MichU
DeptE
ResSIE
D
#266

RESEARCH SEMINAR IN INTERNATIONAL ECONOMICS

Department of Economics
The University of Michigan
Ann Arbor, Michigan 48109-1220

SEMINAR DISCUSSION PAPER NO. 266

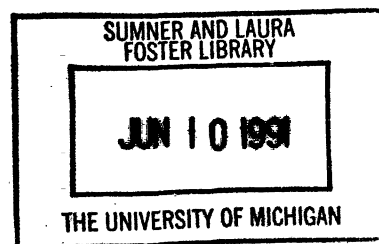
Contingent Commercial Policies and the Credibility of Financial Market Liberalization

by

Bernard Hoekman and Michael Leidy
GATT Secretariat

November 1990

Winner of a special merit award in the 1990 AMEX Bank Review essay competition in international finance. Forthcoming in Sarah Hewin and Richard O'Brien (ed.), ***Finance and the International Economy: 4***, **Oxford University Press.**


SUMNER AND LAURA
FOSTER LIBRARY
JUN 10 1991
THE UNIVERSITY OF MICHIGAN

I. Introduction

A noteworthy development during the last decade has been the significant increase in international trade in services. World trade in services grew faster than merchandise trade during the 1980s, an impressive performance for products that have often been considered to be either difficult or impossible to trade. The reasons for this growth are numerous and include technological and regulatory changes, increasing intrafirm (but cross border) transactions, unbundling of service activities, and rising (per capita) real incomes.[1]

The increasing tradability of services and reductions in the barriers to establishment by foreign firms have increased competition in many service industries, and financial services in particular. The EC 1992 project and the ongoing deregulation and liberalization of Japanese financial markets will increase competitive pressures further.[2] Domestic incumbents can be expected to respond, as always under surges of foreign competition, in two ways; one socially productive, the other counterproductive. First, domestic firms will attempt to identify and correct sources of inefficiency which threaten their ability to compete in the new environment. Second, these firms will have an incentive to expend additional resources on political activity (lobbying) designed to reimpose restrictions on foreign participation. The extent to which firms pursue the latter over the former will depend on the accessibility and manipulability of contingent trade policies under the domestic legal regime.

Trade laws comparable to those governing trade in goods are likely to generate claims that foreign competitors engage in "unfair" competition, and that there is a need to "level the playing field." An increasing trend can be discerned for policymakers to attempt

[1]GATT (1989) analyzes the recent global trade performance of services. Stern and Hoekman (1988) provide a brief survey of the factors underlying the increasing economic importance of services, as well as references to the literature.

[2]See The Economist (1990), Hale (1990) and Walter (1989, 1990) for a discussion of recent and ongoing developments.

to address "unfair" restrictions on market access and the discriminatory treatment of foreign firms through bilateral discussions and unilateral actions. The most prominent examples have been bilateral discussions between the three major traders: the United States, Japan, and the European Community. These have focused largely on practices of trading partners who were perceived to "unfairly" restrict market access, i.e., limit exports from the nation initiating discussions.[3] Financial services have been particularly prominent in such talks and U.S. service firms have stated their desire that such procedures continue to be pursued (Montagnon, 1990).

A number of unilateral actions have also been taken (sought) in instances where service imports are perceived to be priced "unfairly." Examples include calls for antidumping measures against activities of Japanese banks in the United States (such as in the letter of credit market for U.S. municipal securities), a U.S. countervailing duty investigation against software imports from Singapore, and a European Community action against Korean exports of maritime shipping services.[4] While recent attention has centred largely on "unfair" international competition, in general commercial policies may be applied in instances of "fairly" traded imports as well. In particular, most industrialised countries have procedures for "safeguarding" domestic industries if they are being seriously injured by import competition.[5] The increasing tradability of services is also likely to increase the pressure for actions to be taken in instances where "fairly"

---

[3]These discussions may be ad hoc, or mandated by domestic legislation. In the United States, Section 301 of the 1974 Trade Act provides a justification for bilateral talks and allows for the imposition of sanctions if the issue is not resolved satisfactorily. The European Community has a similar instrument in Regulation No. 2641/84. See Jackson (1989).

