A COMPARATIVE REVIEW OF FINANCIAL SERVICES SECTOR COMMITMENTS IN THE SELECTED SAARC MEMBER COUNTRIES: RELEVANT EXPERIENCES FOR NEPAL'S ACCESSION TO WTO

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Abstract

The world economy is integrating at an ever faster pace which can be reflected in both growing global trade and the increasing number of the World Trade Organization (WTO) members. To capture the benefits and advantages of global trade, Nepal has commenced the accession process for membership into WTO and is presently negotiating commitments in the various sectors of goods and services. As one of those sectors, the financial services sector (FSS), has major influence on domestic monetary and financial stability, the present paper examines the appropriate levels of commitments in FSS for Nepal through a comparative review of the FSS commitments by selected SAARC member countries; namely India, Pakistan and Sri Lanka. The analysis indicates that the majority of the financial services sector commitments occur through commercial presence although there exists large country-specific variations. The paper ends by recommending the appropriate level of financial services sector commitments for Nepal and suggesting on the essential preparation required in FSS with WTO membership.

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1. Introduction

The global economy is becoming ever integrated with World Trade Volumes of goods and services increasing by 12.4% in 2000/2001 (IMF, 2001). With growing global integration, there are benefits and advantages to the domestic economy reflected in greater competition, with lower cost and higher quality goods, as well as the opportunity for reaching the potential inherit in the country's comparative advantage (WTO, 2001). To capture these mentioned benefits and advantages of global trade, Nepal has commenced the accession process for membership into the World Trade Organization (WTO) which is likely in the near future.[1] Membership in WTO eventually entails, among many others, commitment for liberalization of financial services sector (FSS) of GATS. However, it is important to determine the *appropriate* levels of FSS commitment for Nepal in the accession process to the WTO. The primary objective of the paper, therefore, is to determine the appropriate and affordable levels of FSS commitments for the country which will be accomplished through a comparative review of levels of FSS commitments in the selected SAARC member countries of India, Pakistan and Sri Lanka.

WTO was established on 1 January 1995 as an "apex" institution responsible for administering the new global trade rules, resulting from the Uruguay Round of Multilateral Trade Negotiations. The Uruguay round embodies three multilateral agreements: (1) the General Agreement on Tariff and Trade (2) General Agreement on Trade in Services (GATS) (3) Agreement on Trade-related Aspects of Intellectual Property Rights (WTO, 1999). Presently WTO comprises of 144 members of which two thirds are in the early stages of economic development with Nepal having the status of observer in WTO. Nepal's membership in WTO would mean negotiating an acceptable terms of accession with regard to the agreements set forth above. As mentioned earlier, the specific sector of concern in this paper is for FSS since it has an important influence on domestic monetary and financial stability. Therefore, to reiterate once again, this paper focuses on those affordable commitments that could possibly be made by Nepal in the FSS of GATS's sector through a comparative review of levels of FSS commitments for liberalization in selected SAARC member countries.

FSS covers three sub-sectors and sixteen categories as cited in WTO Annex and which are discussed later in the paper. Liberalization entails greater competition by having the market become more responsive to forces of supply and demand; this in part allows foreigners access to domestic financial markets and domestic nationals access to foreign financial markets. This increase in financial activity, both domestic and with other countries, will affect financial flows and thus the capital account in the Balance of Payments (BOP).

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[1] This is consistent with a number of publications in Nepal such as Srestha (2001).

With liberalization of FSS there is also increasing probability of crisis in BOP in the absence of *ex ante* strategic protective measures.[2] This may be due to a number of reasons such as volatile capital flows etc. It is assumed that crisis in BOP results from non-symmetric commitments for liberalization of FSS in an economically integrating region. This is because FSS liberalization facilitates capital flows to speedily move between areas to meet profit opportunities. Non-symmetric FSS liberalization provides those profit opportunities through, for example, currency arbitrage. This would result in volatile capital flows from the less liberalized economy to the more liberalized economy (and vice versa) leading to a BOP crisis (specifically through instability in foreign exchange reserves) and possibly ending with a domestic monetary and financial crisis. Thus, it is essential to harmonize the level and the proper sequence of FSS liberalization for countries in an economically integrating region.

