking of the top 25 developing exporters of FS (note: logarithmic axis). Combined exports from top 10 exporters are 95 per cent of total DC FS exports. Nevertheless, relative to their much smaller gross domestic products (GDPs), other DCs remain important sources of world FS exports. China is also becoming an important player. Banks from DCs tend to enter smaller DCs with weak institutions, where high income country banks are reluctant to go to.[†††]

16. With DCs' recent services trade liberalization and increasing openness to capital-account transactions, FDI inflows to DCs rose significantly. Annual inflows to their services sectors increased by almost 10 times from 1990 to 2004. FDI flows to DCs' FS sectors are a major component of flows to their services sectors (currently 22 per cent). High levels of inward FDI flows to their FS sector have created an accumulated inward stock of FDI in FS ($300 billion).

17. Global insurance premiums stood at $3.4 trillion in 2005, life insurance contributing 58 per cent and non-life-insurance 42 per cent. Total world premiums grew by 2.5 per cent in

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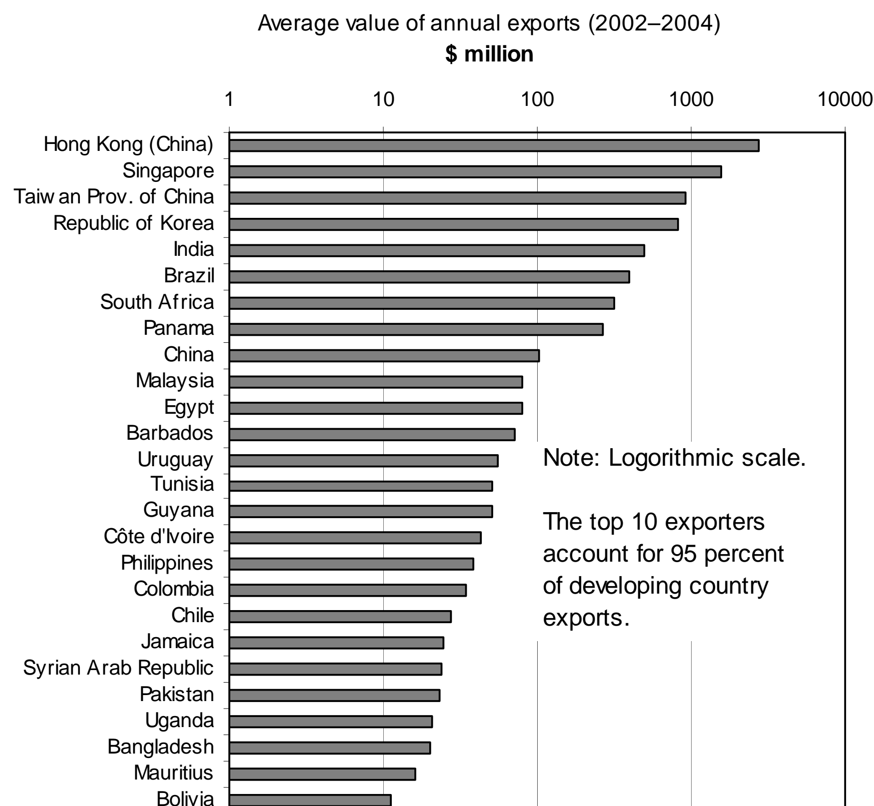
[†††] Neeltje/Van Horen, *Foreign Banking in Developing Countries, Origin Matters,* in Emerging Markets Review 8 (2007).

2005, down from 2.7 per cent in 2004. There is a positive correlation between a country's level of development and insurance coverage. Industrialized countries dominate the world insurance market, with an 88 per cent share as opposed to emerging markets (12 per cent). While collective premiums of developed country markets were higher than those of emerging markets, overall real growth rate of these markets were 2 and 8 per cent, respectively, indicating significant demand in emerging markets.[‡‡‡]

**Figure 3. Top DC FS exporters**




*Source*: UNCTAD Globestat 2007 (based on available data, not all countries reporting).
*Note*: Data presented here are for all commercial financial services excluding insurance.

## B. Market characteristics

18. The era of financial globalization is characterized by greater privatization, liberalization and financial sophistication and by wider access to information, technology and communication. Other trends include deepening regulation and the increasing importance of emerging markets, offshoring and microfinance institutions (MFIs). While some trends could potentially enhance the system's efficiency, they could also make it more vulnerable to failure. The question is to what extent these trends cater to development needs and the majority of people in DCs, an area where further research is required.

### 1. Globalization of financial markets

19. The global FS market is marked by continuing privatization and liberalization – undertaken either autonomously or as a result of international obligations. Largely as a result of this liberalization, there has been an expansion of financial markets. Also, financial depth

[‡‡‡] UNCTAD document on Insurance, UNCTAD/DITC/TNCD/2005/15.

