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Abstract

This paper analyses the possible gains from regional and multilateral liberalization of financial services trade for African countries taking into account the implications of such liberalization for financial regulation and capital account liberalization. It also describes existing efforts to integrate financial markets within four African regions (WAEMU, CEMAC, SADC and COMESA) and discusses the existing GATS commitments of the relevant countries with respect to financial services. Although the regions differ significantly, there is scope for further regional integration in all of them. Significant scope also exists for further multilateral liberalization of financial services, in particular with respect to Mode3.

Key words: regional integration, WTO, financial services trade, Africa

JEL classification: F13, F15, G21, G38.

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1. INTRODUCTION

Africa is home to some 30 regional trade arrangements (RTAs), many of which are part of deeper regional integration schemes. On average, each African country belongs to four RTAs.[2] There has been a renewed push in recent years toward broader and deeper preferential trade arrangements in Africa. RTAs involving African countries are not limited to the continent. The Southern African Customs Union (SACU) is negotiating a free trade agreement (FTA) with the United States. South Africa, the largest African economy, has already signed an FTA with the European Union (EU) and the African, Caribbean and Pacific (ACP) group of states is negotiating Economic Partnership Agreements (EPAs) with the EU. An interesting detail about EPAs is that they explicitly intend to foster regional integration within Africa. Thirty four African countries are besides member of the WTO and are currently negotiating trade liberalization at the multilateral level in the context of the Doha Round. This raises questions concerning the desirability of regional as opposed to global trade liberalization for African countries.

Most of the research comparing the economic effects of RTAs with those of multilateral liberalization has been carried out in the context of merchandise trade. Overall this literature does not come to a unanimous conclusion as to the relative welfare effects of the two approaches.[3] Proponents of RTAs argue that the trade creation effects of RTAs tend to exceed their trade diversion effects with resulting positive welfare effects for the region. They also contend that the multilateral system is unwieldy and that proliferating RTAs can accelerate global trade liberalization. In contrast, opponents of RTAs argue that RTAs produce limited benefits or even losses to their participants and that they are likely to slow global trade liberalization.

The focus of this paper is on liberalization of financial services trade.[4] In particular we compare the benefits and risks of multilateral liberalization of financial services trade in Africa with those of liberalization within African sub-regions. Relatively little research has been done on regional liberalization in the context of services trade. Mattoo and Fink (2002) and Stephenson (2002) are two exceptions. Both papers point out that the welfare effects of regional liberalization in services are likely to differ across services sectors. With respect to the financial sector, both papers argue that it is probably desirable to pursue multilateral rather than regional liberalization. Mattoo and Fink (2002) point out that sunk costs are large in the financial sector. As a result regional liberalization could lead to the establishment of inefficient regional players that may be able to maintain their position in the regional market even if markets are liberalized multilaterally at a later stage. Stephenson (2002) emphasises the positive spill-overs of the financial sector to other sectors of the economy as an argument in favour of multilateral liberalization. This paper argues that the differences between regional and multilateral financial sector liberalization are more complex. In particular it argues that different levels of financial sector liberalization need to be discussed in conjunction with their implications for financial regulation and capital account liberalization.

The liberalization of financial services trade is expected to benefit emerging economies through two channels. First, it has been argued that competition with foreign banks raises the level of efficiency in the domestic banking sector. Second, liberalization may trigger much needed capital inflows. There are reasons to believe that both channels are likely to trigger larger benefits in the case of multilateral liberalization than in the case of regional liberalization. Yet full multilateral liberalization may involve a larger risk of macroeconomic volatility than full regional liberalization. In order to be successful, multilateral liberalization is also likely to impose high requirements on the quality of regulation in African countries.

[2] World Bank (2004).

[3] See, for instance, the discussion in WTO (2003).

[4] In this paper we deal with the banking sector only and not with other types of financial services like insurance or stock market developments.

Financial crises have often been related to the volatility of capital flows and the debate on financial crises in emerging markets therefore focuses on capital account liberalization. Much confusion exists in the public debate about the link between the liberalization of financial services trade and the liberalization of international capital movements. In particular, many observers do not recognise that different modes of financial services trade can have a different impact on the level, volatility and structure of capital flows. This paper builds on the discussion in Kono and Schuknecht (2000) to argue that this impact is besides likely to be different for regional than for multilateral liberalization. In particular, we will argue that the optimal size-structure-volatility mix of capital flows may well imply that certain modes of financial services trade are liberalized more at the regional than at the multilateral level, while other modes receive equal treatment at the regional and multilateral level.

It is widely accepted that appropriate financial regulation is required in order for financial markets to function smoothly. There is less agreement on - and maybe even insufficient understanding of – the exact characteristics of "appropriate financial regulation". The financial crisis in Asia in 1997 highlighted the need for an increased understanding of this issue and set off lively discussions among academics, professionals and policy makers. A reoccurring argument in these discussions is that administrations in developing countries face important capacity constraints which may make it difficult for them to appropriately regulate and supervise the financial sector. Some conclude from this that developing countries should not liberalize the financial sector or only pursue a restricted level of liberalization as long as their regulatory capacity is weak.[5] Others argue that developing countries should aim at regulating the financial sector differently than industrialized countries.[6]

This paper brings the different strands of literature concerning financial services trade, capital account liberalization and prudential regulation together and discusses possible implications of that literature for the African region. We will argue that a combination of regional and multilateral liberalization together with appropriate regulation at the regional level may enhance the performance of the financial sector in African countries. We, however, do not intend to claim that this strategy provides an answer to all the challenges the sector faces in the region. In particular, the policies discussed in this paper are unlikely to represent a straightforward remedy for the lack of access of poor customers to the financial sector. As we consider solutions to this problem to be rather of a domestic nature we will not discuss them in this paper. This implies, among others, that we do not discuss the role of micro credit institutions for the development of African financial sectors. This paper does also not discuss the link between financial sector liberalization and the liberalization of merchandise and other services trade.[7]

The rest of this paper is structured as follows. Section 2 gives a brief overview of the characteristics of the financial sectors in many African countries and discusses the potential benefits and risks of multilateral liberalization of financial services trade for African countries. Section 3 analyses the potential benefits of regional integration and discusses the possible characteristics of regional liberalization of financial services in more detail. In particular this section argues in favour of combining full regional liberalization with regulatory harmonization at the regional level and some liberalization at the multilateral level. Sections 4 and 5 discuss existing approaches in Africa towards regional and multilateral liberalization of financial services trade. The focus is on four major regional trade agreements in Africa: WAEMU, CEMAC, SADC and COMESA.

[5] See for instance Kono and Schuknecht (2000) or Van der Stichele (2004).
[6] See for instance Stiglitz (2000) and Stiglitz and Greenwald (2003).
[7] See Martin and Rey (2005) for a recent contribution to that literature.

2. POTENTIAL BENEFITS AND RISKS OF MULTILATERAL LIBERALIZATION: MODES MATTER

In the 1970s and 1980s the financial sector in many African countries was characterized by significant government intervention of varying forms. Minority or majority government ownership of banks was frequent. Credit allocation quotas often existed and/or governments imposed controls on interest rates and barriers to entry in the banking sector. These interventions often resulted in high interest rate spreads harming both lenders and borrowers and resulting in a shallow financial market. Besides directed credit programs and publicly owned banks do not necessarily channel funds into the most profitable investment opportunities for the economy which results in high default rates on loans.[8]

Many African countries embarked on more or less ambitious privatization programmes in the late 1980s or 1990s with the intention to increase the efficiency of their banking sector.[9] The literature has emphasised the importance of an appropriate regulatory framework for the success of a privatization strategy. It has also pointed out that foreign competition, i.e. international liberalization of the financial sector, can help to increase the efficiency of financial sectors in emerging markets. The arguments that have been put forward are twofold. First, competition with foreign banks can raise the level of efficiency of the domestic banking sector by reducing the market power of existing banks and/or through spill-over effects on domestic banks. Second, emerging economies in general and African countries in particular are typically small in economic terms. Economic smallness imposes serious limitations on the size of capital flows and on the potential for portfolio diversification. One way to overcome this problem is to liberalize the financial sector by allowing some level of cross-border capital flows.

