INTERNATIONAL MONETARY FUND

Reference Note on Trade in Financial Services

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This note addresses key issues with respect to trade policy in financial services and its linkages to capital flows, and prudential regulations and supervision under the General Agreement on Trade in Services (GATS), preferential trade agreements (PTAs), and bilateral investment treaties (BITs). The note should help inform the advice that country teams provide on such issues in the context of surveillance, program negotiations, and technical assistance.[1] It is a response to the Executive Board's call for guidance in this area stemming from the 2009 IEO Evaluation of IMF Involvement in International Trade Policy Issues. A SharePoint site with additional resources for staff will be established, providing easy access to reference material.

I. Introduction

1. **Fund staff regularly addresses issues related to trade policy in financial services in the context of surveillance, the use of Fund resources, and technical assistance.** But more work can be done by staff to explore linkages between issues such as international banking, capital flows, and prudential supervision, and countries' commitments with respect to liberalization of trade in financial services. Against this background, Executive Directors in their discussion of the *2009 IEO Evaluation of IMF Involvement in International Trade Policy Issues*, called for "guidance on the approach to trade in financial services that stresses the links between trade in financial services, the regulatory environment, and capital account liberalization" (Box 1).

2. **The note covers three broad areas:** (1) a general overview of key dimensions of legal and policy frameworks on trade in financial services, including its linkage to capital flows and prudential regulation and supervision as prescribed under multilateral, regional, and bilateral trade agreements; (2) relevant aspects of the multilateral framework for trade in financial services—the GATS—including the related macro-economic and regulatory policy

[1] The note provides a description of the existing framework. It should be noted that interpretations of these treaties offered in the note are staff's own and may differ from those of the World Trade Organization or governing bodies of, or parties to, preferential trade agreements and bilateral investment treaties. A separate question concerns whether the current international framework is appropriate and whether the Fund should play a bigger role, which is beyond the scope of this note. This issue may be covered in the forthcoming paper on the Fund's role in capital account liberalization.

issues, particularly the prudential carve-out; and (3) key aspects of PTAs and BITs that are relevant for trade in financial services.

II. Key dimensions of Legal And policy Frameworks on Trade in Financial Services

3. **The GATS is the principal legally binding multilateral framework of rules governing the liberalization of trade in services, including trade in financial services.** The Preamble to the GATS indicates that the motivation for establishing a rules-based multilateral framework for trade in services is the desire to expand services trade and ultimately growth internationally. The preamble refers to the members "wishing to establish a multilateral framework of principles and rules for trade in services with a view to the expansion of such trade under conditions of transparency and progressive liberalization and as a means of promoting the economic growth of all trading partners," while "recognizing the right of Members to regulate … in order to meet national policy objectives." Many PTAs also provide for rules and disciplines applicable to trade in services including financial services.

4. **The rules and disciplines contained in the GATS and PTAs with respect to trade in financial services are essentially aimed at liberalizing financial services trade**; in particular, through the removal of quantitative or qualitative restrictions that limit cross-border supply of services and foreign commercial presences in domestic markets. Four key principles apply in the context of the GATS and PTAs, many of which typically build on the GATS: (i) host country transparency with respect to its trading regime and prudential supervision regulations; (ii) equal treatment of foreign service providers, the Most Favored Nation (MFN) principle; (iii) market access; and (iv) equal treatment of domestic and foreign service providers, the National Treatment principle.

5. **Depending on how commitments are made, treaties liberalizing trade in services make use of either a "positive list" or a "negative list" approach**. The GATS and many PTAs employ the "positive list" approach under which schedules of commitments by members on market access and national treatment with respect to specific sectors are provided. In these schedules, members identify the sectors to which the market access and national treatment obligations are applied. Nonetheless, members are allowed to indicate limitations on their specific commitments, such as quantitative or qualitative restrictions. In contrast, other treaties such as the North American Free Trade Agreement apply all the obligations to all services covered under the agreement and use the schedules to identify measures to which the obligations do not apply – the "negative list" approach.