(the value of financial assets expressed as a percentage of GDP) has risen substantially. In 2005, global financial stock was more than three times the size of world GDP. Global cross-border capital flows continue to rise, topping $6 trillion, mostly loan and debt securities (almost three quarters), mergers and acquisitions (M&As), and FDI (15 per cent). Interestingly, the United States current account deficit absorbs nearly 85 per cent of total global capital flows. Asia and Europe are the largest net suppliers of such flows, followed by the Middle East and Russia. Increasingly, emerging markets become net exporters of capital as their central banks place foreign exchange reserve assets with more industrialized countries. While deeper financial markets can benefit DCs, they also raise challenges, particularly as DC financial markets, institutions and regulatory frameworks are still evolving. The increase of capital flows between countries can make national financial systems more vulnerable to external shocks and macroeconomic conditions. Empirical research shows that there is a sharp increase in banking and exchange rate crises since the 1980s.[§§§]

### 2. Integration and consolidation

20. FS integration occurs by way of consolidation of FS (within and across FS subsectors) e.g. bancassurance and universal banking, as well as M&As. As markets become increasingly internationalized and open and admit competition, the FS sector sees a process of M&As, driven largely by the need for economic efficiency from economies of scale and consolidating capital and human resources. This is particularly marked in the European Union, where a relaxed regulatory environment, excess capital and increased competition are expected to eliminate by 2010 hundreds of banks and make a small group of pan-European giants rise and dominate the European landscape. Nevertheless, competition in the global FS markets is not only reserved for global players; 48 per cent of global capital markets revenues are captured by other kinds of players, including those based in Europe or the United States with global franchises and regional/national players such as those from Asia. Also, DCs might be able to build on existing national FS capacities or expand regionally (e.g. India and South Africa).

### 3. Growth of equity markets

21. Liberalization and globalization of FS turned the equity markets into an essential source of capital for investment, growth and development (replacing traditional sources of finance, e.g. sovereign borrowing and bank lending). Equities accounted for nearly half of the growth in global financial assets in 2005. While this trend is mainly for Europe, the United States, and Japan, DCs have also seen growth of equity markets, resulting in new patterns of foreign and domestic finance. In 2005, emerging market equities accounted for more than half of the emerging markets growth in financial assets (an increase of $1.7 trillion).

### 4. Proliferation of financial instruments

22. Industry dynamism, needs of new consumers (including from emerging markets) and investors, aging populations (pension plan funding changing from government-led to individual-led) and technology have led to the creation of innovative retail financial products (e.g. derivatives, swaps, etc.) and financial entities (hedge funds). While these financial products are attractive (higher yields), they can also entail higher risks, especially when traded over the counter and not subject to stringent regulation. Derivative instruments raise the possibility of potential risk for domestic and international financial systems.

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[§§§] Ajit Singh (2003); Kaminsky/Reinhart (1999); Demirguc-Kunt/Detragiache (1998).

23. Many hedge funds operate in derivative markets, which are estimated at $17 trillion. This raises fears about shocks. Following five years of 20 per cent average annual growth, an estimated 7,000 global hedge funds hold assets of $1.3 trillion. The sector remains lightly regulated and concerns of developing (mainly Asian) countries resulting from the late 1990s crises remain unaddressed. Recent collapses raise concerns and interest in better regulation for hedge funds, e.g. by the 2007 G8 meeting.

### 5. Continuing opportunities in emerging markets

24. Emerging markets remain attractive for domestic and foreign players, particularly for consumer finance products. Strong economic growth, rising personal disposable income, and large populations put emerging markets on track to produce more than 40 per cent of the industry's growth over the next five years. FS providers are pursuing these opportunities through M&As, joint ventures or the establishment of new operations. Due to Asia's existing and projected growth, it is a prime target for investment opportunities; Bahrain, the United Arab Emirates and Qatar emerge as aspiring global financial centres; Latin America and Eastern Europe (with European Union enlargement) are potential new markets, opening up significant capital flow links with the United States and the euro zone. However, even though capital flows to emerging markets are growing, they still account for just 10 per cent of global capital flows; 80 per cent are between the United States, United Kingdom, and the euro zone.

**Box 1. Dubai International Financial Centre**

Dubai, United Arab Emirates is expected to become a regional financial hub, evolving on par with Singapore and Hong Kong, China. Dubai has developed an appropriate regulatory infrastructure in accordance with international standards, devised well-directed incentives, and created an environment attractive to international financial institutions and investors. In 2004, the Dubai International Financial Centre (DIFC) was established as an independently regulated financial free zone. The Dubai International Financial Exchange was set up in 2005. Incentives include zero tax on income and profits, 100 per cent foreign ownership, no restrictions on foreign exchange or capital/profit repatriation, operational support and business continuity facilities. Since early 2005, Dubai has authorized more than 250 players to open offices. In 2005 the United Arab Emirates attracted $12 billion, a third of the foreign investment across the Middle East. In 2007, the investment arm of DIFC announced the issue of a $1.25 billion *Sukuk* (Islamic bond). The Dubai Financial Centre is active in banking, capital markets, asset management/fund registration, insurance/reinsurance (especially Islamic *takaful* insurance) and back-office operations.