At the same time, entry of foreign banks and cross-border capital flows do not only bring advantages to emerging economies. They may also carry risks. The literature is unanimous about the need for appropriate regulation in order for open financial markets to function efficiently. In this sense, the sophisticated technologies and techniques used by foreign banks do not only represent a promise for progress to emerging markets but potentially also a significant challenge for regulators in those countries.[10] The technical difficulties are often compounded by legal difficulties, as some lack of clarity exists about which legislative entity can and/or should regulate and supervise banks that are active in more than one country. The risks of capital account liberalization discussed in the public debate are of a different nature. Capital account liberalization has been associated with crashes of the entire financial system in cases where internal or external events triggered capital flight out of certain emerging markets. In other words, while foreign bank entry and cross-border capital flows are expected to increase the efficiency of the banking sector in developing economies, they may represent new challenges and bring new potential sources of instability.

While the debate on the gains from internationalization of financial services is typically carried out around the concepts of foreign entry and cross-border capital flows, multilateral negotiations on the liberalization of financial services trade evolve around the concepts of "modes of services trade". Indeed, the General Agreement on Trade in Services (GATS) defines four modes of services trade: the cross-border supply of services (Mode 1), consumption abroad (Mode 2), commercial presence (Mode 3) and the presence of natural persons (Mode 4). Thus, when negotiating financial services liberalization under GATS, governments indicate to which extent they wish to liberalize the four modes in the banking sector. Many regional agreements follow this approach by using the same or a

[8] Collier and Gunning (1999) mention default rates in the 40-95 percent rates for publicly owned banks in Africa.

[9] See, for instance Chirwa (2001), Kasekende (2003), Ikhide and Alawode (2001) and Beck et al (2005) on financial sector reforms in Malawi, Uganda and Nigeria respectively.

[10] See, for instance, Garber (2000) on how derivatives can be used to evade risk-control or prudential regulation and circumvent capital controls.

similar mode and sector classification as GATS.[11] The rest of this section uses the GATS terminology and discusses to which extent the liberalization of different modes of trade in banking services is likely to bring advantages and/or risks for the liberalizing emerging economy and what governments can do to contain the risks. The focus will be on Mode 1 and Mode 3, the two most important modes for financial services trade. Mode 4 liberalization will at several occasions be discussed in conjunction with Mode 3 liberalization. Indeed, when allowing for the entry of foreign banks it may make sense to allow the foreign entity to bring some of its foreign staff. This may be beneficial for the host country to the extent that such staff brings its technical knowledge.

Both Mode 1 and Mode 3 trade are expected to increase efficiency in the developing country's financial sector, mainly through two channels: foreign financial actors are likely to be more efficient service providers and to have access to larger and more diversified funds. In order to take advantage of the latter aspect some type of capital account liberalization is needed. In the case of Mode 1 liberalization foreign banks or other financial actors will be able to offer their services from their home country to clients in the liberalizing African economy. In the case of Mode 3 the foreign bank opens a branch or subsidiary in the liberalizing African economy and serves its clients from there.

Foreign banks may be able to operate in a more efficient way than domestic banks, mainly because they are likely to have a longer experience operating in a competitive environment than domestic banks in African countries. Foreign banks are therefore, for instance, used to dealing with variable prices (e.g. interest rates, fees, commissions), to assessing the risk of projects and, more generally, they are used to choosing activities in a way as to maximize profits. They may also be aware of more sophisticated financial instruments than domestic banks and of more advanced management methods. As a consequence foreign banks are expected to provide different types of financial services to African clients and may be able to offer their services at a better price-quality relationship. Both aspects would be to the advantage of African host economies.[12] Besides, the increased competitive pressure will spur local banks to become more efficient. To the extent that demonstration effects or human capital spill-overs due to the turn-over of bank-staff exist, domestic banks will be able to start applying techniques or approaches similar to the ones used in foreign banks.[13]

The empirical studies on the subject confirm that foreign bank entry increases competition and efficiency in the domestic bank sector. Using data from a sample of 80 countries, Claessens, Demiriguc-Kunt and Huizinga (2000) show that foreign entry reduces the profitability of domestic banks and enhances their efficiency. The empirical work by Unite and Sullivan (2001), Barajas et al. (2000) and Clarke et al. (2000) on the Philippines, Colombia and Argentina, respectively, also

[11] See Stephenson (2002).

[12] Foreign banks, however, do not only have advantages. Domestic banks may have a better knowledge of the domestic market and, in general, enjoy an informational advantage. This may explain why foreign banks tend to concentrate in certain types of financial activities. They tend to focus on lending to the manufacturing sector, rather than entering the retail market. Even in the manufacturing sector they seem to have a preference for serving large clients. This phenomenon has also been referred to as "cherry picking" in the literature. As a result, domestic banks in developing countries may be driven out of the wholesale and large enterprise segments and obliged to focus on retail operations only, albeit with improved efficiency (Clarke et al., 2001). It is often feared that by stripping the higher end customers from existing banks, the entry of new foreign banks will fragilize the whole sector. Others argue that, on the contrary, foreign entry is beneficial for the effectiveness of the banking sector at the top end with no negative, or even positive, effects on the lower segment of the market (Pomerleano and Vojta, 2001).

[13] If domestic banks do not manage to enhance their efficiency they may lose market share. It is also possible that some domestic banks are driven into financial troubles, and perhaps even into bankruptcy, depending on how poorly they were managed before the entry of their new competitors. Although this transition process may be hurtful for owners, employees and creditors of the relevant domestic banks, it is in principle desirable that underperforming banks exit the market. Depending on the size of exiting banks though, their bankruptcy may pose challenges to the stability of the entire financial system. Authorities therefore need to be cautious in these situations and ensure that bank exit can take place in an orderly manner.

indicates that foreign entry exerts competitive pressure on domestic banks triggering cost reductions in domestic banks with resulting increases in profitability. On the other hand, the evidence regarding the impact of foreign entry on the quality of domestic banks' loan portfolios is mixed.[14] Goldberg et al (2000) examine the lending behaviour of foreign and domestic banks in Argentina and Mexico in the period 1994 to 1998. They concluded that foreign banks exhibited stronger loan growth with lower associated volatility compared to all domestic owned banks, and thereby contributed to greater stability in credit. The onshore presence of foreign banks may also foster stability of the deposit base by allowing domestic depositors to do their "flight to quality" at home.[15] Indeed, Demergüç-Kunt et al. (1998) found evidence suggesting that increased participation of foreign banks tends to lower the probability of banking crisis. On the other hand, it has been argued that the decision of a number of foreign banks to leave Argentina at the beginning of its financial crisis may have exacerbated the situation and that these events challenge the notion that foreign banks are a stabilizing force in developing countries' banking sector.[16]

To our knowledge the empirical literature has only analysed the effects of foreign entry (Mode 3) on the competitiveness of domestic banks. Besides this research does not distinguish between the productivity increases due to changes in the market structure of the banking industry versus those due to technology transfers between foreign banks and domestic banks.[17] Presumably both Mode 1 and Mode 3 liberalization would induce increased competition and efficiency improvements in the local banking sector. Despite this lack of empirical literature, there are two reasons to believe that the effect of Mode 3 liberalization would be higher than Mode 1 liberalization.[18] First, information and communication costs may be lower for African clients dealing with foreign banks established in their country than with banks established abroad. As a consequence foreign banks established in the country will be able to reach out to more clients leading to a stronger competition effect. Second, to the extent that demonstration effects, human capital spill-overs or other spill-overs exist between foreign banks and domestic banks, they are likely to be stronger when the foreign bank is established in the country.