6. **Trade in services is usually defined by reference to modes of supply.** In the GATS and PTAs, a distinction is made between four modes of supply, which are meant to capture the different ways in which foreign service providers can reach consumers: cross-border trade (mode 1), consumption abroad (mode 2), commercial presence (mode 3), and cross-border movement of natural persons as suppliers of services (mode 4). Broadly defined, the first two modes comprise the supply of services across borders while mode 3 relates to foreign direct investment. In the case of financial services, the establishment of foreign financial institutions (e.g., through branches, subsidiaries, or joint ventures) in host

jurisdictions is the area where most liberalization commitments have been made under trade and investment agreements (mode 3). Countries have been more reluctant to commit to the liberalization of cross-border trade in financial services (mode 1). Cross-border movement of natural persons supplying financial services is mostly reserved for senior management and technical personnel, including those who are in foreign financial institutions (mode 4).

7. **Financial services imports comprise banking, insurance and insurance related services, and other financial services.** Banking includes: (i) commercial banking activities, such as lending and deposit-taking; (ii) investment banking activities, such as underwriting securities and advising on mergers and acquisitions; (iii) trading activities, such as brokering and dealing in securities and other financial instruments; and (iv) asset management activities, including the management of mutual funds and pension funds. Other financial services provided internationally include: (i) financial information and data processing services; (ii) investment advisory services; (iii) payment and money transmission services, including credit cards; (iv) settlement and clearing for financial assets; and (v) financial leasing.

8. **The treaties covering trade in services do not address the liberalization of capital movements *per se*.** Rather, they address those capital transactions associated with the services covered under the treaties. For example, when a country undertakes a commitment to open up its market for the cross-border supply of a particular financial service, there is typically a commensurate commitment to allow the capital flows that are an essential part of the service itself. The host country typically does not, however, make an across-the-board commitment to liberalize capital movements. Similarly, the establishment of a commercial presence by a foreign service supplier in a host jurisdiction usually requires certain international capital transactions, particularly inflows with respect to establishment.[2]

9. **While openness and deregulation are often undertaken together, the gains and costs of financial reform depend on the regulatory and supervisory framework.**[3] There are many countries that have successfully opened up to foreign financial firms and at the same time have been engaged in a parallel process of deregulation, while strengthening their regulatory and supervisory apparatus. These countries have reaped substantial benefits in terms of efficiency and financial deepening.[4] For example, China's WTO accession commitments motivated a comprehensive and sequenced services reform program. That said, the recent financial crisis has reignited concerns about the appropriate pace and sequencing of financial liberalization.

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[2] Unlike the GATS, the OECD Code of Liberalization of Capital Movements covers both inward and outward investment.

[3] Barth et al. (2002).

[4] Mattoo (2003).

III. Multilateral Framework on trade in financial services and capital mobility: Key Features

A. General Provisions of the GATS

10. **The GATS establishes multilateral rules and disciplines for trade in financial services.** It consists of the framework agreement containing general rules and disciplines applicable to all services, and the national schedules listing individual WTO members' specific commitments on access to their domestic markets by foreign suppliers. With respect to financial services, the GATS includes an Annex on Financial Services containing specific provisions for the sector. It establishes a "prudential carve out" and clarifies the extent to which activities of central banks or monetary authorities are excluded from the scope of the GATS (see III.B). The Annex is an integral part of the GATS and binding on all members.[5]

11. **The GATS framework agreement establishes general obligations of WTO members including the MFN principle.** The MFN principle is a commitment by a country to extend the same treatment it accords to its most-favored trading partner, to all its trading partners.[6] This cornerstone principle of non-discrimination among trading partners is applicable to any measure that affects trade in services in any sector falling under the GATS, irrespective of members' specific commitments in their national schedules. However, derogations are possible upon accession of a new member or, for current members, by way of a waiver.[7] These exemptions are subject to review and should in principle not last longer than 10 years. Other general principles in the framework agreement include: (i) transparency with respect to publication and notification; and (ii) a discipline that monopolies or exclusive service providers do not act in a manner inconsistent with the MFN obligations and specific commitments.[8]

12. **The national schedules of commitments serve as the principal mechanism of liberalization.** Under the "positive list" approach of the GATS, the member chooses the specific sectors where it commits to apply national treatment. All commitments apply on a non-discriminatory basis to all other WTO members. Members are allowed to indicate limitations attached to their specific commitments in respect of sectors listed in their national schedules. For example, a country making a commitment to allow foreign banks to operate in its territory might limit the number of banking licenses to be granted. Members are, however,

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[5] An additional legal agreement is the Understanding on Commitments in Financial Services, which is not an integral part of the GATS but a separate instrument that allowed participants in the Uruguay Round to take on specific commitments to liberalize financial services as an alternative approach to national schedules of commitments under the GATS.