[4]See, for example, Dunne (1990), Bellis et al. (1988), and Bureau of National Affairs (1989, 1990). The most commonly used unfair trade actions are those against dumped imports or imported products benefitting from subsidies. Such antidumping and countervailing actions usually require a finding that the imports have caused or threaten injury to domestic producers.

[5]Such "emergency" protection is usually required to be of limited duration, apply to all imports on a nondiscriminatory basis, and be contingent on a demonstration that the imports have caused injury to domestic producers.

traded services cause "market disruption."

The focus of this essay is on the rationales for, and potential implications of, applying the contingent commercial policies noted above to trade in financial services. This is a neglected issue in the international finance literature, which tends to focus on the effects of (usually exogenous) monetary and fiscal policies on output and relative prices (especially exchange and interest rates). The existence of accessible contingent commercial polices is likely to have important implications for the credibility and feasibility of further liberalization of financial markets. While attention will center primarily on financial services, the issues addressed here are quite general, in that they pertain to most types of traded services, particularly those subject to regulatory oversight.

The plan of the essay is as follows. Section 2 refines the concept of so-called "unfair" trade, and discusses the extent to which the major existing instruments of contingent protection are able to cope with "unfair" international competition. Section 3 explores the extent to which the distinguishing characteristics of services in general, and financial services in particular, together with accessible rules for contingent intervention in trade are likely to impose obstacles to liberalization even greater than those associated with merchandise trade. Alternative responses to instances of "fair" and "unfair" trade in services are discussed briefly in Section 4, while Section 5 concludes.[6]

2. Existing Approaches to "Fair" and "Unfair" Trade

Cries of "unfair international competition" and "structural" or "informal" impediments to trade have been an increasingly common phenomenon in business and policymaking circles during the 1980s. Despite numerous allegations of "unfair" trade and frequent negotiations between governments on specific issues (often involving Japan and the United States), "unfairness" remains an undefined, amorphous, and subjective concept.

---

[6]It should be noted that throughout, a unilateral, national perspective is taken. Ongoing multilateral discussions on services are not discussed as these are not directly relevant to the argument. See Messerlin and Sauvant (1990) on the latter.

This is also reflected in the lack of clarity concerning the characteristics of the counterfactual "fair" competitive situation, often graphically described by the notion of a "level playing field."

The basis for "unfair" trade complaints is usually an alleged artificial price or cost differential that is reflected in underselling of domestic competitors, price discrimination, or government assistance to a foreign firm or industry (including restrictions on market access). Price differences for a similar product may occur within a country or across countries. For example, within a country the price of a product sold by a domestic firm may be lower than that for a similar product provided by a foreign competitor, due to either pure competitive advantage (i.e., lower costs), or due to government-sanctioned restrictions on the contestability of the market. Examples of the latter include barriers to trade and investment (establishment), lack or weak enforcement of competition laws, and subsidies. In the limit, participation of foreign firms in the market may be prohibited. The source of the problem in these cases is clear. Either discriminatory treatment of foreign firms/products exists or government-sanctioned restrictions on market contestability are in place.

Cross-country price differentials, that is, differences in prices charged by a firm for similar products on its home and export markets, may occur for a variety of reasons. For example, transportation and distribution costs will generally drive a wedge between prices charged on the home market and those charged in export markets. All other things equal, the prices charged for a similar product will tend to be higher in the export market than at home. However, many situations exist where the home market price may nonetheless be above the export market price (so that formally dumping occurs). Frequently, government intervention may cause such price differentials to emerge.