In any case, the size of the effect of Mode 1 and Mode 3 liberalization is likely to depend on the openness of the home country's capital account. In this regard, GATS requires only limited liberalization of capital movements in the context of financial cross-border services trade liberalization, movements which are considered as an "essential part of the (liberalized) service". GATS distinguishes twelve activities within the banking sector and, as pointed out in Kono and Schuknecht (2000), for all but three of them cross-border capital flows are crucial in the case of Mode 1 trade. In order for African clients to deposit money in a foreign bank or in order for that bank to lend money to them, for instance, capital has to flow across borders.[19] As a consequence broad liberalization of Mode 1 does not make much sense for a developing country that is unwilling to open its capital account.

By contrast, foreign entry, i.e. Mode 3 trade, can take place even if the capital account is not opened. In fact, in order for Mode 3 trade to take place, the foreign bank – in theory - only needs to be allowed

[14] See Clarke et al. (2002b).
[15] See Clarke et al. (2000).
[16] See the discussion in Clarket et al. (2002b).
[17] See Goldberg (2003).
[18] See also Kono and Schuknecht (2000) on this point.
[19] According to the sectoral classification list (MTN.GNS/W/120) for services trade, the WTO distinguishes twelve activities within the banking sector: (a) acceptance of deposits, (b) lending, (c) financial leasing, (d) payment and monetary transmission services, (e)guarantees and commitments, (f) trading for own account or for account of customers, (g) participation in issues of all kinds of securities, (h) money broking, (i) asset management, (j) settlement and clearing services, (k) advisory services and (l) provision and transfer of financial information. As pointed out in Kono and Schuknecht (2000) cross-border capital flows are important or even crucial in order for a financial institution to provide most of these services across borders, i.e. via Mode 1.

to transfer enough capital to start operations in the host country. Yet the stimulating effects of foreign bank entry are likely to suffer from restrictions on capital flows. One of the reasons why foreign, in particular multinational, banks are more efficient than domestic banks, is that they have access to a larger and more diversified pool of capital, which reduces the risk of their operations and ultimately makes them more profitable.[20] Obliging foreign entrants to tap only local capital may thus significantly reduce their effect on competition and thus efficiency in the host country's banking sector.

3. WHY AND HOW TO GO REGIONAL

(a) The benefits of regional liberalization

The financial markets of many African countries are very small and likely to be relatively unattractive for foreign banks. The IMF (2001: 142) estimates that the minimum efficient scale in retail commercial banking would be between $1 billion and $10 billion in assets in emerging markets (Asia, Eastern Europe and Latin America), and that there would be relatively constant or even decreasing returns to scale after that threshold.[21] Many African economies fall below these thresholds and the size of the market therefore does not allow for the efficient operation of a large number of banks.[22]

To overcome the difficulties related to small market size, a number of recent contributions to the literature argue that there would be value for small developing countries to regionalize their financial systems.[23] Full regional integration would imply an open capital account for regional flows and the liberalization of services trade in all four modes. For instance, allowing banks to branch region-wide without having to incur significant location-specific regulatory costs would allow them to achieve a certain level of economies of scale and risk diversification, and would also potentially allow for more effective competition on a regional basis.[24]

A number of regional initiatives towards the integration of financial markets exist on the African continent. Examples are the West African Economic and Monetary Union (WAEMU) and the Central African Economic and Monetary Community (CEMAC). Also other regional agreements, like the Southern African Development Community (SADC) and the Common Market for Eastern and Southern Africa (COMESA), make reference to financial sector liberalization at the regional level. The potential gains from such liberalization are likely to differ across regions according to their size and composition. The potential for portfolio diversification and ensuing cost reductions depends to a large extent on the diversification of production in the region. In the literature information on countries' main export products has been used as an indication for the potential of financial diversification within a region. [25] Table 1 gives an overview of the main export products of member countries of the regional arrangements discussed in this paper. It reports those products that represent

[20] See Bossone et al. (2001) for an overview of the literature on the geographic diversification of bank portfolios and its effect on banks' expected returns.

[21] By contrast, Bossone et al. (2001) report that about 120 countries have a GDP of less than US$10 billion per year, and 60 of them have a GDP of less than US$1 billion.

[22] Bossone et al. (2001).

[23] See for instance Bossone et al. (2001) and Narain et al. (2003).

[24] The BIS (2004: 24-25) also suggests that such regional arrangements may be beneficial to emerging economies. It is interesting to note that the United States maintained stringent restrictions on interstate banking until 1997. As a consequence banks' activities were to a large extent restricted to the financial markets of limited size within individual states. Bordo (1997) argues that this so-called unit banking business model was at the core of the banking crises that affected the country, as small banks did not have the size nor the sectoral and geographical portfolio diversification required to survive contagious banking failures. Indeed, the incidence of failure was particularly high in states characterized by high bank exposure to one or few sectors, like oil, real estate or agriculture (Narain et al., 2003).

[25] See, for instance, Narain et al. (2003).

more than 10 per cent in a countries total merchandise exports.[26] There appears to be quite some variation of main export products within a region indicating that the potential for financial diversification could be higher within the region than within a single country. For instance, the dominant industries in the WAEMU countries (Benin, Burkina Faso, Guinea Bissau, Côte d'Ivoire, Mali, Niger, Senegal, and Togo) are variously linked to agriculture, mining, and to a lesser extent fishing. The region should hence offer opportunities for sectoral diversification across borders. It should also be noted that services exports are not taken into account in Table 1. Tourism and transport services play quite an important role in some of the countries, for instance, Mauritius, Kenya and the Seychelles. The potential of regional diversification is therefore likely to be higher than Table 1 would suggest.

Table 1: Main export products in member countries of CEMAC, WAEMU, COMESA and SADC.