[6] For instance, if country A imposes a 1 percent tariff on imports of widgets from country B, MFN treatment would require that country A extend the same treatment to the imports of widgets from other WTO members.

[7] Waivers are granted under Article IX(3) of the Marrakesh Agreement Establishing the World Trade Organization (the "WTO Agreement").

[8] WTO Secretariat (2006).

free to provide greater access and more favorable treatment to foreign firms than outlined in specific commitments.

13. **While the GATS does not define market access, it provides six types of restrictions that a member cannot impose, unless identified in its schedule:** (1) the number of suppliers; (2) the total value of service transactions or assets; (3) the total number of service operations or the total quantity of service output; (4) the total number of natural persons that may be employed; (5) the types of legal entity or joint venture (e.g., restrictions on the establishment of foreign bank branches); and (6) the participation of foreign capital. The existence of any limitations in respect of these areas has to be indicated with respect to each of the four modes of supply in scheduled sectors. In contrast, the GATS does not provide a comparable list in respect of national treatment restrictions; it is up to members to ensure that all potentially relevant measures are listed in sectors where commitments are scheduled and, if they wish, members can inscribe various types of national treatment limitation (e.g., regarding taxation or regulations). If a member no longer wishes to conform to its specific commitments, it may modify its schedule by providing compensation in the form of alternative market access (even across sectors). However, this undertaking may involve difficult negotiation and can confuse understandings regarding the member's commitments.

B. Macroeconomic and Regulatory Policy Space

14. **The GATS contains several provisions that accommodate domestic policy making in the context of financial services.** The most notable provisions from the Fund's perspective are those related to monetary and exchange rate policies, balance of payments restrictions, and prudential regulation:

- **Prudential carve-out.**[9] The Annex on Financial Services includes a "prudential carve out" clause that recognizes the right of WTO members to introduce and maintain prudential measures "including for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial service supplier, or to ensure the integrity and stability of the financial system," regardless of any other provisions of the GATS.[10] Since the Annex on Financial Services does not provide any definition or indicative list of prudential measures that would be covered by this provision, governments have considerable leeway in introducing prudential measures that fit their needs. However, the Annex on Financial Services cannot be used by a member to avoid its obligations or commitments. In the case of challenges by other WTO members on the legality of a specific (prudential) measure adopted by a member, a determination on the consistency of such a measure with the prudential

[9] Key (2003).

[10] GATS Annex on Financial Services, paragraph 2(a). The carve-out is very broad as the text refers to "measures for prudential reasons" as opposed to prudential measures or regulations, implying a large menu of potential measures.

carve-out clause would be made through the WTO dispute settlement mechanism. To date, no such dispute has emerged.

- **Monetary and exchange rate policies.** Excluded from the GATS coverage are services supplied in the exercise of governmental authority including (i) activities of central banks, monetary authorities, or other public entities in pursuit of monetary or exchange rate policies and (ii) activities forming a part of a statutory system of social security or public retirement plans.[11]

- **Balance-of-payments safeguards.** Under the GATS, a member may impose temporary restrictions that suspend its commitments (on all sectors included in its schedule, not only financial services) in the event of serious balance-of-payments and external financial difficulties or threat thereof. The restrictions shall: (i) not discriminate among WTO members; (ii) be consistent with the Fund's Articles; (iii) avoid unnecessary damage to the commercial, economic, and financial interests of other WTO members; (iv) not exceed those necessary to deal with balance-of-payments and external financial difficulties or threat faced by the member; and (v) be temporary and be phased out progressively as the member's situation improves. Members invoking the balance-of-payments safeguard are required to consult with the WTO Committee on Balance of Payments Restrictions. As under the GATT's balance of payments safeguard, the Committee accepts factual findings of the Fund relating to foreign exchange, monetary reserves and balances-of-payments and draws conclusions based on the Fund's assessment of the balance of payments and the external financial situation of the consulting member.