### 6. Offshoring and outsourcing

25. By 2010, more than 20 per cent of the FS industry's global cost base might have shifted offshore. Offshore finance centres (OFCs) aim to draw international business through attractive legislative environments, good infrastructural facilities, tax concessions and liberal incorporation requirements. In 2005, 70 per cent of financial institutions used outsourcing, compared to 26 per cent in 2003. For DCs, offshoring and outsourcing in the FS sector offer potential gains, as exports move up the value chain. The types of FS offshored change from basic IT processing and back-office activities to more value added services, including front-office activities. To capture this potential, DCs need to build language skills, understand the culture of the target market, comply with standards (e.g. privacy) and develop the necessary infrastructure.

**7. Regulation**

26. Technological changes and increasing integration/globalization of countries' FS require well-functioning regulatory/supervisory frameworks. There is a trend towards allowing financial institutions operating more freely across sectors (e.g. insurers assimilating banking-type activities), and towards international standard-setting, increasing harmonization and mutual recognition. Currently, there are regulatory responses to FS innovations, which had been put in place to circumvent existing regulation.

**8. Technology and security concerns**

27. Technology brings gains in cost, time and efficiency, and leads to new financial products and easy access to information on FS companies and their products. E-finance and technological advances reduce the role of financial intermediaries. Technology allows creating customer databases and integrating financial information (e.g. risk-assessment/monitoring). E-finance penetration among Internet users may increase from between 40 per cent and 50 per cent in major markets in 2005 (United States, Japan and the United Kingdom) to 90 per cent by 2010, with penetration rates in emerging markets rising from less than 20 per cent in 2005 to 60 per cent or 70 per cent by 2010. This decade is expected to see the share of e-banking in the banking sector increase to 50 per cent (in developed countries) and 20 per cent to 35 per cent (in DCs and transition economies, if their policy environments improve). Numbers for e-brokerage are 80 per cent and 15 per cent to 40 per cent respectively. Security risks (e.g. unauthorized data release) are challenges to overcome.

**9. Islamic financing**

28. The global market for Islamic financial products is over $200 billion, covering more than 75 countries. Total assets of the Islamic financial system are estimated to exceed $1 trillion (estimated annual growth: 15–20 per cent). Traditionally focusing on Middle East and South Asia, sustained high oil prices and the design of modern Islamic financial products have created increasing interest in Islamic financial products in South-East Asia, Europe and North America. In 2006, the Malaysian Islamic banking sector amounted to about $34 billion (13 per cent of market share). The *takaful* sector stood at $1.7 billion; the capital market has been equally encouraging, with Islamic corporate bonds now amounting to $36 billion (48 per cent of the total corporate bond issuance in Malaysia). Yet the market is still under-developed and fragmented.

**10. Microfinance/self-help**

29. In DCs approximately 20 per cent of the population has a "bankable" profile (e.g. adequate income, collateral and credit history). While this has left the poorer majority without access to credit, MFIs are successful in providing small loans to the poor. The potential for microcredit and financing tools is large: in the United Republic of Tanzania in 2002, MFIs reached approximately 6 per cent of the population and held approximately 60 per cent and 11 per cent of total commercial bank deposits and credits. Because of high operating margins, microfinance is viable from a business perspective. Combined with the large untapped markets, this creates increasing interest by commercial banks and private investors (including funds) aiming to exploit the market. Policies are needed to support and regulate the MFI sector.

## IV. REGULATORY ISSUES

30. FS regulation exists at different levels (national, international, regional) and its importance is widely accepted. Regulation is key for many public policy objectives (e.g. protecting consumers, ensuring competition, developing domestic supply capacity, UA). Regulation aims at correcting market failures, e.g. information asymmetry, natural monopolies or externalities, all of which are prevalent in the FS sector (e.g. FS is a knowledge- and intermediation-based sector where providers have information superior to consumers). A central role of the regulator is to ensure the viability, integrity and stability of the financial system. Given that the sector is rather heterogenic, increasingly complex and consistently evolving (e.g. due to changes in technology and industry structure), its regulation and supervision pose considerable challenges. Moreover, financial conglomerates – operating in numerous financial sector activities (e.g. banking/insurance) and in numerous countries – are subject to multiple regulatory agencies. This raises problems of coordination and the potential for regulatory arbitrage. Questions for the cross-border distribution of supervisory responsibilities or for the handling of cross-border insolvencies also arise regarding different forms in which FS providers conduct their operations (e.g. branches/subsidiaries).

31. The risks of failure of domestic legal and regulatory institutions became evident through financial crises. The role of external FS suppliers in destabilizing DC economies or in increasing the fragmentation/segmentation of DCs' FS is highlighted in many studies.[****] Widespread failures in banking practices and international systems of control; insider trading, fraud; connected lending; poor asset quality; distorted management incentives; corruption and regulatory incompetence, in some cases exacerbated financial crises and threatened the stability of the international financial system. The scale and scope of gaps in regulatory/supervisory structures came close to systemic failure, calling for strengthening the architecture of the financial system, both domestically and at the international/regional levels.