CEMAC	WAEMU	COMESA	SADC
Cameroon (petroleum, wood)	Benin (Cotton, Meat)	Angola	Angola
Central African Republic (diamonds, logs)	Burkina Faso (Cotton)	Democratic Republic of Congo	Democratic Republic of Congo
Republic of Congo (petroleum)	Guinea Bissau	Malawi (tobacco, cane sugar)	Malawi (tobacco, cane sugar)
Gabon (petroleum)	Côte d'Ivoire (cocoa)	Mauritius (textile, cane sugar)	Mauritius (textiles, cane sugar)
Equatorial Guinea	Mali (gold)	**Namibia** (printing industry; precious stones or metals)	**Namibia** (precious stones or metals)
Chad	Niger (uranium)	Seychelles (tuna, petroleum)	Seychelles (tuna, petroleum)
	Senegal (petroleum, phosphoric acid)	**Swaziland** ("essential oil and resinoids to be used in food and beverage industry")	**Swaziland** ("essential oil and resinoids to be used in food and beverage industry")
	Togo (cement, cotton, calcium phosphates)	Zambia (precious stones or metals, i.e. copper)	Zambia (precious stones or metals, i.e. copper)
		Zimbabwe (tobacco, cotton, nickel ores)	Zimbabwe (tobacco, cotton, nickel ores)
		Burundi (gold, coffee)	**Botswana** (precious stones or metals: diamonds)
		Comoros (vanilla, cloves)	**Lesotho** (textiles)
		Djibouti	Mozambique (aluminium, electrical energy)
		Egypt (petroleum)	**South Africa** (platinum, bituminous coal)
		Eritrea (fish)	*Tanzania* (gold)
		Ethiopia (coffee, vegetable products)	
		Kenya (petroleum, tea)	
		Madagascar (vanilla, shrimps, printing industry)	
		Rwanda (coffee; tea; precious stones or metals)	
		Sudan (petroleum)	
		Uganda (coffee, fish)	

Source: COMTRADE database. Data for the Republic of Congo are for 1995, those for Comoros for 2000 and those for the other countries for 2001, 2002, 2003 or 2004.
Note: Countries in bold are SACU members and those in italics are members of EAC.

[26] South Africa is a more diversified economy. The products listed represent more than 5 per cent of total merchandise exports. Products are defined at the 6-digit HS level.

The larger the region, the higher the likelihood that there will be a diversity of economic sectors. In addition, even within one sector there may be diversification benefits as large distances may limit the impact of exogenous shocks (e.g. localized droughts or flooding). However, it is important to note as well that beyond a certain geographic size, there may be diseconomies of scale for banks and regulators due notably to distance costs and to coordination costs among countries each having a different heritage in terms of language, culture, and legal systems among other things.

(b) How to design the regional structure

For diversification and scale benefits to materialize in a regionally integrated market, regulation needs to allow for easy region-wide commercial establishment, particularly through region-wide branching. Regional expansion is encouraged if banks established in one country are automatically allowed to be active in other countries in the region without having to go through a new costly licensing process. Regulatory compliance costs would be significantly reduced across the region if banks are subject to a harmonized regulatory framework.[27] The concept of mutual recognition or home country control as applied in the European Union[28] would also reduce private compliance costs, but does not significantly reduce compliance costs of regulators. Indeed, bank supervision remains in the hand of national (as opposed to regional) authorities in the European Union. Whatever the preferred approach, regional expansion will be less costly for banks if they only need to obey to one set of rules, other those of their home country or a harmonized set of rules. If compliance with regulation, for instance with respect to capital adequacy ratios is required to be met at the corporate level within the region, this would lead to additional savings.

Given the capacity constraints many African countries face, harmonization of the regulatory framework may be preferable as it also reduces compliance costs for regulators if certain functions are shifted to regional authorities.[29] Such a move may free up resources that can, for instance, be used for capacity building. The importance of supervisory skills and the problems many emerging economies face to meet these requirements have frequently been emphasised in the literature. Goldberg (2003), for instance, emphasises the need for supervisors in host countries to make early investments in upgrading their skills in order to better evaluate the use and effects of new products. Pooling regulatory capacity at the regional level could help the region to overcome potential capacity constraints.[30] In addition, a regional regulatory framework with a regional regulatory authority is likely to be less subject to discrete political intervention by one national government as the other governments of the region now have a vested interest in a well functioning banking sector elsewhere in the region. As a result, the regulatory framework is likely to become more stable and predictable than if it had remained at the national level.

Allowing region-wide branching in theory is not a guarantee for it to happen in practice, as the regional experiences discussed in the section 4 seem to indicate. It may be necessary to design

[27] Bossone et al. (2001: 15, footnote 7) report that private compliance costs can be as high as four times that of the regulator.

[28] This concept implies that banks are regulated by, and conform to, the regulation and legislation of their home country. If a bank does business in one country in the region, the regulatory authorities of the host nation recognize the primacy of the home nation. In order to pre-empt a possible raise to the bottom in prudential regulation such an approach probably needs to be combined with minimum standards at the regional level, as is the case in the European Union.

[29] See also Bossone et al. (2001) and the BIS (2004). This article is concerned with the banking sector only, but as Bossone et al. (2001) suggest, the same argument would likely be true for other areas of the financial system such as securities and the design of monetary policy.

[30] According to Stiglitz (2000) new foreign entrants often recruit the best and most talented individuals away from government regulatory agencies. This would be less likely to happen in foreign banks are allowed to bring staff from their home country, i.e. if the host region allows for Mode 4 imports in financial services.

policies with the purpose to encourage further regional integration, in particular as regards the cross-border consolidation of the financial sector. One way to encourage regional consolidation may be to establish capital adequacy requirements that explicitly reward the regional diversification of the banks' portfolios of assets.[31] For example, a bank established in only one country would be required to maintain a high capital adequacy ratio to account for low diversification of its portfolio – say, 15% of risk-weighted assets.[32] The wider its regional branch coverage and the more regionally diversified its portfolio of assets, the lower the minimum capital adequacy ratio the bank is required to maintain. For instance, a bank which has branches in each country of the region and has a balanced portfolio of assets across all countries, may be required to maintain a much lower capital adequacy ratio overall – say, 10%. The creation of regional institutions, like a regional interbank market, could also facilitate the provision of cross-border lending opportunities for lending banks not established in the borrowing banks' countries. Furthermore, there are probably economies of scale associated with such a market which would make a regional interbank market more interesting for local bankers than a national interbank market.

(c) Allowing for competition from third countries

To liberalize financial trade only at the regional level has two important disadvantages. First, the efficiency increases through increased competition may be limited if the most sophisticated competitors are not based in the region. Instead the region may end up with a situation where relatively inefficient regional institutions take over the regional market. Mattoo and Fink (2002) argue that such inefficient regional institutions may even survive subsequent multilateral liberalization, if sunk costs are high enough to deter even the globally most efficient suppliers from entering the regional market.[33] Second, the limits imposed on capital flows from outside the region by a purely regional approach would probably not be desirable for a region like Africa that is lacking capital.

Some level of openness with respect to third countries is therefore desirable. In particular, entry of extra-regional banks should be allowed, i.e. Mode 3 trade should be liberalized.[34] According to the arguments developed before, the region may consider to limit Mode 1 trade with third countries instead in order to control the risk of instability.[35] In particular it would be possible to restrict certain types of capital flows only to banks or other financial institutions based in the home country.[36] The developing host country could also consider imposing quantitative limits on banks' lending to non-residents and prudential limits on banks' open foreign exchange position.[37] It could also be stipulated that only banks are allowed to use derivatives and related instruments implying cross-border transactions. The advantage of restricting certain activities to the home country's financial sector is two-fold. First, in order for foreign banks or other institutions to become active in this field they need to get established in the developing country, i.e. Mode 3 trade will be encouraged as Mode 1 trade is restricted. Second, regional regulators can control the activities of financial institutions based in the country, at least to some extent. In particular they can require those institutions to meet regional

[31] The idea of differential capital adequacy ratios has also been put forward by Bossone et al. (2001: 34).

[32] As regards capital adequacy ratios, even if developing country banks were well diversified across their region of operation, they would still not be diversified enough by industry standards. Therefore, regulators may consider increasing the minimum capital adequacy requirements from 8% of risk-weighted assets as indicated in the Basel Accords, to a higher figure more consistent with the diversification potential in the region.

[33] Rueda-Maurer (2003) suggest that this is what may have happened in ASEAN countries.

[34] This approach appears to be close to the one followed by MERCOSUR (Rueda-Maurer, 2003).

