Business as Usual?

How Free Trade in Financial Services Works Against Public Interests and Jeopardises Financial Sector Reform

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The recent financial crisis resulted in a wide-ranging reform agenda in the EU and other countries, which recognised the need for re-regulating the financial sector and reversing financial liberalisation. However, little attention has been paid to the pre-crisis model still being used in continued negotiations on the General Agreement on Trade in Services (GATS) and other Free Trade Agreements (FTAs). These negotiations not only further liberalise trade and investment in a wide range of financial services, including destabilising derivative trading, but also are in conflict with many new financial reforms which countries are undertaking. This is illustrated in this paper with specific examples of new or proposed EU financial regulations that could be challenged by GATS rules as well as rules in the EU's Economic Partnership Agreement (EPA) with Cariforum states and the EU's FTA with South Korea (still to be ratified). This discussion paper aims to raise the public and political debate about the dynamics of continued financial services liberalisation, which have been discouraged by the technical nature of the issue and the lack of transparency of the decision-making. It is argued here that GATS and FTAs should not contribute to financial instability nor promote the interests of the financial sector itself, but rather serve the economy at large as well as the public good.
Comments on this discussion paper are welcome (see colophon for contact information).

After the financial crisis erupted in 2008, agreements were made at many high level meetings to introduce new regulations in the financial sector. At the same time, political and industry leaders called for bringing the stalled negotiations in the World Trade Organisation (WTO) to conclusion and were hailing free trade as a vital ingredient to economic recovery. However, free trade agreements include liberalisation of financial services. In this context, the UN Commission of Experts on the global economic and financial crisis, chaired by Professor Stiglitz stated that: *"The framework for financial market liberalisation under the Financial Services Agreement of the General Agreement on Trade in Services (GATS) under* *the WTO and, even more, similar provisions in bilateral trade agreements may restrict the ability of governments to change the regulatory structure in ways which support financial stability, economic growth, and the welfare of vulnerable consumers and investors"'*[1]

Liberalisation of financial services based on a discredited model

While the need for stronger global financial regulation is widely acknowledged, the Secretariat of the WTO continues to claim that the causes of the financial crisis cannot be attributed in any way to the liberalisation of trade in services.[2] At least it needs to be recognised that GATS promoted the spreading of risky financial products and operators, and increased international competition which resulted in more risky behaviour and made governments support a laissez faire regulatory environment to enable the financial industry to become more competitive (and make big profits, seen as contributing to GDP and economic growth). As explained in this paper, this model of so called 'light touch' regulation was integrated in on financial services liberalisation through GATS and FTAs agreed by the EU, which underpinned the dynamics, the structures and thinking that ultimately led to the financial crisis. Although many questions and concerns about deregulation and financial liberalisation have been raised since the financial crisis fully erupted in 2008, the current path of GATS and FTA negotiations continues to follow the pre-crisis model.

Dangers of liberalisation before sufficient regulation and supervision

The global financial and economic crisis has revealed the dangers of a globalised and liberalised financial market without adequate regulatory and supervisory systems in place at equivalent levels. Research has indicated how in the past inadequate regulation and lack of supervision at the time of financial liberalisation is closely entwined with banking crises.[3] GATS and FTA rules to liberalise financial services integrate the assumption stated by negotiators that it is not necessary to regulate before you liberalise, and that 'more regulation comes along with liberalisation'. However, the current GATS negotiations and the new EU FTAs with South Korea and Cariforum continue financial sector liberalisation in the same way as before the crisis, while the global and EU financial reforms have hardly reached the point of agreement, let alone become operational.

Financial services as a public good or designed to serve the interest of the rich?

The lack of attention for adequate regulation and supervision results from the fact that GATS and FTA rules are largely based on lobby interests of the financial and other services industry.[4] Stricter regulation and supervision was argued to be an unnecessary cost that would, moreover, make the financial industry less competitive and innovative, and inefficient. For instance when a government would have prevented banks from becoming too big to fail, this would have been seen as not allowing banks to become competitive enough (through economies of scale and larger profits). The fierce international competition to which GATS contributed made national regulators and supervisors reluctant to curtail their financial industries through (international) regulations. In addition, negotiators were lobbied to liberalise many risky, opaque and innovative instruments which were very profitable for the industry but risked financial stability and ultimately damaged the economy and citizens world wide.

The fierce international competition made (international) banks increasingly focus on serving the most profitable clients and providing poorer clients with no, fewer or increasingly expensive financial services. Countries that liberalised financial services, especially in developing countries, also experienced negative impacts on their general economic and public interests. In the agriculture sector, foreign banks in developing countries have hardly been financing small farmers nor are they interested in providing services in the rural areas. In the industrial sector, foreign banks have been reluctant to provide credit to smaller local companies or the domestic industry as a whole – even more so in times of crisis, which leads to less finance for trade and reduced competitiveness of the domestic industry. Foreign banks have the capacity to finance large companies and projects that can damage the environment and contribute to climate change.[5]

Rethinking Liberalisation of Banking Services under the India-EU Free Trade Agreement[6]
An analysis of the performance of EU banks in India as compared to the developmental needs of the un-banked and underbanked regions and groups of people in India, provides an insight into the possible winners and losers of liberalisation of financial services in a future free trade agreement between the European Union (EU) and India.[7] Several trends were revealed, including: a dramatic decline in rural and agriculture credit, small business loans, and services to poor clients. Conversely, foreign banks, as well as big domestic private banks competing with them, have specifically been targeting wealthy and affluent customers. The financial and economic crisis has highlighted the fact that liberalised and deregulated financial services have damaging effects on a country, and has reinforced rather than mitigated current negative trends in India.