The need to harmonize both the level and proper sequence of FSS liberalization for Nepal (and thus for their commitments onwards) is very important due to two levels of economic integration. First, the South Asian region, embodied by the seven member[3] South Asian Association for Regional Cooperation (SAARC), is moving toward greater economic integration with a goal of economic union in 2020 as put forward in the report of the SAARC Group of Eminent Persons (SAARC, 1997/1998). Second, Nepal and India share an open and contiguous border with limited controls on capital mobility resulting partly from the 1950 Treaty of Trade and Friendship. These two factors suggest that Nepal's commitment for FSS liberalization cannot diverge greatly from that of the South Asian region, or face a BOP crisis, due to volatile capital flows, and possibly ending in a financial crisis. This crisis in BOP was most recently seen in East Asia and is a cost that Nepal’s small, developing economy cannot bear.

To limit the probability of BOP crisis, it is essential for Nepal to commit to the *appropriate* levels of FSS liberalization in the accession to WTO. There are a number of ways to determine the appropriate level of FSS liberalization such as by examining Nepal’s characteristics and putting forward country consistent FSS commitments. However, the trend of economic integration in South Asia suggests that Nepal’s commitments for FSS liberalization cannot greatly diverge from Nepal’s neighbors. Thus, there is a need for harmonizing Nepal’s commitments for liberalization of FSS with the existing nature of FSS liberalization in South Asia. Because of this regional circumstance, it is of utmost importance to review the commitments for FSS liberalization made by the neighboring selected SAARC

[2] Domestic monetary and financial stability will also be affected, however is assumed to be a result of crisis in the BOP.

[3] SAARC was established in 1985 and include the countries of Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka.

member countries. This will give an upper bound to the FSS commitments for Nepal and will allow Nepal to harmonize FSS liberalization with the South Asian region.

The paper proceeds by introducing some background information on concepts of FSS and FSS liberalization in the next section. The third section reviews the levels of FSS liberalization in selected SAARC countries, as put forth in WTO Schedule Format, and does a comparative review of FSS liberalization in those countries. The fourth section puts forward some observations and suggestions for Nepal while the last section summarizes and concludes.

2. Background Information on the Concept of FSS and of FSS Liberalization

To understand FSS, it is important to understand GATS in context of WTO. Prior to the formation of WTO, the existing GATT dealt only with trade in goods. However, the changing composition of trade, in part, resulted in a more comprehensive set of rules over international trade represented by the establishment of WTO on 1 January 1995. An integral portion of WTO is GATS which covers all internationally traded services in twelve sectors.[4] These included sectors are the various possible ways of providing an international service.[5] One of these services is the FSS. FSS facilitates financial intermediation in the economy (i.e. mobilization and allocation of funds). Further, FSS is important for the economy as a whole since it allows financial transfers and payments. In other words, a healthy and stable FSS is essential for sustainable economic growth. Conversely, instability in FSS can potentially have economy wide effects and can be seen most dramatically in the crisis in East Asia where fragility in the financial system spilt over to other countries in the region.[6,7] This short background note, therefore, demonstrates that it is essential to understand and accurately represent a country's FSS.

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4 These sectors of GATS are: Business (including professional and computer) services; Communication services; Construction and related engineering services; Distribution services; Educational services; Environmental services; Financial (insurance and banking) services; Health-related and social services; Tourism and travel-related services; Recreational, cultural and sporting services; Transport services; and Other services not included elsewhere).

5 GATS defines four avenues which will be discussed in greater detail in the next section, they are: cross-border supply; consumption abroad; commercial presence; and finally presence of natural persons.

6 The financial services annex says that governments have the right to take prudential measuring, such as those for the protection of investors, depositors and insurance policy holders, and to ensure the integrity and stability of the financial system. It also excludes from the agreement services provided when a government exercises its authority over the financial system, for example central bank's services. Negotiations on specific commitments in financial continued after the end of the Uruguay Round and ended in late 1997.

7 The only exception to this is when there are BOP difficulties and even then, the restrictions must be temporary and subject to other limits and conditions.

In this regard, there are a number of ways for representing a country's FSS such as through the United Nations or national classification. Because of the varying classification standards, there have been confusion and problems with cross-country comparison. This paper consistently uses the format provided by the GATS Annex on Financial Services which is presented below[8]:

FINANCIAL SERVICES

A. All insurance and insurance-related services:

  a. Life, accident and health insurance services;
  b. Non-life insurance services;
  c. Reinsurance and retrocession;
  d. Services auxiliary to insurance (including broking and agency services).