**Box 2. Financial crises**

In many cases, particularly in DCs, currency crises and banking failures are often preceded by financial liberalization. Most of the financial crises in the post-Bretton Woods era were characterized by nominal interest rate differentials and the resulting portfolio investment.[††††] Crises affect investment and long-term growth, and have fiscal and distributive implications. Estimates indicate that the costs of banking crises are typically quite large, the average cost of currency crisis being 8 per cent of the pre-crisis GDP and the average cost of a simultaneous banking crisis being 18 per cent of pre-crisis GDP.[‡‡‡‡] Recent FS crises include Asia (1997), Russia (1998) and Argentina (2001). In Russia, the crisis resulted in a shrinking GDP (by 4.9 per cent in 1998) and increase in inflation (December 1998 12-month-inflation was 84 per cent). An estimate of the cost of the 1980 Argentina crisis amounts to 55.3 per cent of pre-crisis GDP.[§§§§] Accordingly, DCs need to carefully weigh the costs and risks with the potential gains of FS liberalization.

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[****] UNCTAD *Trade and Development Reports*; Stiglitz, "Capital market liberalization, economic growth and instability", World Development, Vol. 28, No. 6, pp. 1075–1086, 2000; Stiglitz, "Capital-market liberalization, globalization, and the IMF", Oxford Review of Economic Policy, Vol. 20, No. 1, 2004.

[††††] Sections I: D, E and II:A in the Report of the Secretary-General of UNCTAD to UNCTAD XII, Globalization for development: Opportunities and challenges, 4 July 2007. See also TDR, 2004, 2005 and 2006 as well as "Reforming the Global Financial Architecture" (2002), which provide in-depth analysis of the implications of foreign ownership of financial institutions, development impacts of Basel II, currency and financial sector crises.

[‡‡‡‡] Caprio/Klingebiel (1996), Aizenman (2002).

[§§§§] Empirical research on financial liberalization, stabilization and crisis includes Diaz/Alejandro (1981).

32. The 1980s saw an accelerating trend towards financial deregulation within domestic financial systems (e.g. reducing the role of the State) and through the internationalization of FS (e.g. eliminating barriers to trade, discrimination between foreign and domestic FS providers; reducing capital-account restrictions). Deregulation included, among others, elimination of restrictions on intra-sectoral activities (e.g. removing barriers between products and markets) and between countries; withdrawal of government intervention (e.g. through privatizing State-owned banks, and leaving interest rates market-determined); and elimination of competition-restraining regulation.

33. Deregulatory trends, combined with technological advances, created challenges, and resulted in a parallel/subsequent trend of "re-regulation", with numerous objectives (e.g. prudential, competition-enhancing, social policy, good corporate governance). Regulations take many forms, including entry requirements (to avoid that financially weak/non-credible insurance companies are admitted to the market) and requirements with which FS companies have to comply once they have entered the market. Other trends include (a) shifting towards regulation by function (e.g. regulation applicable to all types of entities that supply identical services); (b) creating "super regulators" which can exercise effective supervision over various types of financial institutions and conglomerates; and (c) increasing regulatory activity at the international or regional levels. Cooperation (South–South, North–South) to build regulatory frameworks can help.

34. Prudential regulatory and supervisory frameworks include measures aimed at ensuring the viability, integrity and stability of the financial system and maintaining public confidence in the institutional financial structure of the economy as a whole. Prudential regulations, helping financial institutions to measure and manage risk exposure are diverse:

(a) Entry/operating requirements (capital adequacy, solvency margins, requirements for reserves, asset-quality, business operating plans);

(b) Requirements for enhanced transparency/disclosure, strengthened financial reporting/monitoring, and enhanced corporate governance (e.g. proper legal/accounting systems, ensuring compliance, safety nets, privacy);

(c) Technical provisions to ensure that arising liabilities can be met (rules on assessing non-performing loans and rules to avoid exposure to single borrowers); and

(d) Rules on regulating investments of FS companies (e.g. investment of premium money).

35. Competition regulations aim to address e.g. switching costs (such as in consumer finance); externalities (such as in e-finance); or network services (such as in payments, distribution and information systems). Challenges arise from trends towards M&As and from more complex and global FS markets, requiring adapting competition policy tools and devising novel approaches/institutional arrangements (e.g. bringing together functions dispersed among regulatory agencies such as for banks, insurance, securities). All this needs to be adapted to the specificities of DCs.

36. Regulation as a social policy instrument responds to the recognition that access to FS is essential, including for the poor or for specific business sectors. This includes universal services obligations (e.g. Indian banks must lend at least 40 per cent of their assets to government-specified priority sectors) or regulations which promote MFIs. Increasing interest of commercial banks in MFIs prompted calls for regulations that cap generally high effective interest rates paid for microcredit, and that ensure the sector's financial stability, competition, accountability, transparency, consumer protection and UA objectives.

37. According to foreign FS providers, regulatory frameworks should not act as barriers to trade. Regulations should be objective, fair, transparent, non-discriminatory, proportionate and increasingly convergent at the international level. Moreover, providers argue that they face numerous regulatory difficulties in emerging markets. It has to be noted, however, that specific regulatory policies which may be viewed by some as discriminatory or disproportionate can indeed serve legitimate development policy objectives. Developed countries tend to achieve regulatory objectives with more sophisticated means.