C. The Capital Flows Nexus[12]

15. **The GATS recognizes that for many areas of financial services, international capital transactions are typically associated closely with the provision of services.** GATS obligations relating to capital flows ultimately depend on the mode of supply being used (i.e., mode 1 or mode 3). Specifically, WTO members must allow cross-border (inward and outward) movements of capital if these are an essential part of a service for which they have made liberalization commitments regarding its cross-border supply (without establishment). For example, international capital transactions are an integral part of accepting deposits from or making loans to nonresidents (mode 1). International capital transactions are also usually associated with financial services such as securities trading on behalf of a customer residing in another country. The establishment of a commercial presence (mode 3) in a host country by a foreign services supplier involves both trade in services and international capital transactions. In permitting the establishment of a commercial presence, WTO members must allow inward (but not outward) capital transfers related to the supply of the service committed.

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[11] GATS Article 1, paragraph 3(b).

[12] Key (2003).

16. **While capital controls may be considered a legitimate part of the toolkit to manage capital inflows in certain circumstances,[13] they may, in some cases, be inconsistent with GATS obligations.** Such controls can take various forms, including price-based measures such as explicit taxes or unremunerated reserve requirements with respect to specific investment vehicles (stocks, bonds, loans), or other measures, such as an outright prohibition against the sale of short-term securities to nonresidents. A country imposing such controls may have commitments under the GATS to allow nonresidents to provide the specific financial service unhindered and thus its underlying capital flows (for discussion on overlaps of PTAs/BITs with Fund jurisdiction, see Section IV.C).

17. **The GATS safeguard the rights and obligations of common WTO/Fund members under the Fund's Articles.**

- Article XI of the GATS prohibits WTO members from applying restrictions on payments and transfers for current international transactions relating to their specific commitments. However, Article XI also provides that nothing in the GATS will "affect the rights and obligations" of Fund members under the Fund's Articles, including the use of exchange actions which are "in conformity" with the Fund's Articles. Article XI of the GATS thus ensures that the exercise by a member of its right under the Fund's Articles to impose or maintain such restrictions will be automatically consistent with the member's obligations under the GATS and that no further conditions need be met. The Fund's Articles permit members to impose restrictions on current payments and transfers if: (i) they have been temporarily approved by the Executive Board for balance-of-payments reasons; or (ii) their maintenance is authorized under the transitional provisions under Article XIV of the Fund's Articles.[14]

- Article XII of the GATS sets forth a number of conditions under which a WTO Member can impose restrictions in the "event of serious balance-of-payments and external financial difficulties or threat thereof." One of the conditions set forth in Article XII of the GATS is that the restrictions be "consistent with" the Fund's Articles.

- Regarding restrictions on capital movements, as a general rule, these restrictions will only be permitted if they meet all of the conditions set forth in Article XII of the GATS. The exception to this general rule would be restrictions imposed "at the request" of the Fund. Article VI, Section 1 of the Fund's Articles authorizes the Fund to request a member to exercise controls to prevent the use of the Fund's general resources to meet large or sustained outflow of capital. The restrictions imposed at the request of the Fund under Article VI, Section 1 of the Fund's Articles do not need to meet the additional conditions set forth in Article XII of the GATS.

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[13] Ostry et al. (2010).

[14] The Fund also permits members to impose restrictions on current payments and transfers for reasons of international or national security pursuant to Decision No. 144-(52/53).

D. Liberalization Commitments under the GATS

18. **The coverage of sector specific commitments under the GATS is modest overall.** The original commitments were often limited to the partial "locking in" of policies that had already been implemented on a unilateral basis at the time of the initial services trade negotiations (Uruguay Round, 1986–94).[15] In the case of financial services, the relatively high number of commitments (second only to tourism services) is explained by the fact that negotiations were extended well beyond the Uruguay Round end date, and finally concluded in December 1997. While developed countries made more substantial commitments than developing countries,[16] reflecting actual openness at the time, in practice, many WTO members have less restrictive policies than implied by their legal bindings; it would be inconsistent with their GATS commitments to apply more restrictive policies (unless justified for prudential reasons). It is nonetheless evident that, under significant external pressure, latecomers—25 emerging markets and low-income WTO accession countries—have made substantial commitments, either binding the status quo or, in some cases, using those commitments to motivate domestic reform programs. Twenty-nine additional countries are now in the process of WTO accession, some of them significant oil-exporters (e.g., Russia, Kazakhstan, Belarus, Uzbekistan, Iran, Iraq, Libya, Algeria, Syria, Sudan, and Equatorial Guinea) and hence potentially important trading partners under the GATS.