B. Banking and other financial services (excluding insurance):

  a. Acceptance of deposits and other repayable funds from the public;
  b. Lending of all types, including, *inter alia*, consumer credit, mortgage credit, factoring and financing of commercial transaction;
  c. Financial leasing;
  d. All payment and money transmission services;
  e. Guarantees and commitments;
  f. Trading for own account or for account of customers, whether on an exchange, in an over-the-counter market or otherwise, the following;
    - money market instruments (cheques, bills, certificate of deposit, etc.);
    - foreign exchange;
    - derivative products including, but not limited to, futures and options;
    - exchange rate and interest rate instruments, including products such as swaps, forward rate agreements, etc.;
    - transferable securities;
    - other negotiable instruments and financial assets, including bullion.
  g. Participation in issues of all kinds of securities, including under-writing and placement as agent (whether publicity or privately) and provision of service related to such issues;
  h. Money broking;
  i. Asset management, such as cash or portfolio management, all forms of collective investment management, pension fund management, custodial depository and trust services;
  j. Settlement and clearing services for financial assets, including securities, derivative products and other negotiable instruments;

[8] The rationale for using this system, versus other comparable systems, is given in (WTO, 1998).

k. Advisory and other auxiliary financial services on all the activities listed in Article 1B of MTN.TNC/W/50, including credit reference and analysis, investment and portfolio research and advice, advice on acquisitions and on corporate restructuring and strategy;
l. Provision and transfer of financial information, and financial data processing and related software by providers of other financial services.

C. Other.

Liberalization of FSS, on the other hand, entails that the existing financial regulations are accommodative to greater financial intermediation along with greater financial transfers and payments; the later will eventually be reflected in the inflow and outflow of funds. This also necessitates that there be deregulation of various financial service activities and increase in industry competition.

3. Comparative Review of Selected SAARC Country's FSS Commitments in WTO Schedule Format

As mentioned, it is essential to characterize a country's FSS commitment's in a format which is comparable with other countries. In this vein, this section proceeds as follows: First, review of WTO schedule format then, secondly, putting forward the level of FSS commitments of selected SAARC member countries and lastly doing a comparative review of those countries FSS commitments.

3.1 Review of WTO Schedule Format

This section reviews the WTO schedule format for accurate submission of factual information and is based on WTO (1996). It should be noted that there are two sorts of provisions under the GATS. The first are general obligations, some of which apply to all sectors (e.g. MFN, transparency, etc.). The second are specific commitments which are negotiated undertakings specific to each member. These commitments can further be broken down into horizontal and specific commitments. Horizontal commitments affects all sectors, and sub-sectors, equally; this is usually at the top of the Schedule of Service Sector Commitments.[9] Specific commitments, on the other hand, are commitments specific to the sector and are provided for market access and national treatment which are generally put forward with two separate columns. [10,11]

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9 The discussion will be consistent with the schedule of the selected SAARC member countries' FSS is provided on the Internet web home page of Nepal Rastra Bank at www.nrb.org.np as the first and second appendix for market access and national treatment respectively for the interested to look into its details.

10 For ease of understanding, the general table format for market access, which is also true for national treatment, is presented below in tabular form:

In the first table for market access, the first column puts forth the various categories under each sub-sector of a particular sector. So, in the case of FSS, the first column includes the sub-sectors of "All insurance and insurance-related services", "Banking and other Financial Services (excluding insurance)" as well as the "Other" sub-sector along with the different categories described earlier. In the second column information relating to market access are included for each category based on the four modes of supply which are: *Cross border supply* (i.e. the service supplier is typically not present within the territory of the government where the service is delivered with some examples being international transport, the supply of a service through telecommunications or mail, and other such services embodied in exported goods [e.g. a computer diskette, or drawings]); *Consumption abroad* (i.e. this mode of supply is often referred to as "movement of consumers" whose essential feature is that the service is delivered outside the territory of the government concerned and typically includes crossing for the border of the consumer as, for example, in tourism services[12]); *Commercial presence* (i.e. this mode covers not only the presence of juridical persons in the strict legal sense, but also that of legal entities which share some of the same characteristics includes, *inter alia*, corporations, joint ventures, partnerships, representative offices and branches); *Presence of natural persons* (i.e. this mode covers natural persons who are themselves service suppliers, as well as natural persons, who are employees of service suppliers). The four modes of supply are simply stated as Mode 1, 2, 3 and 4 for cross border