[35] Note that arguing in favour of limited Mode 1 liberalization implies the assumption that the gains from increased stability for the host country would be larger than the losses because of reduced capital flows. It has been argued in the literature that the opposite may be the case. See for instance Griffith-Jones (2002).

[36] See the more extensive discussion in Ishii and Habermeier (2002).

[37] See Ishii and Habermeier (2002).

prudential regulations and they can check whether the requirements are met. Regional regulators do not have this power in the case of foreign entities conducting Mode 1 trade with the country.

When liberalizing Mode 3 the region may consider imposing conditions on foreign bank entry for instance with respect to entrants' corporate structure. The corporate structure and other characteristics of the foreign entrant may, among others, have an impact on the volatility of the entrant's performance, the information local or regional regulators are able to obtain about that performance and the possibilities regulators have to supervise extra-regional banks.[38]

It has been argued in the literature that it is easier to control subsidiaries than branches of foreign banks, because the former tend to be regulated as stand-alone entities in host countries, independent of the activities of the foreign parent company. Foreign bank subsidiaries are, for example, typically required to maintain adequate capital and liquidity reserves within the host country to support their operations. But, for this and other reasons, the costs of running subsidiaries are higher for the parent company than those of running a branch and restrictions on the corporate structure may therefore discourage foreign banks to invest in the emerging economy. The creation of a single regional financial market has the potential to offset this effect, at least to some extent. If subsidiaries of foreign banks – like regional banks- are allowed to branch within the region and regulatory requirements target the corporation at the regional level and not each local branch, the set-up costs of a subsidiary can be spread over the whole regional market making it more likely that such an investment is profitable.

4. EXISTING REGIONAL EXPERIENCES

(a) CEMAC and WAEMU

The Central African Economic and Monetary Community (CEMAC) and the West African Economic and Monetary Union (WAEMU) were established in 1994 after the devaluation of the CFA franc, replacing respectively the Central African Customs and Monetary Union and the West African Monetary Union that were established in the early 1960s.[39] CEMAC and WAEMU are both monetary unions belonging to the so-called "Zone Franc". As a consequence both regions are endowed with an institutional set-up that should in principle facilitate the regional integration of financial markets.

In both regions a regional central bank was active well before any significant move towards regionally integrated markets for banking services took place.[40] In response to a serious financial crisis that hit both regions in the 1980s, CEMAC and WAEMU in the early 1990s each created a new regional institution, the Banking Commission, with significant responsibilities in the setting of prudential regulation and the supervision of banks. About ten years later both regions introduced the so-called "agrément unique", a legislation aiming to facilitate cross-border activities of banks established within each region. Although the relevant institutional and legislative set-ups are similar in both regions they differ quite significantly when it comes to the details.

[38] See the discussion in Cárdenas et al. (2003).

[39] The members of CEMAC are: Cameroon, the Central African Republic, the Republic of Congo (Brazzaville), Gabon, Equatorial Guinea and Chad. WAEMU comprises Benin, Burkina Faso, Guinea Bissau, Côte d'Ivoire, Mali, Niger, Senegal and Togo.

[40] The Banque Centrale des Etats de l'Afrique de l'Ouest (BCEAO) in the case of WAEMU and the Banque des Etats de l'Afrique Centrale (BEAC) in the case of CEMAC.

CEMAC

In CEMAC the rule-making and supervisory authority is shared between the regional central bank (BEAC), the Banking Commission and the national governments. The Banking Commission and national governments both play a role in setting prudential regulation. The BEAC is in charge of on-site supervision of banks on behalf of the Banking Commission. The Banking Commission in turn may sanction banks for failing to meet prudential standards, from the issuance of a warning to the outright revocation of the license.[41] The Banking Commission is a body of CEMAC, but it is chaired by the Governor of the BEAC and its members are appointed by the Board of the BEAC.

A move towards harmonized prudential regulation at the regional level was made in the early 1990s with the Covenant on the Harmonization of the Banking Regulation in Central African States, signed on January 17, 1992. The Covenant stipulates that the Banking Commission has jurisdiction over bank ownership rules; prudential regulation respecting bank liquidity, solvency and stability; accounting rules specific to banks; and the conditions under which banks may take ownership of other entities and under which they can lend to insiders. Yet national authorities maintained a significant level of control over the banking sector as they maintained responsibility for minimum up-front capital; the conditions of network establishment and expansion; and the conditions of operations, especially as regards customer relationships and competition policy. Foreign banks were allowed to establish subsidiaries, branches, agencies and representative offices in all CEMAC countries, but such cross border activities were subject to the authorization of the national government of the host countries.[42] Local branches were also required to maintain locally at all times the established minimum capital endowment as if they were a full subsidiary. In addition, foreign banks establishing branches in a host country were expected to permanently maintain a minimum employment level locally.[43]

The 1992 Covenant resulted in very limited reductions in compliance costs for banks and national authorities maintained the bulk of their pre-Covenant discretion. As a result of pressure by foreign investors on CEMAC authorities[44], the Banking Commission started devising a new regional framework that would lead to the "agrément unique" approved in late 2000. The "agrément unique" relieves licensed banks from all national requirements related to the legal structure of their operations in the host countries, the composition of their capital, and the process for selecting local managers.[45] Yet, a number of significant administrative hurdles to regional integration continue to exist. To establish a subsidiary, the process remains the same as provided for in the 1992 Covenant, even for CEMAC-based banks. Furthermore, in the case of the establishment of a branch or subsidiary local minimum capital requirements described above remain applicable. These requirements vary from country to country, from CFAF 150 million in Equatorial Guinea to CFAF 1 billion in Gabon and Cameroon (approximately between 230,000 and 1,500,000 euros).[46]

The "agrément unique" also added new obligations to banks on top of those already included in the 1990 and 1992 Covenants, including the obligation for expanding banks to maintain, at the same time, consolidated financial accounting for the entire banking group across the region, and unconsolidated accounting at the country level. In addition, all legal and prudential regulations applicable to banks

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[41] The CEMAC Banking Commission does not have jurisdiction over postal banks.

[42] From the 1992 Covenant, it is understood that the term "foreign" applies to CEMAC countries other than the host country as well as to third, that is, non-CEMAC countries.

[43] At least two general managers with a permanent resident status under art. 18 of the 1992 Covenant.

[44] See COBAC (2003) for anecdotal evidence on the level of discretion maintained and used by national authorities under the 1992 Covenant and on the pressure by above all French banks and investors for the elimination of this discretion and for further moves towards a regionally integrated market for banking services.

[45] This "freedom of establishment" is conditional on banks having been active in CEMAC for at least two years.

[46] IMF (2003b).

must strictly be complied with at the banking group level and at the branch or subsidiary level at the same time (including maintaining a capital endowment equivalent to that of a subsidiary). These conditions may seriously hamper the potential of the "agreement unique" to encourage cross-border banking within the region.