If an exporting firm or industry produces a relatively homogenous product, cross-country price differentials exceeding transactions costs can only emerge if there is some barrier to arbitrage across markets. That is, for dumping to occur, there need to be

constraints on re-importation of the product in question. If this were not the case, as long as the price differences exceed transaction costs,[7] traders could simply buy the product in the export market, ship it back to the producer's home market and make a profit. In practice, the exporting firm's government will often have imposed barriers against imports and/or establishment, thus preventing such arbitrage.

A point to be emphasized is that "unfair" price or cost differentials within or across countries arise principally as a result of either limits to, or distortions of, competition. A possible rule of thumb then is that if price differences are not due to, or supported by, government intervention, this cannot be considered to be "unfair."[8] In general, public assistance to, or taxation of, specific firms or industries is a necessary condition for "unfair" trade competition to occur. Assistance should be understood to include both direct and indirect aid to domestic firms, examples being trade barriers, direct or indirect subsidies, exemptions from competition laws, or mandated barriers to entry. However, it would clearly be neither correct nor desirable to conclude that all forms of public intervention in markets warrant accusations of "unfair" international competition.

Government policies or government-sanctioned private actions that reduce competition and may cause markets to be segmented can be characterized as belonging to one of three broad groups, depending on their objectives: (1) those that are intended to address domestic economic distortions; (2) those that are intended to attain certain so-called non-economic objectives; and (3) those that directly limit competition from foreign firms or enhance the market power of domestic firms while addressing neither market distortions nor pursuing non-economic objectives. Only the last type constitutes a gratuitously protectionist policy and might be a justification for unilateral action.

---

[7]These comprise the sum of transportation costs, other transaction costs, as well as the opportunity cost of the arbitrageurs time.

[8]Theoretically, the only exception is if there is predatory intent. However, given national antitrust rules and the existence of international competition, predation will be difficult to achieve. Indeed, a recent study of the phenomenon was unable to find any recent major examples. See OECD (1989).

Regrettably, the reach of existing instruments such as antidumping and countervailing duty actions, as well as "market opening" instruments such as Section 301 in the U.S., is not limited to instances of the third type of problem. Moreover, these instruments often lead to a marked reduction in competitive forces, both ex ante and ex post, and can thus be argued to lead to more rather than less "unfairness." There is an extensive literature analyzing the scope and economic effects of instruments addressing "unfair" practices such as dumping or subsidization. Observers have concluded that in most circumstances dumping reflects optimal behavior and is likely to be a normal competitive pricing practice. The reach of antidumping is quite broad, as the criteria that need to be satisfied to gain protection are rather weak. Thus, threats of antidumping actions tend to reduce import competition, and antidumping legislation that offers broad access with low costs is likely to induce import-competing firms to "try their luck." Instead of fostering competition, antidumping measures tend to reduce it.[9] Similar arguments apply to anti-subsidy actions. Although subsidization may cause "unfair" trade, once a subsidy has been given, imposing a countervailing duty can at most reduce the volume of imports to the level that would have occurred in the absence of the subsidy. While this will benefit the domestic industry, it will generally reduce both national welfare and the level of competition.[10]

As far as measures focusing on foreign market access restrictions are concerned (that is, Section 301-type actions and bilateral discussions aimed at increasing market access), there is a significant danger that the net effect will also be a reduction in competition. The primary reason is that the implicit or explicit focus of these instruments is on market share. Such instruments are likely to have two consequences. First, because the focus is on market share the process itself may encourage collusive agreements among

---

[9]For more detailed arguments and references to the literature, see Hoekman and Leidy (1989) or Messerlin (1989).