Financial Service Sector – market access	
All insurance and insurance-related services	1) Cross-border supply 2) Consumption abroad 3) Commercial presence 4) Presence of Natural persons
Banking and other Financial Services (excluding insurance)	1) Cross-border supply 2) Consumption abroad 3) Commercial presence 4) Presence of Natural persons
Other	1) Cross-border supply 2) Consumption abroad 3) Commercial presence 4) Presence of Natural persons

[11] An example from WTO (1998) will clarify this "if a government commits itself to allow foreign banks to operate in its domestic market, that is a market access commitment. And if the government limits the number of licenses it will issue, then that is a market access limitation. If it also says foreign banks are allowed one branch while domestic banks are allowed numerous branches, that is an exception to the national treatment principle."

[12] Although activities such as ship repair abroad, where only the property of the consumer moves, or is situated abroad, are also covered.

supply, consumption abroad, commercial presence and presence of natural persons respectively.

Commitments are recorded in the WTO schedule format in the table for market access, through a number of ways. First, as mentioned earlier there are horizontal commitments which apply to trade in services in all scheduled services sectors unless otherwise specified; it is in effect a binding either of measures which constitutes a limitation on market access or national treatment, or of a situation in which there are no such limitations. Second, there are sector specific commitments which apply to trade in services in a particular sector; it is in the context of such a commitment, when a measure is maintained which is contrary to Article XVI or XVII, it must be entered as a limitation in the appropriate column (either market access or national treatment for the relevant sector and modes of supply). Third are recordings of the various levels of commitments; their presentations are extremely important and have to be very precise since the terms used create legally binding commitments indicating the presence or absence of limitations to market access and national treatment. Depending on the extent to which a member has limited market access and national treatment, for each commitment with respect to each mode of supply, four cases can be foreseen:

- *Full commitment* – Members do not seek in any way to limit market access or national treatment in a given sector and mode of supply through measures inconsistent with Article XVI and XVII. In this situation, the appropriate column is marked with NONE. However, any relevant limitations listed in the horizontal section of the schedule will still apply.

- *Commitment with limitations* – Where market access or treatment limitations are inscribed, the member must describe in the appropriate column the measure maintained which are inconsistent with Articles XVI or XVII. The entry should describe each measure concisely, indicating the elements which make it inconsistent with Articles XVI or XVII. Further, in some cases, members may choose to partially bind measures affecting a given category of supplier. This may be achieved through an indication in the horizontal section of a schedule with the corresponding sectoral entry under the relevant mode of supply (i.e. it may thus read "Unbound except as indicated in the horizontal section").

- *No Commitment* – In this case, the Member remains free in a given sector and mode of supply to introduce or maintain measures inconsistent with market access or national treatment. In this situation, the Member must record in the appropriate column the word: UNBOUND. This case is only relevant where a commitment has been made in a sector with respect to at least one mode of supply.[13]

[13] Where all modes of supply are "unbound", and no additional commitments have been undertaken in the sector, the sector should not appear on the schedule.

- *No commitment technically feasible* – In some situations, a particular mode of supply may not be technically feasible. An example might be the cross-border supply of hair-dressing services. In these cases, the term UNBOUND* should be used. The asterix should refer to a footnote which states "Unbound due to lack of technical feasibility."

It is in "Commitments with limitations" that acceding government may limit market access horizontally or to any specific service sector. Such limitations for market access[14] may include: Limitations on the number of service suppliers (e.g. ceilings on the total number of banks); Limitations on the total value of transactions on assets (e.g. foreign bank subsidiaries limited to X per cent of total domestic assets of all banks); Limitations on the total number of service operations or on the total quantity of service output (e.g. restrictions on broadcasting time available for foreign firms); Limitations on the total number of natural persons (in particular non-nationals) that may be employed in the sector (or the share of wages paid to foreign labor); Restrictions on, or requirements of, specific types of legal entity through which that service may be supplied (e.g. commercial presence exclude representative offices, foreign companies required to establish subsidiaries, commercial presence must take the form of a partnership); Limitations on the participation of foreign capital. In addition to these limitations it is suggested that clear reference will also have to be made to the relevant laws or regulations.