38. Countries differ in their regulation of subsidiaries and branches. While some prefer branches to subsidiaries (regulatory burden being left to the – possibly better equipped – home-country regulator), others prefer subsidiaries to branches (fewer difficulties subjecting subsidiaries to regulation/enforcement, as subsidiaries are legally incorporated in the host country as stand-alone entities and independent of the activities of the foreign parent company, and required to fulfil capital-requirements and liquidity reserves within the host country to support operations). Accordingly, the costs of running subsidiaries may be higher for the parent company than those of running a branch.[*****] Countries with regulatory differences between the two include, China, Hong Kong (China) Malaysia, India, Republic of Korea, the Philippines and Thailand.

**International approaches**

39. Regulatory initiatives in the FS sector are increasingly taking place at the international level because, among other things:

(a) Financial conglomerates, internationally active institutions and collective problems permeating national boundaries require coordinated corrective action at the international level; and

(b) Lack of coordination can induce regulatory competition (race to the bottom) and/or increase costs for internationally operating firms, suggesting a harmonized approach to level the playing field.

40. By establishing clear rules of the game, international standards can help improve the functioning of the market, perform an important guiding function for domestic reform processes and facilitate liberalization and integration of FS markets. The international financial order has particular characteristics, including its loosely connected/decentralized structure of international governance (the international FS landscape is composed of numerous institutions, entities and informal networks of national officials/authorities); the legal nature of the rules (hardly legally binding, instead policy recommendations/international guidelines); implementation of the rules (informally monitored, with attendant variations in level of compliance); content/substance of rules (covering a wide variety of issues sometimes sector-specific and sometimes functional); specificity of the rules (mostly setting broad principles/best practices, granting flexibility for adjusting them to the specificities of individual countries).

41. International bodies include, Bank for International Settlements (BIS, 1930); Basel Committee on Banking Supervision (BCBS, 1974); International Association of Insurance Supervisors (IAIS, 1994); International Organization of Securities Commissions (IOSCO, 1983), aiming at enhancing cooperation and exchange of experiences, and development of standards, guidelines, best practices and surveillance mechanisms. The Organization for Economic Cooperation and Development (OECD) hosts the Financial Action Task Force

[*****] Jansen, Vennes ( 2006) .

(FATF, 1989, established by the G7), and the IMF plays an informal role in monitoring the process of work and the national implementation of FS-related international standards (e.g. through multilateral/bilateral surveillance and the Financial Sector Appraisal Programs (FSAPs)). There are also joint bodies – e.g. Financial Stability Forum, convened in 1999 – bringing together senior representatives of financial authorities, international financial institutions, international regulatory/supervisory groupings, central bank experts and the European Central Bank.

**Box 3. Basel II**

In June 2004, the Basel Committee issued a Revised Framework on International Convergence of Capital Measurement and Capital Standards, a vehicle for improving internal control/risk management. Similar to earlier 1988 Basel rules, the 2004 rules aim to prevent banks from increasing their credit risk. Basel II improvements include aligning regulatory capital requirements more closely to the underlying risks that banks face. Basel II is based on three pillars:

(a) Risk assessment mechanisms and capital requirements: the “standardized approach”, where banks refer to corporate rating agencies; the “internal rate-based approach”, where banks use their own risk estimation systems. Basel II also introduced a securitization framework (as banks increasingly transfer their asset risks to outside investors), offering a choice between the “standardized approach” and the “internal rate-based approach”; and offers different approaches for assessing operational risk.

(b) Supervisory processes: Basel II gives more scope to banking supervisors to intervene and monitor risk assessment systems of banks and requires supervisors of the home and host countries to improve cooperation/information exchange.

(c) Market discipline and disclosure: Basel II requires banks to publish more differentiated data and enhance transparency.[†††††]

42. International financial architecture has seen rapid changes in response to challenges created by international financial reality. International bodies have identified issues to avoid financial crisis; enhanced technical assistance, monitoring and cooperation between different authorities (nationally and internationally); and promoted international standards and guidelines. Regulatory convergence has increased, with greater emphasis on prudential supervision and corporate governance, a focus on risk and increased use of dynamic preventive tools. The creation of new bodies and broadening of activities of existing bodies highlight this trend towards a deeper and broader regulatory agenda.

43. Need for ensuring adequate DC representation (or consultation) in setting of international standards is exemplified by the process of adopting capital adequacy rules, as undertaken by Basel Committee of Banking Supervisors (late 1980s) and in handling of OFCs.