Given the conditions attached to the "agrément unique", the IMF (2003b) showed scepticism as to its potential in terms of improving bank soundness, increasing competition, and deepening the regional financial integration.[47] In particular, the IMF was of the view that the entire jurisdiction relating to the banking sector should rest with the Regional Banking Commission, and should not be shared with national authorities. The branch licensing rules at the regional level as currently in place are not conducive of deepened financial integration, as there is no visible advantage for a bank to expand its branch network by opposition to establishing subsidiaries, and it is reflected in the fact that as of 2003, no bank had made any submission for a region-wide license.[48] As a result, the IMF fears the banking sector in CEMAC will remained fragmented, undiversified, and uncompetitive. The World Bank held similar views in 2003, and stated its intention to work with the authorities to relax the financial and administrative constraints to the regional financial integration of the banking sector.[49]

WAEMU

With the 1990 covenant establishing the regional banking commission of the regional central bank (the BCEAO), the member states of WAEMU agreed to disband and transfer the responsibilities of their national banking commissions and in particular their rule-making and supervisory functions, to the Regional Banking Commission. Since then the regional institutions (Council of Ministers, BCEAO and Banking Commission) have been responsible for the regulatory framework applicable to all banks across the region, including the minimum up-front capital needed to operate a bank, the standard prudential ratios, reserve requirements and accounting rules, and for on- and off-site supervision of banks throughout. However, national Ministers of Finance retained a number of responsibilities in matters such as: licensing, suspension and liquidation; nationality of banks' senior managers; legal structure; and take-overs.

WAEMU's 1990 Covenant served as a stepping stone towards the full harmonization of the banking regulation that took place in 2000 with the introduction of the so-called Prudential Framework.[50] Since then WAEMU-based banks are subject to the same rules and regulations across the region as regards, for instance, their minimum regulatory capital, prudential ratios, legal structure, and the nationality of senior managers. In particular and in contrast with the situation in CEMAC, the minimum capital requirement is the same in all WAEMU countries and amounts to CFAF 1 billion, or approximately 1.5 million euros. The licensing responsibility still remains at the national level (subject to a review process by the Council of Ministers of the Union under articles 32-33 of the 1990 Covenant).

A bank wishing to enter the regional market for the first time has to apply for a license with the Ministry of Finance of the country where it wishes to establish its operations. The Minister of Finance

[47] IMF (2003b).

[48] The BEAC reports on its website (accessed in August 2005) that in 2005, 33 banks were operating in the CEMAC area, a number of them having operations in more than two countries of the area through subsidiaries. Banks operating in several countries are mostly foreign-owned, and local governments sometimes have minority stakes in some of the local subsidiaries. Three African-owned banks, two from Cameroon and one from Gabon, operate in more than one country, through subsidiaries.

[49] World Bank (2003: 33).

[50] "Dispositif prudentiel applicable aux banques et aux établissements financiers de l'Union Monétaire Ouest-Africaine (UMOA) à compter du 1er janvier 2000" and "Instruction n° 2000/01/RB du 1er janvier 2000 relative aux modalités d'application du dispositif prudentiel des banques et établissements financiers de l'UMOA à compter du 1er janvier 2000".

will deliver the license, following a positive advice from the BCEAO which investigates licensing applications. Under article 20 of the Banking Act, banks – be they locally owned or subsidiaries of foreign banks – must be locally incorporated and must at all times maintain a minimum level of capital as set forth in the Prudential Framework. The 2000 Banking Act also allows branches of foreign banks to operate; however, they must maintain locally a minimum capital endowment equivalent to that of a bank.

On January 1st, 1999, the so-called "agrément unique" came into force, allowing all banks based in any WAEMU country to establish operations in all other countries of the Union under the legal structure of their choice.[51] The freedom of establishment is however subject to an investigation process by and an advice from the BCEAO and to the agreement of the Ministers of Finance of the home and the host countries.[52] In other words, although the administrative process for establishing regional branches or subsidiaries has significantly been simplified, the right to establish in other WAEMU countries is not automatic. Besides, each local establishment is required to maintain locally the established minimum capital requirement. The filing requirements in terms of information are more demanding for a subsidiary than for a branch. In fact, for a cross-border subsidiary the filing requirements are the same as if it were a completely new bank or if it were the subsidiary of a bank from non-WAEMU country.

In spite of this unified regulatory system, the banking sector remains organized mostly along country lines, with only a few banks having subsidiaries or branches in more than one country of the region. The BCEAO reports on its website that in July 2004 eight banking groups dominated the sector in the Union, although only four of them had operations in more than two countries. Two of these banking groups were West-African-owned. In total, the regional market counted 74 banks across the area, each country having between 2 and 18 banks. According to the IMF (2003a), in 2002, 21 banks out of 65 were not compliant with the minimum capital requirement of CFAF 1 billion, and only 26 were compliant with the minimum ratio of coverage of the medium- and long-term assets by resources of similar maturities. Overall, the IMF was concerned by the significant number of banks that did not meet several prudential ratios. It suggested that the Regional Banking Commission be given sole responsibility for closing insolvent banks.

(b) SADC/SACU

Regional financial integration in Southern Africa rests on the initiatives of the Southern African Customs Union (SACU) and of the Southern African Development Community (SADC).[53] Both initiatives are largely led by the country with the largest economic and financial players: South Africa.

The financial integration in the SACU countries is already well advanced, due to the dominance of South African commercial banks throughout the union and the existence of a Common Monetary Area (CMA) between four of the five SACU members.[54] Lesotho, Namibia and Swaziland notably have a right of access to the South African capital and money markets through the CMA. Nevertheless, the level of financial development in the union outside South Africa – and to a lesser extent Botswana – is still very low, as evidenced by the weak competition, wide interest spreads,

[51] "Instruction no. 01/RB du 31 décembre 1998 relative aux modalités d'établissement des banques et établissements financiers dans l'Union monétaire Ouest Africaine (UMOA)".

[52] In case of divergent views between the three authorities, the matter will be referred to the Council of Ministers of the Union.

[53] SACU members are: South Africa, Botswana, Lesotho, Namibia and Swaziland. SADC members are the SACU countries plus Angola, the Democratic Republic of Congo, Malawi, Mauritius, Mozambique, Tanzania, Zambia, and Zimbabwe. The Seychelles withdrew from SADC in 2004. Madagascar joined in 2005.

[54] South Africa and its neighbour countries Lesotho, Namibia and Swaziland formed the Common Monetary Area in 1986 as a replacement to the Rand Monetary Area, which had been in place since 1974. Botswana ties its currency to a basket of currencies comprised of the South African rand and the IMF's Special Drawing Rights.

inefficient banking, and low intermediation.[55] Moreover, Aziakpono (2005) suggests that the less-than-perfect convergence in interest rates within the region may be due to institutional factors in Botswana, Lesotho, Namibia and Swaziland (BLNS) hampering capital flows across the region, and to a lack of investment opportunities outside South Africa.

Part of the problem may lie in the lack of harmonization of the prudential regulation across SACU[56] and to entry requirements that may add to the cost of doing business outside South Africa. In particular, the legal and regulatory infrastructure is very weak in some of the SACU countries,[57] and cross-border branching by foreign banks is forbidden in BLNS countries.[58]

SADC countries have been negotiating a Finance and Investment Protocol (FIP) since 1997. This FIP initiative has been primarily driven by South African and Mauritian financial institutions and regulators. Under this initiative, memorandums of understanding (MOUs) are being drafted on a wide array of topics related to investment and finance, except for the harmonization of banking supervision frameworks, which is being dealt with separately.[59]

With respect to banking supervision, national authorities have been working with the Basel Committee since 1993 towards the harmonization of their regulatory frameworks through the Eastern and Southern African Banking Supervisors Group (ESAF), a group that extends beyond SADC membership.[60] A memorandum of understanding has been developed stressing the importance of harmonizing national regulations in a manner consistent with internationally accepted standards, including among other things bank licensing and regulation, on- and off-site supervision, accounting rules, and the supervision of cross-border operations.[61]

However, the South African Reserve Bank (2004) reports that the ESAF was dissolved in late 2004 following the decision of the Committee of Central Bank Governors of SADC to form a bank supervisory body confined within SADC, the SADC subcommittee of bank supervisors (SSBS), with the aim of harmonizing banking legislations and supervisory systems and practices across the whole Community, based on the Core Basel Principles for Effective Banking Supervision. The SSBS held its first meeting shortly thereafter.