The second table elaborates on national treatment.[15,16] Following the same format as market access, the first column puts forth the various categories under each sub-sector of a particular sub-sector. The second column puts forward limitations on national treatment which follow a similar format as above where, along with each mode of supply, a detailed description of existing measures maintained by the acceding governments which may limit market access will be noted as well as the relevant laws or regulations.[17]

[14] This is consistent with Article XVI of WTO (1995).

[15] This is consistent with Article XVII of WTO (1995).

[16] The GATS states that "in the sectors covered by its schedule, and subject to any conditions and qualifications set out in the schedule" each member shall give treatment to foreign service and service suppliers treatment, in measures affecting supply of services, no less favorable than it gives its own service and suppliers.

[17] For completeness an additional column is usually provided for additional commitments with respect to measures affecting trade in services not subject to scheduling under market access or national treatment. Thus, additional treatments are expressed in the form of undertakings, not limitations. In the schedule, the additional comments column would only include entries where specific commitments are being undertaken, and need not include those modes of supply where there are not commitments undertaken.

3.2 Level of FSS Commitments for Liberalization of Selected SAARC Member Countries

As mentioned, the selected SAARC member countries for this paper are limited to India, Pakistan and Sri Lanka. This is because Bangladesh and Maldives have not made any commitment in the financial services sector[18] and Bhutan, like Nepal, is on the process of acceding to WTO;[19] these are:

3.3 Comparative Review of FSS Commitments

All three selected SAARC member countries have strong similarities with minor differences which are consistent for all sub-sectors in FSS for both market access and national treatment. Initially, a sub-sector wise comparative analysis for FSS is put forth.

As mentioned, there are two aspects for making an analysis on the "All insurance and insurance related services" portion of FSS. First is the limitations on market access in those selected SAARC countries, which finds that India does not have any commitment in life insurance whereas Pakistan and Sri Lanka are "Unbound" in all modes of supply except for the commercial presence. Pakistan has already given 25% equity participation to foreign shareholding in existing foreign life insurance services providers and this participation has increased upto 51 % in new life insurance companies and Sri Lanka permits new establishments only after the approval from the government of Sri Lanka. So far for the non-life insurance services providers, all the three SAARC countries have made unbound commitments in all modes of supply except for the commercial presence. India and Sri Lanka are bound with some specified provisions in the area of reinsurance and retrocession but Pakistan is unbound in all modes of supply, in this regard, except for the commercial presence where it does not have any commitment. With regard to the "services auxiliary to insurance (including broking and agency services)", only India has made some commitments. In regard to the limitations on national treatment in this sector, all the selected SAARC countries are either unbound or do not have any commitment with a number of exceptions.

Additionally, there are also two aspects for making an analysis on the "Banking and other financial services (excluding insurance)" of FSS for these three selected SAARC member countries. First is the limitations on market access, where for India, Pakistan and Sri Lanka, the first and second mode of supply are generally unbound. In the case of the fourth mode of

[18] From the "Summary of Financial Service Commitments" in the WTO home page.

[19] The levels of FSS commitments of India, Pakistan and Sri Lanka for market access and national treatment are placed on the Internet web home page of Nepal Rastra Bank at www.nrb.org.np for easy access.

supply, there is also the condition of being unbound except for the condition as "indicated under the horizontal measures." However, for Sri Lanka in the categories of "Advisory and other auxiliary financial services.." and "Provision and transfer of financial information.." there are no limitations except for those "provided in the General Conditions." Further for Pakistan, in terms of "Advisory and other financial services..", there are no restrictions except for those "provided in the General Conditions." The greatest variation was in terms of the third mode of supply (i.e. commercial presence). While all sectors of commitments for India, Pakistan and Sri Lanka require that approval be taken from the relevant authorities and incorporation in the country, with significant equity participation generally around 50% (in some cases, 49% while in others 51%), there were some notable differences. For example, India limited the number of service providers to twelve and put a cap on the total assets foreigners in the banking system, but this was not the case in the other two countries. Further, for "Advisory and other auxiliary financial services" Pakistan diverges with India and Sri Lanka by allowing 100% subsidiary companies in commercial presence.