[10]See, for example, Deardorff and Stern (1987).

existing domestic firms and newly admitted foreign firms. Successful government-to-government talks imply the elements of enforcement and oversight needed to stabilize the agreement. Second, as emphasized by Curzon and Curzon (1989), those countries that are pressured for concessions can be expected to make strong efforts to prevent "free riding" by third parties. This is likely to be especially true of financial services for which no multilateral most-favoured-nation rule exists. This suggests that bilateral measures designed to pry open foreign markets might provide the external framework needed to facilitate and stabilize a collusive agreement, while potentially reducing market access to third-party firms in the process. Despite the appearance of liberalizing intent, therefore, such measures may effectively reduce competition. Of course, if Section 301-type discussions fail to generate an agreement and threatened sanctions are implemented, subsequent retaliation is likely to reduce market access and competition in both countries.

With this said, it remains to address briefly the most prominent rationales for "unfair" trade laws. There are just two that have any merit. The first argues that "unfair" trade practices may be part of a strategy of predation. However, the conditions necessary for a strategy of predation to have any chance of success are very strict and unlikely to arise in markets where entry is relatively easy and competition is on a global scale. In addition, there is no empirical evidence for the existence of successful predatory pricing (OECD, 1989). The predation rationale is simply a red herring.

The second supporting argument for "unfair" trade laws is that they are necessary to defuse counterproductive protectionist pressures. It is argued that in the absence of such laws protectionists will ultimately prevail in the political arena.[11] While there is clearly substance to this argument, it is equally true that a free trade regime which offers the club of "unfair" trade laws to protection-seeking import-competing firms won't long be a free trade regime. The point should be made that such laws defuse public protectionist

---

[11]See, for example, Bhagwati (1988), who notes that "A free trade regime that does not rein in or seek to regulate artificial subventions will likely help trigger its own demise" (p. 35).

sentiment precisely because they accommodate the interests of the protectionists. While this "capture" is sometimes recognized, the proposed solution tends to be reform, e.g.: "...minimize the capture of the antidumping and countervailing mechanism by protectionists ... by permitting the imposition of penalties on petitions whose complaints are adjudicated to have been frivolous and to have been intended only for harassment..." (Bhagwati, 1988, pp. 115-116). Such reform appears to be largely unenforceable in the context of (financial) services as it will be very difficult to objectively rule that a petition was frivolous given the highly differentiated intangible products involved.

In conclusion, existing unilateral contingent trade policy instruments can be characterized as collusive policies that foster instead of combat "unfair" trade. Collusive policies reduce competition by sheltering domestic firms, and often selected foreign firms as well. Examples of collusive policies also include voluntary export restraint agreements and other forms of market sharing, managed trade arrangements which substitute for GATT-mandated emergency protection against "fairly" traded products. It has been well-established in the economics literature that the benefits of such measures accruing to the protected firms are usually greatly outweighed by the costs to other agents in the economy.

A reduction in competition is also the result if "fair" trade procedures are invoked. As noted earlier, most countries allow domestic import-competing industries to petition for protection if they can demonstrate serious injury caused by import competition. However, the great advantage of intervention under such legislation is that measures are applied for a limited time period on a nondiscriminatory basis. While they are to be preferred over "unfair" trade instruments, they remain an inefficient way of addressing adjustment pressures, in part because both types of procedures reduce the credibility of a liberalization program. We shall return to this issue presently.

3. Applying Existing Approaches to Financial Services

Two important differences distinguishing goods and services are that, first, many services are intangible, and second, they tend to be nonstorable. The latter condition implies that consumers and producers often have to be close to each other both in space and in time for provision or sale of a service to be feasible. That is, cross-border trade analogous to trade in goods will frequently not be possible. Instead, international transactions in services often require a local presence of foreign firms in the market of the consumer or movement of the consumer.[12] Not only is the cross-border tradability of service products less than that of goods, it should be recognized that because services usually are not storable, there will often be great scope for product differentiation, as the services will be tailored to the specific needs of the customer.[13]

There are three important consequences of the differences between goods and services. First, nontradability of service products often requires providers or consumers/ receivers to move to each others location for provision to occur. An obvious example is retail banking. Second, secondary markets rarely exist as resale of services tends to be difficult given their nonstorability. While this is less true of financial services, as secondary markets exist for products such as loans, securities, etc., brokerage and other intermediation services cannot be resold. Third, often production can only occur if the consumer provides some of the required inputs. Examples include services such as automatic teller machines, electronic point of sale services, and home banking.