The Table below summarizes the information about bank presence in the SADC countries. It shows that South African banks have recently made important inroads in the SADC countries. The impression therefore arises that regional integration within SADC is to a significant extent driven by the private sector. Due to the fact that a significant number of banks operative in SADC have their head office in South Africa, the home-host country problem in terms of banking regulation poses a problem for most (host) countries in the region. With ESAF not having succeeded to harmonize banking legislation across the region, this issue is now taken up the SADC Subcommittee of bank supervisors. Given the substandard efficiency of the South African banks compared to international benchmark[62] and the importance of the sunk cost associated with setting up operations in a new country, the question also arises whether the ongoing regional liberalization process for financial services within SADC may result in South African banks locking in the SADC countries against non-SADC foreign banks, along the lines of the arguments developed in Mattoo and Fink (2002).

[55] Aziakpono (2004).
[56] The SACU Treaty does not cover trade in services.
[57] Grandes and Pinaud (2004).
[58] WTO Trade Policy Review for SACU, 2003.
[59] See Genesis Analytics (2004). See also the Report of the Trade, industry, Finance and Investment Directorate on http://www.sadcreview.com
[60] ESAF also includes, for example, Kenya, Uganda and Rwanda.
[61] See Genesis Analytics (2004), section 2.9 and Appendix 7.
[62] South African Reserve Bank (2003: 54-55).

Table 2: South African bank presence in SADC countries

Country	Number of commercial banks[63]	Number of branches of foreign banks	Concentration (%) (number of banks in brackets)	South African banks' share (% of assets, 1994)	South African banks' share (% of assets, 2003)
Angola	11	N/A	76 (3)	0	0
Botswana	5	0	90 (5)	9	22
DRC	8	N/A	N/A	9	7
Lesotho	4	0	N/A	0	87
Malawi	15	N/A	66 (2)	0	17
Mauritius	7	4	90 (4)	0	35-40
Mozambique	6	N/A	96 (5)	0	30
Namibia	4	0	90 (4)	82	72
Seychelles	3	3	95 (5)	0	0
South Africa	24	15	82 (4)	N/A	N/A
Swaziland	4	0	87 (3)	18	72
Tanzania	21	N/A	46 (3)	0	21
Zambia	14	N/A	80 (5)	7	12
Zimbabwe	11	N/A	N/A	9	3

Sources: Economist Intelligence Unit, IMF, central banks, governments, Genesis Analytics (2004).

(c) COMESA

The Common Market for Eastern and Southern Africa (COMESA) was established in 1994, replacing the Preferential Trade Area that had existed since 1981, in an aim to eliminate all internal trade tariffs and barriers. It has 21 members, several of which are also members of SADC.[64] COMESA's long-term objectives include the establishment of a monetary union by 2025.

Chapter 10 of the COMESA Treaty provides the basis for the cooperation within the region as regards the financial sector and monetary affairs. In particular, the integration of the national financial structures of member states is an explicit goal of the Treaty. To this end, member states are expected to move towards the liberalization of the financial sector by deregulating interest rates and by enhancing competition and efficiency in their financial systems. In view of the increasing regional integration of their financial systems, the Heads of States decided in May 1999 to pursue the harmonization of regulatory frameworks for the banking sector. To this end, they mandated the heads of their banking supervisory units to set a unified prudential framework that member states would be encouraged to adopt. Preparatory work in this respect has been taking place in the context of regular meetings of the so-called Committee of COMESA Central Bank Governors. In addition the so-called COMESA Banker's Association was established with the aim to act as a forum for the exchange of information on banking practices in the sub-region. It also aimed at strengthening correspondent relationships between banks.

In February 2003, the Council of Ministers agreed on a framework which included, among other things, a minimum initial capital equivalent to US$1.5 million and minimum capital adequacy ratio of 10% of risk-weighted assets, for application by January 1st, 2005.[65] The action plan does not foresee the establishment of a regional authority with legislative and supervisory responsibilities.

[63] Onshore domestic banking only.
[64] See Table 1.
[65] http://www.comesa.int/monetary_cooperation/Part%20VI%20Monetary%20Affairs/view accessed in February 2006.

In spite of this regulatory cooperation at the highest levels, there is reason to believe that in fact regional integration is not happening as well as one would like in the COMESA area. The Central Bank of Mauritius indicates in its 2003/2004 annual report that due to the inability of the COMESA Bankers Association to find a satisfactory solution to its membership and financing situation, the Council of Ministers of COMESA decided to disband it. It also appears[66] that the existence in parallel of COMESA and SADC, where an important number of countries participate in both Treaties, creates political problems and issues of incompatible and overlapping legal obligations which may hamper the development of a regionally integrated Southern Africa. Also, the membership of South Africa to SADC provides it with an "anchor-state" and a leadership which COMESA does not have.[67]

5. MULTILATERAL LIBERALIZATION

This paper has argued that regional integration should not preclude competition from outsiders and thus argues in favour of financial services liberalization with third countries, in particular for Mode 3 trade. Thirty two of the thirty eight African countries being member of at least one of the regional agreements discussed in this paper are WTO Members, but only twelve have made commitments under GATS in the financial sector. Comoros, Equatorial Guinea, Eritrea, Ethiopia, Seychelles and Sudan are not Members of the WTO. The absence of commitments in these countries and the other twenty countries that are Members of the WTO does not necessarily imply that these countries do not allow for financial services trade. Banks with UK ownership are, for instance, active in Botswana and Zambia and French banks are active in a number of CEMAC and WAEMU countries that so far made no commitments under GATS.

As for the 12 WTO Members that made commitments in financial services, it is not straightforward to interpret the scope of these commitments.[68] The GATS Schedules of commitments are complex documents, containing for each Member, market access, national treatment and additional commitments, on up to sixteen sub-sectors of financial services, four in insurance and twelve in banking and other financial services. The focus in this paper is on the second group and only on market access commitments within that group.

Table 3 gives an overview of the commitments made by twelve members of COMESA, SADC or WAEMU. Note that no CEMAC country made commitments for financial services. Within WAEMU, only Côte d'Ivoire and Senegal made commitments, but of a very limited nature. Table 3 distinguishes three levels of commitments for the different modes of supply: unbound, limited commitments and full commitments. Members indicating that a certain mode is unbound, indicate that they do not make any commitments in that category. Full commitment implies that Members either do not impose any market access limitations in the relevant mode, or that we interpret their restrictions as being minor. Limited commitments imply the existence of market access limitations in the relevant mode that we interpret as not being minor. Table A1 in the appendix gives more details about the specific limitations individual members impose.

[66] Genesis Analytics (2004: 25-27).

[67] Genesis Analytics (2004: 25-27). Egypt, with its over $100 billion in banking assets, could act as such. However, it has its own banking restructuring process to deal with at the moment: the IMF indicates in its latest 2005 article IV report that Egypt is currently in the process of consolidating its banking sector to cut by half the number of banks in the country.

[68] See also Mattoo (1998), Kono and Schuknecht (2000) and Qian (1999) on the interpretation of GATS commitments in financial services.