With respect to the limitations on national treatment all the three selected SAARC countries are unbound in the first two modes of supply except for "Advisory and other auxiliary services.." where the limitation for Sri Lanka in the first and second mode of supply is "None except those provided in the General Conditions." For the fourth mode of supply, it is either unconditionally unbound or unbound "except as indicated under the horizontal measures." Just as in the prior paragraph, the third mode of supply has the largest variation. For India it is limited to proper establishment however an interesting feature for India is the requirement that foreign banks constitute a "Local Advisory Board." For Pakistan, this mode of supply is generally unbound except for some limitation such as on the transfer of shares as well as no limitations on both "Asset management.." and "Advisory and other auxiliary financial services..". For Sri Lanka, this mode of supply is limited to the general conditions which require approval of the relevant authorities and provide maximum of 49% of equity share.

Finally, the last subsection of FSS is "Others". However, all three SAARC countries are Unbound in all the four modes of supply for both market access and national treatment.

The prior analysis is summarized in the table below:

Table 1: Comparative Review of FSS commitments for India, Pakistan and Sri Lanka

	Market Access	National Treatment
Similarities	**A. Insurance:** All three countries are "Unbound" in all four modes of supply of life and non-life insurance except for commercial presence in life insurance. Some other exceptions are India and Pakistan who are bound in cross border supply and commercial presence in reinsurance and retrocession. **B. Banking and Other Financial Services:** All countries are "Unbound" in all three modes of supply except, in some cases, for commercial presence such as for India and Pakistan in financial leasing.	**A. Insurance:** All three countries are "Unbound" in all modes of supply with regard to life insurance, non-life insurance, and reinsurance and retrocession. **B. Banking and Other Financial Services:** All countries are "Unbound" in all four modes of supply and require the approval of the respective authorities.
Differences	**A. Insurance:** All countries varied in terms of the degree and form of limitations for commercial presence. For example, Pakistan and Sri Lanka are bound with some commitments in commercial presence with regard to life and non-life insurance but not India etc. **B. Banking and Other Financial Services:** All countries varied in terms of the degree and form of limitations for commercial presence. For example, India permits only through branch operations whereas Pakistan and Sri Lanka permit to open a new licensed bank under commercial presence etc.	**A. Insurance:** All countries varied in terms of the degree and form of limitations for commercial presence. For example, Sri Lanka has no commitment in Commercial presence for life insurance etc. **B. Banking and Other Financial Services:** All countries varied in terms of the degree and form of limitations for commercial presence.

In sum, the similarities are in the restrictive limitations on the first and second mode of supply for the three countries. This can be interpreted as being protective of the domestic financial sector as well as reserving the flexibility to respond as and when the situation dictates. The fourth mode of supply was likewise restrictive, with some variation, which most likely reflect the different labor and immigration laws of the specific countries. A similarity can likewise be seen that the third mode of supply, commercial presence, has been the choice for commitment in liberalization. This liberalization tries to capture the benefits of foreign experience and expertise in the financial sector without having to go through the many difficulties of having volatile capital flows.[20] Likewise, the difference are small compared to the similarities however they give important information about the country peculiarities.

4. Some Observations and Suggestions for Nepal in FSS

The last sections have given an analysis of FSS and of FSS commitments in the selected SAARC countries. This section attempts to apply this knowledge to Nepal and thus proceeds forward in three parts: first, a description and overview of the Nepalese financial services sector, second, some suggestions for Nepal in FSS commitments and lastly, a caveat.

4.1 Nepal's financial services sector – an overview

FSS in Nepal is a fairly recent phenomenon which commenced with the establishment of Nepal Bank Ltd. in 1937.[21] Since then, there have been entry of approximately a dozen financial institutions whose number had really accelerated after 1990, with the advent of multiparty democracy and a liberalized economy. As of January 2002, the financial network of the country has been widened with the operation of 15 commercial banks, 15 development banks, 5 rural development banks, 49 finance companies, 34 co-operatives and 16 NGOs performing financial activities, as per the instructions and guidelines of Nepal Rastra Bank (NRB), along with 17 insurance companies.[22] It is important to note that these different financial institutions are guided by existing laws such as the Commercial Bank Act 1974, Development Bank Act 1996, Finance Company Act 1986 and Insurance Act 1992 along with Foreign Exchange (Regulation) Act 1962 etc.[23]

[20] Kono and Schuknecht (2000) and Maskay (2002).

[21] The *Tejarath Adda* had been established in 1880 however, as it had been only a credit institution, it did not play the essential role of financial intermediation.