19. **Regarding banking, most countries have made deeper and broader commitments than they are legally obliged to under their GATS commitments.** A study drawing on WTO data on commitments and World Bank Survey data on foreign bank entry regulation, as reported by country supervisory authorities, compares GATS commitments against actual regulatory practices with respect to the opening up of the banking sector to foreign banks. The findings confirm that developed countries as a group have taken a more open stance under the GATS than have developing countries. However, developing countries as a group have a less restrictive policy in practice than their GATS commitments would imply whereas developed countries generally do not go beyond their commitments. Hence, while developing countries reserve the right to a substantially greater degree of regulatory discrimination than do developed countries, the degree of discrimination against foreign banks and in favor of domestic banks is about equal in practice.[17]

20. **Various attempts have been made to estimate services trade restrictiveness, but there is no consensus on methodology while lack of comprehensive data limits such investigations.** Empirical efforts to quantify market openness under the GATS have tended to use either a simple count of commitments by sector and mode or frequency-based measures on the basis of a scoring and weighting scheme for restrictions scheduled. Alternative methods involve surveys of effective market restrictions involving governments

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[15] Hoekman (2006).

[16] Mattoo (2000).

[17] Barth et al. (2006).

or market participants.[18] The measurement challenges are analogous to problems associated with attempts to characterize the restrictiveness of national policy stances through indices.[19]

E. The Cooperation Agreement between the WTO and the Fund

21. **The Cooperation Agreement between the WTO and the Fund sets out a detailed framework for cooperation between the institutions**. The Agreement, approved by the Fund's Executive Board and the WTO's General Council, recognizes the linkages between the various aspects of economic policymaking that fall within the respective mandates of the Fund and the WTO. Within the framework of the Cooperation Agreement, Fund staff and the WTO Secretariat consult regularly to ensure that neither institution would advocate measures to their members that would be inconsistent with rights and obligations of the common members of the Fund and the WTO or provide inconsistent advice. For Fund staff, this has mostly involved informal contacts and the review of operational documents. Over time there have been no formal queries regarding inconsistency between measures under discussion with a common member.

IV. Key Aspects of Preferential Trade Agreements and Bilateral Investment Treaties Relevant for Trade in Financial services

A. Preferential Trade Arrangements

22. **What typically motivates PTAs is the desire to remove or reduce trade barriers and ultimately establish a free trade area or a customs union among the parties**. In parallel with advocacy for multilateral liberalization in financial services, developed countries have sought to expand market access through PTA negotiations.[20] The coverage of financial services, however, varies from one agreement to the next. Some have separate chapters on financial services whereas others exclude financial services altogether. Some have separate investment chapters that address foreign direct investment, which are similar to BITs.[21] Some PTAs have taken liberalization commitments in financial services beyond the GATS, including with respect to commercial presence. The United States, in particular, has succeeded in advancing liberalization in financial services through such agreements (e.g., U.S.-Chile, U.S.-Singapore). The number of outstanding agreements is in the hundreds.

23. **PTAs generally build on the key principles established under the GATS, while the former are recognized under the latter as a vehicle for economic integration.** PTAs, however, do not always follow the GATS model on scheduling market access and national

[18] IEO (2009a).

[19] Hoekman (2006).

[20] Roy et al. (2006) studied 28 PTAs (including nine PTAs that involve the United States) negotiated since 2000, and found that more than half of countries reviewed made more commitments on commercial presence than their existing GATS offers.

[21] UNCTAD (2009).

treatment commitments. For example, some treaties use the "negative list" approach under which national treatment and market access are general obligations that apply to all services covered under the agreement, unless exceptions are specifically noted. This approach obliges countries to list all non-conforming measures prior to an agreement's entry into force; otherwise, they are required to be fully and automatically liberalized to the extent they are covered under the agreement. The choice of modality used to negotiate and schedule liberalization commitments can be an important contributing factor to the actual level and quality of liberalization attained.

24. **Many PTAs and BITs do not contain the GATS' safeguards and exceptions that provide governments with both short-term and long-term policy space.** As discussed above, of particular relevance for the Fund are the special provisions that accommodate monetary and exchange rate policies, balance-of-payments measures, and prudential measures. Concerns have been raised regarding inconsistent approaches to such provisions in overlapping trade and investment treaties signed by individual countries, particularly PTAs and BITs.