Table 3: GATS commitments of COMESA, SADC and WAEMU members with respect to banking and other financial services (excl. insurance)

	Mode 1 cross-border supply of services	**Mode 2** consumption abroad	**Mode 3** commercial presence	**Mode 4** presence of natural persons
Angola	limited	limited	limited	limited
Benin	limited	limited	limited	limited
Côte d'Ivoire	limited	limited	limited	limited
Egypt	unbound	unbound	limited	full
Gabon	limited	limited	limited	limited
Kenya	full	full	full	limited
Lesotho	unbound	unbound	full	limited
Malawi	full	full	full	limited
Mauritius	limited	limited	limited	limited
Senegal	unbound	unbound	limited	unbound
South Africa	unbound	unbound	full	limited
Zimbabwe	full	full	limited	limited

Source: WTO services database and authors' interpretation.

The approach taken towards multilateral liberalization differs significantly within this group of countries. Lesotho and South Africa have chosen not to bind modes 1 and 2, but commit Mode 3 fully. This approach bears resemblance to the cautious approach suggested in Kono and Schuknecht (2000). Kenya, Malawi and Zimbabwe, instead, commit Mode 1 and 2 fully. Kenya and Malawi do the same thing for Mode 3.

The absence of multilateral commitments for financial services in the SADC countries Botswana, the Democratic Republic of Congo, Malawi, Mozambique, Namibia, Swaziland, Tanzania and Zambia may indicate that South African banks can expand their activities in the region without effective competition from third country competitors. This may be a reason of concern according to the arguments developed in Mattoo and Fink (2002).

6. CONCLUSIONS

In this paper we compare the benefits and risks of multilateral liberalization of financial services trade in Africa with those of regional liberalization. The liberalization of financial services trade carries significant potential benefits for African countries to the extent that it leads to increased capital inflows and increased competition in the banking sector with resulting efficiency gains. The paper argues that these benefits are likely to be higher for multilateral than for regional liberalization, but that multilateral liberalization may also carry higher risks in term of macroeconomic volatility.

African countries could control this risk by allowing for Mode 3 trade in financial services at the multilateral level, while limiting Mode 1 flows as they require in principle a higher degree of openness of countries' capital accounts. Such an approach is however likely to result in reduced capital inflows, a significant drawback from the point of view of most countries in the region. The paper argues that this negative effect could be offset –at least to some extent- by the creation of integrated financial markets within African sub-regions, that are characterized by free financial services trade across all modes and harmonized financial regulation. Regionalization of this type could stimulate entry of banks from third countries as it would reduce regulatory compliance costs for banks establishing in the region and wishing to act across borders within the region. It would also allow entrants to reach higher levels of portfolio diversification than if they were only allowed to act within individual domestic markets. Both factors are likely to increase the profitability of banking in the region. The paper also argues that countries within the region could gain from pooling their regulatory and supervisory capacity and create one regional regulatory authority. A note of caution is, however, warranted. Given the very low level of development of some of the countries reviewed in this paper, regional integration of financial markets alone is unlikely to automatically trigger significant numbers of foreign entrants. It should rather be seen as one of many elements of a successful development strategy.

Within Africa a number of regional initiatives exist that aim at integrating the financial markets of the relevant member countries. In WAEMU and CEMAC those initiatives started on the basis of a rather favourable institutional set-up due to the fact that both regions are monetary unions belonging to the Zone Franc. Nevertheless, regional integration has so far not been very successful. This paper points out that this may to a significant extent be due to the design of the regulatory system , particularly within CEMAC. In SADC the integration process appears to a large extent to be driven by South Africa, and more specifically by South Africa's private banks. COMESA countries do not share an institutional framework like WAEMU or CEMAC, nor do they have an "anchor state" like South Africa within SADC. This may explain why regional integration appears to be least advanced in this African region.

No CEMAC country has made commitments in the financial sector under GATS and only two WAEMU countries have made such commitments, albeit very limited ones. This may imply that in these two monetary unions competition from extra-regional banks is very limited or – due to the colonial heritage- dominated by French companies. Also a significant number of SADC and COMESA countries have made no commitments under GATS or only limited commitments. Meanwhile South African banks are expanding in the SADC region. According to the arguments developed in this paper, significant scope therefore exists for further multilateral liberalization of banking services, in particular with respect to Mode 3.

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8. APPENDIX: MULTILATERAL LIBERALIZATION OF FINANCIAL SERVICES TRADE

Table A1: GATS commitments of CEMAC,COMESA, WAEMU and SADC members with respect to banking and other financial services (excl. insurance)

	Mode 1 cross-border supply of services	**Mode 2** consumption abroad	**Mode 3** commercial presence	**Mode 4** presence of natural persons
Angola	**limited** full commitments on acceptance of deposits; discretionary licensing with respect to lending; other sub-sectors unbound	**limited** discretionary licensing with respect to acceptance of deposits and lending; other sub-sectors unbound	**limited** full commitments on acceptance of deposits; other sub-sectors unbound	**limited** limits on the share of personnel that are not Angolan citizens
Benin	**limited** full commitments on acceptance of deposits; discretionary licensing with respect to lending; other sub-sectors unbound	**limited** full commitments on acceptance of deposits; discretionary licensing with respect to lending; other sub-sectors unbound	**limited** discretionary licensing with respect to the allowance to accept deposits; other sectors unbound	**limited** only some level of commitment for high skilled intra-corporate transferees
Côte d'Ivoire	**limited** full commitments on acceptance of deposits; other sub-sectors unbound	**limited** discretionary procedures for acceptance of deposits; other sub-sectors unbound	**limited** discretionary procedures for licensing and limited sectoral coverage	**limited** restrictions concern administrators and managers of financial institutions
Egypt	**unbound**	**unbound**	**limited** with the exception of the requirement of approval for individual share ownership above certain limit and an economic needs test for the establishment of foreign bank branches	**full** with the exception of certain qualification requirements for directors
Gabon	**limited** fully committed but limited sectoral coverage (deposit taking not included)	**limited** fully committed but limited sectoral coverage (deposit taking not included)	**limited** discretionary procedures	**limited** only some level of commitment for high skilled intra-corporate transferees
Kenya	**full** with the exception of some restrictions with respect to securities related services	**full**	**full** with the exception of some restrictions with respect to securities related services and asset management	**limited** horizontal section: unbound, except for temporary stay of natural persons employed in high skill jobs related to implementation of foreign investment

Lesotho	**unbound**	**unbound**	**full** with the exception of the requirement of approval for individual share ownership above certain limit	**limited** horizontal section: automatic acceptance of limited number of high skilled personnel per enterprise; discretionary procedures for numbers exceeding this limit
Malawi	**full**	**full**	**full**	**limited** horizontal section: unbound, except for temporary stay of natural persons employed in high skill jobs related to implementation of foreign investment
Mauritius	**limited** economic needs test; acceptance of deposits unbound	**limited** economic needs test	**limited** economic needs test; discretionary licensing with respect to the allowance to accept deposits	**limited** horizontal section; unbound, except for highly qualified persons and subject to national legislation
Senegal	**unbound**	**unbound**	**limited** limitations on legal form and discretionary licensing procedures	**unbound**
South Africa	**unbound**	**unbound** except for provision and transfer of financial information and financial data processing	**full** only limitations on legal form; branches must keep some capital within the country	**limited** horizontal section: unbound, but with rather generous exceptions in particular with respect to intra-corporate transferees and senior personnel
Zimbabwe	**full**	**full**	**limited** 60% limit on foreign equity	**limited** horizontal section: unbound except for intra-corporate transferees and high skilled persons subject to economic needs test