By now, it is widely acknowledged that financial stability is an important public good. The huge bailouts by governments of banks and risky, even speculative operators indicate how the financial industry has serious impacts on the economy and society as a whole. This could lead to a formal recognition that the financial sector must serve the public interest and contribute to a sustainable and equitable society – a concept not integrated in GATS and FTAs. The enormous financial and economic costs of rescuing the financial sectors, with amounts that could have saved millions from poverty and hunger, means that all possible measures should be taken to avoid making the same mistakes.

Too technocratic decision making on financial services liberalisation

Public and political debates to defend the public interest and integrate the lessons of the financial crisis are currently missing in the GATS and FTA negotiations that aim to liberalise financial services. The complex and technical nature of the issues at stake, which are discussed during non-transparent negotiations, and lack of appropriate knowledge by the public and politicians about the consequences, hinders the indispensable public debate. Even for trade lawyers the issues are very difficult to understand, and 'almost impenetrable for human rights lawyers or domestic policy makers'.[8] As there is much at stake for the public interest, this is very problematic in itself. This has allowed the strong and resourceful lobby of the financial industry to continue to convince negotiators to establish liberalisation of financial services as one of the priorities in the current GATS and FTA negotiations, without changing the rules, taking into account the effects of the financial crisis or the need to re-regulate financial markets.

How GATS and FTAs contradict the EU's financial reforms

The manner in which the GATS and FTAs continue to liberalise financial services has far reaching consequences for how the financial sector can be regulated and whether it can be reformed. This chapter provides a brief overview of the main issues at stake when GATS and FTAs are specifically applied on financial services. The following sections give some examples of how GATS and EU FTAs with South Korea and the Cariforum, contravene reforms that the EU is introducing to avoid a new financial crisis.
It is important to note here that the GATS and the EU FTAs with South Korea and the Cariforum cover a comprehensive and diverse

range of financial services in banking, insurance, trading in all kind of financial products, asset management and financial advice. Trade in those financial services not only refers to a financial product crossing the border, e.g. cross-border internet banking, or the crossing of the border by a financial person, e.g. manager of a foreign bank. It also allows banks and other financial services providers to establish themselves in the host country from where they offer their financial services. In other words, all free trade agreements in financial services are also investment agreements in financial services.

Why liberalisation leads to deregulation

Liberalisation of financial services does not remove tariffs as is the case when liberalising goods. Within the GATS and EU FTAs, regulations of financial services are considered to be barriers to trade and are tackled as follows:

- **'Scheduling' financial services**

Firstly, each member country of GATS and EU FTAs agrees to open up its markets to those particular financial services products, providers and 'modes' of trade from other members, as is listed in its country 'schedule' attached to the agreement.[9] Such a schedule means among others that the listed financial sub-sectors cannot be banned any more, except if other parties to the agreement are provided with compensation for potential losses of profits if they so request. Most EU member states have liberalised to varying degrees many financial products which the financial crisis has shown to be risky, enhancing instability and excessively speculative, such as hedge funds, over the counter (OTC) derivative trading, speculation in food commodities, investment banking and credit rating agencies.[10] EU financial reforms that would limit or prohibit those risky financial services and providers would become very costly if the EU's trading partners would ask for compensation – a serious deterrent for financial reform.

The high level of liberalisation of EU member states is due to their adherence to the GATS Understanding on Commitments in Financial Services, an optional GATS protocol fostering the most extensive liberalisation possible.[11] The level of liberalisation of financial services is high in the Korea and Cariforum[12] FTAs as a result of GATS Art. V that compels FTAs to substantially cover all sectors. The EU has been insisting that up to 80% of all services sectors are covered and that financial services are included.

- **'Deregulation'**

Secondly, GATS and FTAs consider many regulations, laws, measures, qualitative requirements and administrative decisions (e.g. authorisation to a foreign bank to open new branches) by the host country as barriers to trade. Consequently, the texts of GATS and FTAs contain articles and rules that restrict or even prohibit particular regulations from being implemented in the financial sector. Signatory countries have to respect those restrictive rules for those financial sub-sectors that they have scheduled except if they have made exemptions. Otherwise, they risk a costly WTO or FTA dispute settlement. The sections below explain how those so-called GATS and FTA 'disciplines' on regulation form a central drive towards deregulation as they limit the state's ability to regulate financial services. Further, it is shown how financial regulations and reforms can only marginally be exempted or safeguarded from such deregulation by special prudential rules.