B. Bilateral investment treaties[22]

25. **The purpose of investment treaties is to improve business conditions through the protection of foreign investments.** BITs typically obligate their members to provide fair and equitable treatment to foreign investors in other contracting parties, to ensure due process in case of expropriation, and to grant investors access to international dispute settlement fora. The scope of obligations for BITs concluded by the United States and Canada with other countries goes beyond what is typically provided in BITs and includes additional disciplines that provide for the opening of host markets to foreign investment. For example, while four less developed countries (Bangladesh, Democratic Republic of Congo, Mozambique, and Senegal) have undertaken national treatment obligations across some 130 subsectors in investment treaties with the United States, their GATS schedules contain less than 20 subsectors on average. BITs are, however, more limited in their scope than PTAs, as they are principally concerned with foreign direct investment (overlapping with mode 3 under the GATS). More than half of BITs capture North-South investment relations whereas South-South treaties are on the rise. Thousands of BITs have been signed, with Germany (140) and China (120) leading the way. The United States has signed over 40.[23] Investment relations among developed countries have been governed by mainly two instruments: the OECD Code of Liberalization of Capital Movements and the OECD National Treatment Instrument.

26. **The protection afforded by investment treaties usually extends to international transfers of funds pertaining to an investment.** Some BITs entail the obligation to allow the movement of funds arising from both current and capital transactions related to the investment.

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[22] Aldlung and Molinuevo (2008).

[23] Economist Intelligence Unit (2010).

C. Capital Controls in PTAs and BITs

27. **Some PTAs and BITs restrict the use of capital controls during macroeconomic and financial distress and do not provide for a "safeguard" clause.** That is, a provision that allows a country to impose capital controls during times of macroeconomic or financial crisis. The absence of a safeguard provision can potentially create problems for the Fund in two ways.

a. First, a member's performance of obligations under PTAs/BITs may conflict with its obligations under the Fund's Articles. Like the GATS, these PTAs and BITs overlap with Fund jurisdiction to the extent that they cover certain transfers that are defined under the Fund's Articles as payments for current international transactions. In the event of a financial crisis, problems of discrimination among Fund members could arise if a party were to impose controls on nonparties to the PTA or BIT only, in order to avoid acting inconsistently with the PTA or BIT. Since such a restriction would discriminate among the Fund's largely universal membership, it could not be approved and would therefore be inconsistent with the member's obligations under Article VIII, Section 2(a).

b. Second, the absence of a safeguard provision could increase demand for and result in the inappropriate use of Fund financing. The right of members to impose capital controls under the Fund's Articles reflects, in part, a recognition that the Fund's resources and the members' adjustment measures may not, on their own, be sufficient to address balance-of-payments crises arising from capital outflows. Moreover, as noted above under Article VI, Section 1, a member may not use the Fund's general resources to meet a "large or sustained" outflow and the Fund may request a member to exercise controls to prevent Fund resources from being used for that purpose. Even though this provision has never been formally invoked, the prohibitions on such controls in PTAs or BITs could preclude the member from complying with the Fund's request.

Box 1: The 2009 IEO Evaluation of IMF Involvement in International Trade Policy Issues

1. **During the Board discussion of the 2009 IEO Evaluation of IMF Involvement in International Trade Policy Issues, Executive Directors welcomed the IEO assessment and broadly agreed that the Fund has an important role to play on broad trade policy issues.** Regarding financial services specifically, Executive Directors noted the benefits from guidance on the approach to trade in financial services that stresses the links between trade in financial services, the regulatory environment, and capital account liberalization. Directors also welcomed the IEO's finding that institutional cooperation with the WTO and the World Bank on trade has evolved and should be strengthened further, and agreed that occasional meetings on trade with counterparts in other multilateral economic institutions would—if focused and well-designed—bring important benefits. The following are among the issues highlighted in the background documentation for the Board discussion; welcomed, but not necessarily endorsed by the Board in their entirety. In particular, the IEO report argued that:

- **The Fund had not clearly enough defined or pursued a role vis-à-vis trade in financial services;** more explicit guidance on objectives of and approaches to surveillance of trade in financial services—as well as better use of tools for tracking openness to trade in financial services—would have facilitated work in this area: surveillance should be actively involved in understanding and anticipating problems in financial services commitments through PTAs and the WTO; and the Fund needed to move beyond what it characterized as uncritical support for liberalization of trade in financial services—a position that had at times been inconsistent with the IMF's more cautious approach to more general risks from inadequate financial supervision and prudential control.