[22] Economic liberalization and financial sector reforms have given necessary impetus to the economy and have supported economic activities thereon. As the number of the financial institutions have increased, financial flows and operations have substantially been increased. The financial liberalization has made the financial market more competitive because of the entry of banking and financial institutions in the financial system of the country in a significant number. As mentioned above, the sizeable increase in the number of \banks and financial institutions has significantly contributed to resource mobilization and needed credit resulting the widening accessibility of financial facilities to various sectors of the economy.

[23] There also exists the International Financial Transactions Act, 1998 however the goal of offshore banking has not actualized .

To develop the soundness in the financial system of the country, the process of financial sector reform[24] has been initiated since the mid-80s and is continuing today. An important result of recent efforts has been the Nepal Rastra Bank Act 2002. Further, the formulation of Debt Recovery Act, process for the management transfer of the two largest commercial banks: Rastriya Banijya Bank and Nepal Bank Limited, proposals for restructuring the Agricultural Development Bank and Nepal Industrial Development Corporation are important initiatives undertaken with regard to the financial sector reform. Furthermore, NRB has formed a special project for financial sector reform which is expected to develop necessary policies and guidelines for further consolidation of the financial system. This project has developed the action plan for financial sector reform with a special emphasis on broader and deeper reforms to strengthen the financial system as well as improve its capability to face the vulnerability to financial crises.

4.2 Suggestions for Nepal's FSS commitments

The financial sector reform, as stated above, has been undertaken in a regular manner. These reform measures, in a way, do not necessarily need any immediate compliance or any stringent commitments. This is especially true given that Nepal falls under the category of a "least-developed country".[25] In retrospect, the potential FSS commitments for Nepal's entry into the WTO will pose the serious challenges if sufficient homework is not done before the agreement.[26] This is specially so since there is no possibility of reversion once commitments are made. Because of this, the financial services sector commitments are to be developed

[24] Nepal initiated the process of financial sector reform in the decade of 1980s. Since then, various programs have been launched to strengthen the capability of banks and financial institutions with an aim to support the liberalization process. Various regulatory and prudential consolidation measures for commercial banks and finance companies have been unrestrained since 1986. Deregulation of interest rate and removal of credit ceilings and Statutory Liquidity Ratio were the measures applied in this regard. An important reform initiated in the financial sector was easing of entry restrictions to commercial banks. Establishment of Nepal Arab Bank Limited in 1984 as the first joint venture bank of the country was the result of the liberalized financial policy undertaken by the country. Three new commercial banks were established and the Agricultural Development Bank started its commercial banking transactions in the decade of 1980s (Nepal Rastra Bank, 1996). In this vein, it may not be unjustifiable to mention here that the process of financial sector liberalization in Nepal started in 1980s and accelerated after 1992 when the elected government under multi-party democracy undertook an open policy framework in various sectors of the economy.

[25] According to GATS Article IV (3), "Particular account shall be taken of the serious difficulty of the LDCs in accepting negotiated specific commitments in view of their special economic situation and their development, trade and financial needs".

[26] Along with FSS, the other three sectors are namely telecommunication and tourism, health and travel related services.

taking into consideration the many influencing factors[27] along with the pertinent issues which also emerge such as foreign currency reserve management, balance of payment crisis, internal financial sector stability, possible threat of capital flight and increasing influence of the technological innovation in the financial system as a whole. Taking these experiences of Nepal and that of the neighboring SAARC countries, the commitments in FSS are to be made.

Therefore the discussions and observations submitted here are based on the comparative review of the commitments made by the selected SAARC member countries in the financial services sector and Nepal's own experience. These observations are expected to result in some guidelines to Nepal for making appropriate commitments. **It should however be mentioned that the FSS commitments should be consistent with the current (financial) rules and regulations in Nepal with necessary consultation from the relevant authorities.** As such, the suggestions and recommendations for Nepal can be made in the following levels taking into account the various factors that may affect FSS:

- For the "Insurance" sub-sector of FSS it is suggested that Nepal be "Unbound" with regard to both market access and national treatment in all modes of supply, except for commercial presence in market access. Further, Nepal's commitment for commercial presence, as stated above, should be conditioned to the number of insurance companies which can get permission in a certain period of time. For this, it is proposed that the number of institutions be approximately three with the period of time being five years. Further, the ceiling of ownership for such companies should be fixed at not more than 51 percent of total equity participation.