The general implication of all of these characteristics is that there exists greater scope for product differentiation in services than in goods. Thus, market segmentation and

---

[12]In the literature, a distinction has been made between demanders or consumers and receivers of a service. The former two can be defined as being those who pay for the service, while the latter pertains to the person(s) or object(s) upon which the service is performed. They may be identical, but often will not be. For more on this, see Sampson and Snape (1985).

[13]Certain financial services are, of course, relatively homogenous (e.g., brokerage or underwriting operations). Frequently, however, even such services are bundled into a composite and thus differentiated product.

price discrimination will be much more prevalent in services than in goods, whether there is government intervention or not. This is primarily due to the nonstorability or nontransferability of most services, which will severely constrain the possibility of arbitrage across markets.

Although there are inherent reasons to expect markets to be segmented, it remains the case that government policies may impose additional barriers to arbitrage and thus give rise to "unfair" competition. It is important to note that even though arbitrage of service products will rarely be possible, in principle price differences can be competed away if foreign providers are allowed to operate in the domestic market. In practice, governments may constrain market access of foreign firms. This is, of course, frequently the case for certain, if not all, types of financial activities. Furthermore, a non-negligible number of services can be traded in a manner analogous to merchandise, so that barriers to trade may continue to inhibit arbitrage. In the context of financial services, one can think of exchange restrictions, capital controls, or operating restrictions.

Thus, in the case of both goods and services, government action may inhibit arbitrage from occurring, although the form the arbitrage takes will generally differ. In particular, many service industries tend to be highly regulated. In practice regulatory standards vary widely across countries and industries, and differences in regulatory regimes may frequently be a major barrier to arbitrage and are a source of "unfair" competition complaints. Indeed, regulatory regimes may be used to inhibit cross-border trade in cases where this would be technically feasible, or they may be used to limit or prohibit market access for foreign providers. Such issues are clearly prevalent in financial services. However, in the financial services context existing rules often serve a prudential or insurance role, so that it is impossible to generalize a priori as to whether they constitute a source of "unfairness."

Summing up, services are different from goods, and one implication of their distinguishing characteristics is that price discrimination is likely to be ubiquitous, both

within and across countries. Nevertheless, this does no damage to the central proposition of the previous Section that government intervention is likely to be the primary source of "unfair" competition. The main difference is that in the goods context arbitrage usually will be inhibited primarily by government-imposed trade barriers, while in the services context the main problem is likely to be one of barriers to local establishment by foreign service providers and/or operating restrictions.

Applying contingent trade policy instruments to services will lead to adverse results similar to those familiar in the context of merchandise trade. Specifically, a regime of contingent trade policy is likely to be captured by the interests opposed to liberalization, thereby precipitating setbacks to the liberalization objective. Antidumping and countervailing duties, "emergency protection," and market sharing arrangements are likely to proliferate. Indeed, there are two reasons for believing that the problem is likely to be more pronounced in the services context.

The first is analogous to a problem cited by Bhagwati (1988) pertaining to the application of antidumping laws to imports of goods produced in nonmarket economies. Because of the difficulty of establishing "fair value" of goods produced in such countries, he argues that the only outcome of an "unfair" trade investigation can be a "political" one. Similarly, because services tend to be highly differentiated and intangible, determining units of measurement and assessing "fair" or "normal" value must be subject to significant discretion on the part of the investigating authorities. Like the process of determining "fair" value in nonmarket economies, there may be a tendency to look for "comparable" third country service providers or perhaps to look for "comparable" consumers of services in the providers home market in order to establish "fair" value. Most often, a cost-based methodology will be required. The danger of arbitrary and politicized outcomes should be clear.[14] Similar issues are likely to arise in the context of market access negotiations, as

---

[14]A number of the technical issues that may arise when applying existing procedures to services are discussed in Hoekman and Leidy (1990).

these are inherently political.