**Box 4. DCs and international processes**

To avoid the need to undertake individual, case-by-case grading, the BIS Committee in 1988 created two country categories: one with zero-risk-weighting (those countries represented in the Basel Committee, OECD and Saudi Arabia), and another with a 100 per cent risk-weighting (for any other country). This put at a disadvantage countries not represented in Basel. DCs perceived this as arbitrary process, alien to risk-weighting and instead a tax on lending to poor countries. To help address risks

[†††††] Andrew Cornford, "Basel II, the revised framework of June 2004", UNCTAD Discussion Papers, No. 178, April 2005, UNCTAD/OSG/DP/2005/2.

generated by OFCs – predominantly in DCs – several organizations assess OFCs' conformity with international regulatory standards (OECD Financial Action Task Force, FATF; Financial Stability Forum (FSF); IMF financial sector assessment project). As part of a larger strategy of naming and shaming to induce OFCs to comply with international standards, OECD FATF and others issued lists identifying countries with potentially harmful tax, money-laundering and financial practices. Concerns include lack of DC participation in standard-setting, non-uniform application of standards, non-transparent assessment processes; and no specification of ways for countries to improve practices.

44. Many DCs face difficulties in terms of complying with standards. Further research is needed to identify how they can benefit from international processes. They have problems keeping up with rapid developments of markets and are in need of assistance, cooperation and expertise (including monitoring of market developments/data) and regulatory cooperation on how to develop a well-functioning/efficient FS regime. South–South cooperation is important.

## V. TRADE LIBERALIZATION AND FS

45. Liberalization is happening through different avenues, autonomously, through GATS or through regional trade agreements (RTAs).

### 1. GATS

46. GATS provides for progressive liberalization of services trade. A new round of services negotiations started in 2000, now folded into the Doha Round of WTO trade negotiations, intended to place the needs and interests of DCs at its heart. FS-related provisions are included in the GATS Agreement, Annex on FS, Understanding on Commitments in FS and individual members' schedules of specific commitments. FS have been the subject of extended sectoral negotiations after the Uruguay Round. GATS objectives and principles (e.g. progressive liberalization, flexibility, increasing participation of DCs in international services trade) also apply to FS. Among the 11 services sectors covered by W/120 (WTO's sectoral classification list), the FS sector ranks second regarding numbers of commitments. As of July 2007, 121 members have commitments in at least one of the FS subsectors (counting European Union member States individually), representing 80.66 per cent of WTO membership.

47. In making FS commitments, members use two scheduling approaches:

(a) Positive-listing of commitments: choosing any number of subsectors/modes of supply and scheduling any type of market access/national treatment (MA/NT) limitations;

(b) Understanding on FS, offering an alternative mechanism for deeper commitments by giving details about the sectoral/modal scope/nature of commitments and by containing additional obligations (e.g. standstill, government-procurement, new FS, transfer/processing of information and non-discriminatory measures). Two DCs used this.

48. Para 7 of the understanding requires members to permit any Mode 3 FS supplier to offer any new FS. Given the proliferation/rapid development of new financial products, concerns arise about difficulties to anticipate the exact scope of commitments. Accordingly, members carefully limit respective commitments. The understanding also addresses Mode 4, providing for temporary entry for senior managerial personnel and specialists in the operation of the FS supplier, and – associated with commercial presence – specialists regarding computer, telecommunication, accounting, actuarial and legal services.

49. Members' FS commitments exhibit interesting patterns. After tourism, FS is the sector with the most commitments. For DCs, in many cases, commitments enshrined recent FS reform and liberalization; Mode 3 is the mode in which members prefer allowing access to domestic markets for direct insurance services and, apart from Asia, also for banking. This preference for Mode 3 over Mode 1 could originate in expectations that (a) positive effects of liberalization may be weaker in Mode 1 than in Mode 3; (b) Mode 1 liberalization may create more risks for domestic financial systems (e.g. regulatory control is easier for banks established within borders); and (c) that implementing Mode 1 commitments may require cross-border capital flows. When comparing GATS commitments to the level of bindings in RTAs, the latter generally go further, and tend to also exceed offers made in the Doha Work Program (DWP), and sometimes even requests. There are differences depending on the type of services RTA (positive or negative list) and the parties to the agreement.[‡‡‡‡‡]

50. Recently acceded countries made FS commitments in nearly all subsectors, the breath and depth of which raise questions about their sustainability, particularly in the light of these countries' comparatively weak regulatory frameworks, practices and institutions. Some members (acceding/original) used "pre-" or "phased-in" commitments, committing to market-opening in the future. They thereby create a certain incentive/pressure for domestic reform, while at the same time granting time to develop the necessary regulatory and supervisory mechanisms and prepare industry for enhanced competition. Countries using this technique for FS include Egypt, the Czech Republic, Slovakia, Hungary, Poland, Slovenia, China and Malaysia. For example, China's banking commitments include a detailed system of phased-in opening of FS (RMB and foreign currency business) to different clients and in different cities. In these cases, GATS commitments go beyond binding the status quo and require changes in policymaking (de novo liberalization).

51. Some members use a particularly flexible type of phase-in, making market access dependent on the existence of a particular regulatory framework, such as Japan and Mauritius for new financial products. Thailand, in turn, appears to "phase-out" commitments, allowing for higher equity participation for a period of 10 years, with foreign shareholders entering in this period being grandfathered thereafter.