- **Trade liberalization in recent years had been dominated by PTAs, which had placed trade policy somewhat outside the scope of Fund surveillance (bilateral, regional, and multilateral).** The GSFR had, nonetheless, on occasion adequately covered trade in financial services from the multilateral side, addressing its risks and benefits; while coverage in bilateral surveillance was found to be less thorough, lacking at times appropriate balance between advocacy for openness and attention to risks.

- **The most prominent issues related to the banking sector,** including advocacy for eliminating explicit barriers to foreign entry and urging the sale of government-owned banks. The background note on financial services (IEO 2009a) noted that Fund advice in support of financial services liberalization had been supportive of countries' unilateral policy actions and the WTO accession process.

- **Most of the conditions in IMF-supported programs during the evaluation period (1996–2007) were found in transition countries in Asia, Central Asia, and Europe.** Conditionality was concentrated on reforming banking and financial systems to foster competition and improve efficiency. The sample was based on eleven Fund-supported programs in ten countries with a total of 18 conditions, most of which were defined as structural benchmarks.

Box 2: The Treatment of International Capital Movements under the Articles of Agreement

1. **The Fund's Articles recognize the right of members to restrict capital movements.** While members are prohibited from imposing, without Fund approval, restrictions on the making of payments and transfers for current international transactions under Article VIII of the Fund's Articles, Article VI, Section 3 recognizes the right of each member to exercise "such controls as are necessary to regulate international capital movements" as long as the member, in applying such measures, does not restrict or unduly delay the making of payments or transfers for current international transactions. The scope of the right of members under Article VI, Section 3 has been interpreted broadly and includes the authority to permit, prohibit, or limit inward and outward capital movements.

2. **Notwithstanding the broad scope of the right of members to impose capital controls under Article VI, Section 3, the freedom of members in this area is circumscribed to some extent by other provisions of the Fund's Articles.**

- **Capital movements deemed current payments:** Article XXX includes within the definition of "payments for current transactions" a few types of capital movements (i.e., payments of moderate amount for the amortization of loans or for the depreciation of direct investments, and normal short-term banking and credit facilities). As they are defined as current payments under the Fund's Articles, members may only impose restrictions on such capital movements with the Fund's approval.

- **Capital controls in Fund surveillance over exchange rate policies:** Article VI, Section 1(iii) requires members to avoid manipulating exchange rates or the international monetary system "in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members". Under this provision, it has been understood that a member may not impose capital controls if such controls are used to manipulate the member's exchange rate in order to prevent balance of payments adjustment or to gain an unfair competitive advantage over other members.

- **Imposition of capital controls in use of Fund resources:** In certain circumstances, a member may be called upon by the Fund to impose capital controls under the Fund's Articles. Article VI, Section 1 empowers the Fund to "request" a member to impose controls on capital movements to prevent the use of the Fund's general resources "to meet a large or sustained outflow of capital." This provision seeks to ensure that the Fund's resources are not used to resolve problems arising from large capital outflows.

- **Imposition of capital controls in Fund conditionality:** Article V, Section 3(a) sets forth the conditions governing the use of the Fund's general resources. It provides that the Fund shall adopt policies on the use of its resources that will assist members to solve their balance of payments problems in a manner consistent with the provisions of the Fund's Articles and that will establish adequate safeguards for the temporary use of the Fund's general resources. This provision has been understood to permit the Fund to require members, as a condition of access, to impose restrictions on capital inflows, e.g., establishing limits on external borrowing.

- **Removal of capital controls in Fund conditionality:** The Fund has generally not required the removal of capital controls as a condition for access to Fund resources. Since capital account liberalization is not a purpose of the Fund and as the Fund's Articles recognize the right of members to restrict capital movements, the Fund may not establish conditionality which would require members receiving financial assistance to remove particular capital account restrictions. However, there is one important exception to this practice. While Fund members generally have the right to impose capital controls, members using Fund resources must apply capital controls in a manner that will not give rise to external payment arrears.

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