The second reason why contingent trade policy instruments may pose more serious problems for liberalization of trade in services pertains to the existence of regulatory oversight in many service sectors. These regulatory regimes have been justified as a means of correcting some market failure or promoting a non-economic social objective (e.g., financial system stability, professional quality standards, etc.). As regulatory restrictions are frequently the source of barriers to services trade, liberalization may require a partial dismantling of a country's regulatory apparatus. Unless those regulatory provisions which are eliminated in order to liberalize contributed nothing at all to the advancement of the stated social (economic or noneconomic) objective, liberalization will tend to damage or injure this objective. It is not unreasonable to suspect, therefore, that the concept of injury, a necessary condition for invoking contingent trade policy against both "fairly" and "unfairly" traded products, may be broadened in the services context to include any threat to the stated social objective.

In the likely event that the injury concept is broadened in this manner, there will now tend to be two groups who are eager to demonstrate that foreign trade practices have caused injury: the domestic import-competing industry and those groups whose interests are tied to the advancement of the social objective. These may include consumer interest groups and professional associations, in addition to the regulators empowered to oversee the service industry under scrutiny. A broadening of the concept of injury, therefore, may introduce additional interest groups in favour of re-regulation and protection. A coalition between such groups and the import-competing service industry is likely to produce a formidable lobby seeking intervention.

The implication of the foregoing is that the existence of accessible contingent trade policy instruments may lead to a weakening and perhaps the de facto demise of liberalization efforts. This is not just a theoretical issue. Safeguard clauses are part of the European Community financial liberalization exercise. As noted by Grilli (1989), the EC

directive establishing deadlines for abolishing restrictions on intra-EC capital movements allows member states to take emergency protective actions in cases where serious disturbances arise with respect to monetary and exchange rate polices. Thus, the injury concept is already broader than in the merchandise trade area. As noted earlier, pressures in the United States to deal with both "unfair" import competition and market access restrictions in financial services have also been mounting.[15]

It might be argued that contingent protection is expected to be temporary and that such episodes mark only short-lived setbacks, not permanent obstacles to liberalization. But intervention, even if purportedly temporary, tends to be difficult to abolish once imposed. This has been the experience in such sectors such as steel, textiles, and automobiles, and there is no reason to believe this experience will not be repeated in financial services. Indeed, events in the EC support this conclusion. Early efforts to liberalize financial markets under the Treaty of Rome witnessed long-lasting suspensions of liberalization as a result of the safeguard clauses (Grilli, 1989, p. 315). Hence, the intent to allow for temporary suspension of liberalization has been met repeatedly (in goods and services) by unintended setbacks of significant duration.

4. Alternative Policies for Financial Services

An extensive literature exists which argues that the optimal trade policy in most circumstances is no trade policy, i.e., free trade. While there exist conditions under which restraints on trade improve welfare, these conditions are rather restrictive. Once allowance is made for the dynamic costs of protection, for the costs of rent-seeking and lobbying activities, as well as retaliation by trading partners, the no-intervention-in-trade recommendation is quite robust. Similar arguments apply to trade in services. However, in the services context it is by no means clear what should be understood by the term liberalization. Many of the rules and restrictions that inhibit market contestability may be

---

[15]Hale (1990), Dunne (1990), The Economist (1990).

justifiable, in that they increase welfare. It is therefore impossible to equate "free trade" with the abolishment of all regulations. Indeed, it is not clear that free trade in financial services is implied even under a policy of market access and national treatment, if this implies identical treatment of foreign and domestic firms. Because the same set of regulations might impose nonidentical costs on foreign and domestic firms, identical treatment may not imply "effective" national treatment.