52. Other GATS provisions central for members' financial systems are Articles XI (payments/transfer for current transactions relating to specific commitments) and XII (balance of payments exception). According to Article XI, members shall not impose restrictions on any capital transaction inconsistent with their specific commitments.

**Box 5. Prudential carve-out**

Appropriate regulatory/supervisory frameworks are prerequisites for successfully opening up FS, reflected in the "prudential carve-out", in paragraph 2(a) of the annex on FS. Members have different views regarding the carve-out, some suggesting that it is too broadly defined (and a more precise definition would be required) and others fearing that this would erode members' right to impose prudential measures. Some schedules contain explicit references to prudential measures. In negotiations on domestic regulation, DCs (e.g., African, Caribbean and Pacific Group of States) suggested that future disciplines should explicitly affirm the right to prudential measures.

53. When making FS commitments, it is important to consider possible linkages between FS liberalization and capital-account liberalization. While GATS rules/obligations are designed to decouple the liberalization of trade in FS from the liberalization of capital-account transactions, certain practical linkages exist. These include situations where capital-

[‡‡‡‡‡] Roy/Marchetti/Lim (2006).

account transactions are key for complying with GATS commitments. For example, the effective implementation of certain FS commitments in Mode 1, e.g. in deposit services, can require capital-account liberalization the scope and extent of which are hard to anticipate. Liberalizing capital accounts prematurely without adequate institutions and prudential regulations in place can induce economic and social distress and financial crises.

54. Unlike trade in goods, capital flows are more subject to information asymmetry, agency problems, adverse selection/moral hazard (Stiglitz, 2000); price-formation in asset markets may often be dominated by speculation; capital-flows to DCs are volatile (without links to the receiving country's economic fundamentals); substantial empirical evidence suggests a close link - particularly in DCs - between liberalization of the financial system and economic and financial crises; and selective policies (e.g. selective economic openness) are needed (Singh, 2003).[§§§§§] More research is needed on connections between FS in WTO and other areas of the international FS system.

55. The DWP's FS negotiations saw numerous bilateral requests and one plurilateral (February 2006) request, coordinated by Canada. The plurilateral request was submitted by 10 countries with strong FS sectors, directed to mostly DCs (Argentina, Brazil, India, China, Association of South-East Asian Nations (ASEAN), Egypt and South Africa). Bilateral/plurilateral requests exhibit similar features, calling for enhanced commitments on: Modes 1 and 2 (e.g. for all subsectors mentioned in the annex, for a specific set of sectors, or for a minimum cluster of commitments as per understanding); Mode 3 (e.g. eliminating certain sectoral and horizontal limitations); and Mode 4 (e.g. seeking greater freedom for intra-corporate transferees and contractual service suppliers). Despite its far-reaching nature, numerous countries have also requested DCs to subscribe to some parts, if not all, of the understanding or to use the understanding as a reference point for commitments. Interestingly, the FS plurilateral request does not refer to the understanding. Two model-schedules were put forward by the FS industry (e.g. Financial Leader Group) aimed at deeper commitments. The model-schedule for investment banking, trading and asset management aims at opening markets in the respective services by binding most favourable current market access conditions and amending current laws and regulations for bringing them in line with the model-schedule. The insurance model-schedule aims at effective access for insurance providers, through MA/NT and additional commitments, covering domestic regulation-type measures (best practices). Given the far-reaching nature of these proposals, the importance of FS for development and the cost of failure, in-depth analysis of their implications on DCs is required.

56. Suggestions have also been made on regulatory issues. Regarding transparency, the plurilateral request on FS flags transparency in development and application of laws and regulations; transparent and speedy licensing procedures have been suggested. The April 2007 text of the Chair from the WTO Working Party on Domestic Regulation (WPDR) addresses transparency in terms of publication requirements, a priori comment procedures (on a best endeavour basis) and due process-related implementation questions. Some suggested pursuing FS sector-specific work in parallel with WPDR horizontal work.

57. Only a few offers introduce significant changes and many, including developed countries', do not match actual openness. Some add new FS subsectors; reduce foreign-equity limitations (India rose limits in transferable securities from 49 to 74 per cent), or requirements for juridical form (India allows wholly-owned subsidiaries as legal entities);

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[§§§§§] See also D. Rodrik, "Who needs capital account convertibility?" 1998, Essays in International Finance, Vol. 207.

eliminate residency requirements (Canada for dealers, brokers, advisors in trading of securities and commodity futures and to a limited degree also for citizenship/residence requirements for boards of directors); relax exchange-regime limitations (European Union); remove Mode 2 limitations (Japan); and increase numbers of licenses (India, now 15 bank licenses). In addition, the United States offers liberalization of interstate branching and acquisitions. Offers introduce greater precision on Mode 4.