- For the "Banking and Other Financial Services" sub-sector of FSS it is suggested that Nepal be "Unbound" in all modes of supply with regard to market access, except for commercial presence where permission has already been given to joint venture banks with a maximum foreign equity participation of 67 percent. Further, the foreign financial institutions who enter should be limited to those of eminent reputation and sound financial health.[28] Also, it is suggested that commitments be fully "Unbound" for all modes of supply with regard to national treatment. It is noted that, as with the recommendation above for the insurance sub-sector, there should be a maximum number of banks to be permitted under such sector of commercial presence in a certain period of time. Further, the details of this sub-sector of FSS may not allow particular commitments, e.g. derivatives, due to problems of technical feasibility resulting from the embryonic nature of the Nepalese financial sector.

- For "other" sub-sector of FSS, there are no special recommendations suggested.

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[27] They may contain external shocks in the economy, current and future prospect of the macro economic conditions of the country, limitations in the supervisory and legal framework for financial system, existing state of internal governance and others.

[28] This necessitates the development of a ranking strategy for foreign financial institutions which may be similar to that of Moody's etc.

Thus broadly, these are some potential commitments suggested for Nepal which has resulted from the comparative analysis.

4.3 A Caveat

Awareness of the appropriate targets of FSS liberalization, as put forward in this paper, by itself is not enough. A wider and deeper analysis is also required. The immediate question is, how to achieve the targets committed in FSS liberalization (i.e. the liberalizing strategy for Nepal). For this a study is key to understand the proper sequencing for FSS to attain the committed targets. The absence of the liberalizing strategy may result in BOP crisis and pressure on the domestic financial system which, in the extreme, may become a monetary and financial crisis. Further, a related point is the question of the speed of financial liberalization to attain the above mentioned possible FSS commitments. Will it be a gradual process or will it be a "big bang"? In sum, a clear perspective is necessary for Nepal's financial liberalization strategy to attain the commitments made in FSS.

The broader necessity for successful FSS liberalization is to put forward a stable and conducive financial environment in Nepal. A market friendly atmosphere together with the building up of basic infrastructure required for the efficient functioning of the financial system in an open economy is essential. This may necessitate an immediate attention consisting of the introduction of new and appropriate technology, infusion of human capital through education and training and development of appropriate organizational structure. Besides these, necessary rules and regulations for the financial services sector must be put forward. This requires adherence to a number of core principles, reflected in the so called "Basel principles", and encouragement of information disclosure, to name a few. Additional to the prudential regulation, it is essential that there be a sound and sensitive mechanism of inspection and supervision for the increasing number of financial institutions which also requires development of competent manpower and implementation of necessary technology. If implemented appropriately, these measures will limit the probability of instability in the financial market and, moreover, will mitigate the cost for getting out of monetary and financial crisis as and when it does occur. In all these endeavors, laudable progress is occurring represented in the Financial Reform Project. However, the pace with which this takes place must necessarily be coordinated with the opening of the FSS.

5. Summary and Conclusion

The increasing pace of globalization has compelled Nepal to take important steps in contemplating the liberalization of the domestic economy. Though this trend is consistent with the present reality of globalization, Nepal's move for economic liberalization is not so easy. Entry into the agreement to liberalize necessitates that there can be no back tracking (i.e. reversion). Because of this, it is imperative that the *appropriate* commitments are given during the accession process. To meet this demand, the paper's comparative analysis of the selected SAARC member countries has put forward some appropriate levels for Nepal of commitments in the financial services which are mainly in commercial presence. Further, the paper highlighted the need for developing a financial liberalization strategy, for attaining those commitments which focus on sequencing and speed, as well as putting forth policies for providing a stable and conducive financial environment. In this regard, Nepal's commitments in the financial services sector in the accession process should, in general, be in line with the time frame under Financial Reform Project as mentioned above.

These are all important for developing the, for lack of a better term, "WTO-FSS roadmap" for Nepal. At this point, a touch of reality is interjected via a general observation which is true for all countries and is also especially relevant for Nepal. That is, developing the optimal strategy, as indicated above, may be the less difficult portion. The more difficult portion may be the implementation of the "WTO-FSS roadmap" with painful economic costs and likely negative political repercussions. However, the appropriate and timely implementation of the "roadmap" is essential for providing a financial environment for Nepal to *maximize* the net benefits of WTO membership. <u>In the final analysis, responsibility and reward is fully on Nepal to reap the maximum net benefits with entry into WTO.</u>

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