As emphasized by Porter (1990), national policies are playing an increasingly important role in creating competitive advantages for domestically established firms. The key element of such policies should be to create an environment that fosters competition, as rivalry tends to induce innovation and productivity growth. The question is then to determine "optimal" regulatory rules. As far as financial services are concerned, the basic pillars should be antitrust policy to maintain competition, standard setting to deal with market failure specific to financial services (primarily information asymmetries), and market access for foreign providers. All of these elements are of equal importance. The first and third will ensure the existence of competition, while the second addresses potential sources of market failure. The deposit-taking and payments functions of many financial institutions may require them to be subject to regulations concerning liquidity and solvency. In the absence of such rules, individual depositors will usually find it difficult to determine the reliability of varying institutions. Also, because the financial system is an interlocked whole, rules are required to safeguard the payments system. What precise rules should be imposed is an issue that goes beyond the scope of this paper. In general, it is likely that the process of arriving at "optimal" rules will be a continuous one, given technological developments. It is crucial, however, that rules be neutral across institutions, i.e., they should apply to specific financial activities or functions, independent of who performs them.[16]

---

[16]As is well known, one of the problems that has emerged in many countries is that similar financial services have come to be offered by different types of institutions that are subject to different regulations, thus biasing competitive opportunities.

Those promoting unilateral liberalization often regard the existence of instruments of contingent trade intervention as necessary in order to make the policy politically feasible. But feasibility only requires that there be procedures for those who gain to compensate those who lose. Doing this through contingent trade policy is extremely inefficient, both ex ante and ex post. Ex ante inefficiency occurs because the prospect of protection will bias production decisions of firms, implying that the expected efficiency gains associated with free trade may never be realized in full as long as this prospect is in place. In other words, the existence of instruments of contingent intervention will reduce the credibility of the liberalization program. In an ex post sense such policies are a costly means of redistribution as they distort both production and consumption decisions. Given a politically determined need to compensate those who lose from increased market contestability, what is required is that instruments are used that have minimal distortionary effects. One such instrument may be income support, financed by a lump sum tax on those who gain.

While there may be a need to facilitate adaptation to a more competitive environment, the "optimal" contingent trade policy is to have no such policy. To the extent that foreign subsidization has a negative impact on domestic firms, or that there are restrictions on foreign market access, the only efficient solution is to attempt to reach a multilateral agreement with adequate enforcement. This is also the case for issues such as safeguarding the operation of the global payments system, as this can be argued to be an international public good. However, if the experience of the last decade is any guide, even if multilateral agreements are not achieved, it can be expected that over time examples of unilateral liberalization will be followed by other major traders, as the costs and benefits of alternative trade policy strategies become clear. The EC financial liberalization project is a case in point, as it has fostered a re-evaluation of regulatory policies in the United States.

5. Concluding Remarks

Increased competition by foreign firms causes adjustment pressures, and such pressure is clearly going to mount in many industrialized countries as the EC 1992 programme is implemented and Japanese financial markets are liberalized further. In the context of merchandise trade (tangible products), liberalization has gone hand in hand with the creation of procedures that allow domestic import-competing firms to re-gain protection. Access to such instruments of contingent trade policy – which include antidumping, countervailing, and safeguard or emergency protection actions, as well as market sharing arrangements that are tolerated by the domestic authorities – have been justified as being politically necessary to assuage those interests initially opposed to liberalization. But such policies may themselves impede the liberalization process de facto, even if it appears to be underway de jure.