**2. Regional integration**

58. Most RTAs refer to FS, following different approaches:

(a) Explicit exclusion of FS from agreements (e.g. Chile free trade agreements (FTAs)) or from initial schedules of commitments (e.g. Thailand–Australia);

(b) Additional chapter/annex clarifying general provisions for FS specificities (e.g. Singapore FTAs; Southern African Development Community (SADC)[******]);

(c) Separate, self-contained chapter on FS, governing all aspects of FS (e.g. United States FTAs, European Union–Mexico, European Union–Chile, Japan–Mexico, Republic of Korea–Singapore);

(d) Deep coverage (the European Union has specific directives on FS) where services trade liberalization is part of the four freedoms and rules for an internal services market; and

(e) Implicit/indirect coverage, where a generic chapter on services and/or investment covers FS together with other sectors.

59. RTAs adopt different approaches to liberalization (positive list, negative list or a combination). While different approaches can lead to the same level of liberalization, the negative list requires a higher level of capacity among negotiating countries, posing particular challenges for DCs. Preference for one or the other approach originates, among others, in a country's perception of its regulatory regime (whether there will be major changes in future). Some RTAs cover FS in a non-exhaustive way through provisions for future negotiations or reviews (Chile–European Union).

60. FS commitments in RTAs tend to be more far-reaching than those in GATS. Sometimes, RTA FS commitments exceed not only offers made in the context of the Doha Round (particularly in the case of the United States Preferential Trade Agreements) but they also match/exceed demands made in multilateral requests. For instance, Latin American and Caribbean FTAs exhibit MA/NT FS commitments that tend to have significant additional liberalization comments compared to GATS. Some FTAs tend to reflect liberalization provisions contained in the WTO understanding. Many RTAs exhibit a rise in commitments for cross-border supply of FS, often going beyond the traditional concept of GATS Mode 1, to include Mode 2 and in some cases even Mode 4 (e.g. Republic of Korea–Chile and the North American Free Trade Agreement (NAFTA), which defines cross-border trade in services to include three of the four GATS modes, i.e. cross-border supply, consumption abroad and the movement of natural persons).

61. Regarding regulatory harmonization/transparency, RTAs tend to echo GATS provisions on domestic regulation and prudential carve-out. For example, European Union–Mexico provides for parties to regulate FS supply on a non-discriminatory basis and contains a GATS-style prudential carve-out. The India–Singapore Comprehensive Economic Cooperation Agreement contains provisions for domestic regulation; NAFTA contains "good

[******] UNCTAD is providing assistance to SADC regional integration for services.

government" disciplines (to ensure reasonable, objective and impartial administration). Other provisions relate to freezing of existing regulatory regimes and ratcheting (automatically locking in any liberalization, e.g. United States FTAs).

62. Some RTAs set up institutional arrangements to address issues related to the implementation of FS-related aspects, or for moving towards further harmonization within the sector. For example, NAFTA provides for a FS committee. Some RTAs focus on cooperation, without corresponding liberalization. The Euro–Med Association agreements emphasize cooperation, including for FS. The European Union–Morocco Association Council included FS in the listed sectors where cooperation should occur. In the 1990s, following financial crises in the 1980s, The Economic and Monetary Community of Central Africa and the West African Economic and Monetary Union implemented regional approaches to FS regulation (e.g. a regional banking commission), not all of which are effectively implemented.

## VI. CONCLUSIONS

63. For FS reform and liberalization to generate pro-development outcomes, it needs to be supported by appropriately designed, paced and sequenced policies (e.g. macroeconomic, prudential, regulatory and supervisory), to be determined only on a case-by-case basis adapted to the specificity of each country. For many DCs, this remains a challenge, further compounded by difficulties of properly managing capital-account liberalization. Emerging markets are those in greatest need of economic and social benefits of financial development and stability. But they have difficulties achieving macroeconomic stability and developing institutional and regulatory frameworks in parallel with rapid changes in the financial system. The development of proper regulatory systems is a long-term process; DCs need time to adopt and properly implement the respective legislation and regulations.

64. When aiming to strengthen the international regulatory system in FS, policymakers face challenges, including the limited institutional role of international regulatory initiatives; DCs' difficulties to effectively participate in international regulatory initiatives (e.g. ineffective voice, no one-size-fits-all, DCs' lacking ownership of reform and attention for their priority issues); tendency to deal with past crises; lack of tools for facing new complex financial products, technologies, and management techniques; cross-border insolvency; and expansion of consolidated firms.

65. A developmental approach to FS liberalization in GATS is needed:

- Given continuing weakness of DCs' FS, demands for MA/NT commitments need to be cognizant of flexibilities for DCs to carefully choose the extent of bindings according to the maturity of financial and regulatory systems; phasing-in commitments or a possibility to roll-back commitments could facilitate DC participation.
- Commercially meaningful commitments in sectors/modes of export interest to DCs, e.g. niche opportunities including in Modes 4, advisory services computer related services, information technology-enabled services, offshoring, microfinance and Islamic finance.
- Disciplines on regulatory issues (including transparency) would give primacy to the right to regulate and UA, consider DCs' resource and administrative constraints (with

a view to ensure their effective participation in international standard-setting) and preserve the prudential carve-out.

- Binding obligations need to be conditional upon the existence of effective regulatory frameworks (e.g. trade-facilitation approach), and supported by clear commitments for capacity-building/technical assistance, focusing on both improving DCs' regulatory and institutional framework and their supply side.

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