If contingent trade policy instruments are applied to financial services, this can only reduce the credibility of a liberalization program. Similar considerations pertain to the invocation of Section 301-type actions insofar as they lead to greater managed trade in financial services (Hale, 1990). The danger of this occurring is not negligible. While ostensibly aimed at liberalization, the parties involved in bilateral market access discussions have little incentive to allow "free riding." The goal of policymakers should be to foster the global competitiveness of financial institutions. As noted by Porter (1990), this requires vigorous domestic competition, which can be assured by enforcement of appropriate antitrust rules, while granting all foreign firms access to the domestic market. While unilateral liberalization without the availability of contingent trade policies will ensure that expected gains are not reversed, it would, of course, be preferable that domestic firms also benefit from a reduction in foreign distortions, especially restrictions on market access. There will always be actions by foreign governments that impact negatively on domestic competing firms, but such actions are likely to be of second order importance, given a competitive environment in the domestic economy.

As competitive pressures mount, rational financial firms will attempt to avail themselves of all accessible contingent trade policy instruments. The central theme of this essay is that if a program of financial market liberalization is accompanied by accessible and manageable trade policy instruments the liberalization process may not proceed de facto. If the objective is indeed liberalization, the best contingent trade policy is to have no such policy.

References

Bhagwati, Jagdish. 1988. *Protectionism.* Cambridge, MA: MIT Press.

Bureau of National Affairs. *International Trade Reporter.* September 13, 1989 and January 17, 1990.

Curzon, Gerard and Victoria Curzon. 1989. "Non-discrimination and the Rise of 'Material' Reciprocity," *The World Economy*, 12,481–99.

Deardorff, Alan and Robert Stern. 1987. "Current Issues in Trade Policy: An Overview," in Robert Stern (ed.), *U.S. Trade Polices in a Changing World Economy.* Cambridge, MA.: MIT Press.

Dunne, Nancy. 1990. "Japan accused of bank "dumping" in U.S.," *Financial Times*, May 18.

The Economist. 1990. "A Survey of International Banking," April 7.

General Agreement on Tariffs and Trade. *International Trade, 1988–89.* Geneva: GATT.

Grilli, Vittorio. 1989. "Financial Markets and 1992," *Brookings Papers on Economic Activity*, 2, 301–24.

Hale, David. 1990. "Global Finance and the Retreat to Managed Trade," *Harvard Business Review*, (January-February), 150–62.

Hoekman, Bernard and Michael Leidy. 1989. "Dumping, Antidumping, and Emergency Protection," *Journal of World Trade*, 23, (October), 27–44.

Hoekman, Bernard and Michael Leidy. 1991. "Antidumping for Services?," in P.K.M. Tharakan (ed.), *Policy Implications of Antidumping Measures.* Amsterdam: North Holland.

Jackson, John H. 1989. *The World Trading System: Law and Policy of International Economic Relations.* Cambridge, MA.: MIT Press.

Messerlin, Patrick. 1989. "The European Community Antidumping Regulations: A First Economic Appraisal, 1980–85," *Weltwirtschaftliches Archiv*, 125, 563–87.

Messerlin, Patrick and Karl Sauvant (eds.). 1990. *The Uruguay Round: Services in the World Economy.* Washington D.C.: The World Bank and United Nations Center for Transnational Corporations.

Montagnon, Peter. 1990. "US services sector urges White House to retain right to sanctions," *Financial Times*, May 10.

Organisation for Economic Cooperation and Development. 1989. *Predatory Pricing.* Paris: OECD.

Porter, Michael. 1990. "The Competitive Advantage of Nations," *Harvard Business Review*, (March-April), 73–95.

Sampson, Gary and Richard Snape. 1985. "Identifying the Issues in Trade in Services,

The World Economy, 8, 171–81.

Stern, Robert and Bernard Hoekman. 1988. "The Service Sector in Economic Structure and in International Transactions," in Leslie Castle and Christopher Findlay (eds.), *Pacific Trade in Services*. London: Allen & Unwin, 19–63.

Walter, Ingo. 1988. *Global Competition in Financial Services: Market Structure, Protection, and Trade Liberalization*. Cambridge, MA.: Ballinger Press.

Walter, Ingo. 1990. "European Financial Integration and Its Implications for the United States," Working Paper No. 90/22/FIN, Paris: INSEAD.

DEMCO