- **Non-discrimination**

Thirdly, GATS and FTAs liberalise the scheduled financial sectors, which are subject to the agreement, by removing host country measures that discriminate between domestic and foreign financial services ('national treatment' or NT) and discriminate among foreign financial services ('most favoured nation treatment' or MFN). The GATS (Art. XVII and the Understanding), and similar EU FTA rules, also prohibit or try to limit non-discriminate measures that favour the competitiveness of financial services or service suppliers of the host country and prevent those from other countries from entering and competing.

This latter specification suggests the agreements' incompatibility with bank rescue measures. Such bail outs by EU member states were benefiting, or gave competitive advantage to their domestic financial industry over those banks from countries that could not pay for bank bail outs. Since this resulted in less ability of third country banks to enter EU member states' financial sector markets to replace non-competitive and shaky banks, such bail outs contradicted GATS Art. XVII.

Prohibitions on how to regulate the financial sector and introduce bans

Some of the most far-reaching obligations that restrict regulation in the financial sub sectors committed in the schedules are the 'market access' rules which are identical in GATS (Art. XVI) and EU FTAs. They prohibit signatory countries to maintain, amend or adopt many measures and regulations in the financial sector, and require:

- no measures that limit the number of financial service suppliers e.g. the number of bank branches;
- no restrictions on the total value of financial transactions or assets;
- no limitations on the total number or the total quantity of financial service operations;
- no 'economic needs test' assessing whether a financial service is needed;
- no measures which restrict or require specific types of legal entity of financial providers, including joint ventures;
- no limitation on foreign ownership of financial services providers, i.e. full mergers and acquisitions have to be allowed.

Only if countries have written explicit exemptions of these market access rules in their GATS or FTA schedules related to their financial sector commitments, they are not obliged to respect these rules.

These market access rules contradict many of the EU's financial reform proposals that are based on lessons from the recent financial crisis and aim at restricting unlimited financial products and financial operators. Below are some examples that are related to financial services which the EU has liberalised under GATS and FTAs:

- The EU wants to limit the use of too many loans by hedge funds and private equity to finance their investments (a 'leverage ratio') under the forthcoming directive on Alternative Investment Funds Managers (AIFMD).[13] Some of the proposals to do so could be in breach of the market access rule that prohibits 'limitations on the total value of service transactions or assets in the form of numerical quotas or economic needs tests'.

- The EU is considering limiting trading in OTC derivatives because their risky and speculative nature, and lack of transparency, has been shown to aggravate financial crises and even food price crises, maybe even causing them.[14] The European Commission (EC) favours to make clearing[15] of OTC derivative trading mandatory and ensure that more derivative contracts are traded through exchanges. Such a measure could be considered to be contrary to the prohibition to restrict or require specific types of legal entity through which a service supplier may supply a service (see GATS Art. XVI. (e)). Also, potential limits on how much speculators can trade in commodity derivatives, would be against the GATS and FTA prohibitions to limit the total number of services operations or on the total quantity of services expressed through quotas.

- Given the financial turmoil in 2010 on the EU's financial markets, more regulations are still to be expected to limit or prohibit risky financial products and operators. Also, some fundamental solutions still need to be taken such as prohibiting banks from becoming too big to fail, for instance by limiting the size of individual financial firms and the volume of their transactions. All such limiting measures or prohibitions would be in breach of GATS and FTA market access rules since a non-discriminatory ban on a listed product was considered a 'quota of zero' by the WTO Appellate Body.[16]

How domestic regulation rather than the financial sector is being disciplined

Without exception, the GATS rule on domestic regulation (Art. VI), and similar rules in recent EU FTAs[17], result in particular disciplines that apply regarding all the financial products and providers which countries have committed to liberalise in their schedules.

First, the GATS and EU FTA rules on domestic regulation stipulate how authorities take, and remedy, administrative measures or authorisation procedures. Second, qualification procedures, technical standards and licensing requirements in the financial sector should not undermine commitments. They need to meet stringent conditions, such as not being more burdensome than necessary, not be unforeseen, and being based on 'objective' and transparent criteria. Licensing procedures should not in themselves constitute a restriction on the supply of the service (GATS Art. VI.4.(c)). Current GATS negotiations under the Doha Round are further defining these disciplines and some WTO members want strict criteria to avoid protectionist measures, e.g. by introducing a test whether standards, qualification and licensing measures are necessary. If applied in the future to scheduled financial services sectors, draft negotiation texts indicate that (new) financial qualifications and standards could be challenged in the WTO dispute settlement on a variety of grounds, such as being not 'objective', 'relevant', or acting as a disguised restriction on trade. Also, licensing procedures for banks would have to be made 'as simple as possible'.[18]

These restrictions on domestic regulation contrast with the lessons from the financial crisis that have shown that 'light touch' regulation in the financial sector results in financial crises and that preventive regulations are needed against the many risks in this sector, even if they might seem 'more burdensome than necessary for the quality of the service' or unnecessary barriers to trade.

- In the EU, a new legislation on Credit Rating Agencies (CRAs) imposes all kind of new qualification requirements (e.g. on rating methodology) and prohibits that CRAs continue to provide advisory services in order to avoid wrong assessments of risks as CRAs did with sub-prime mortgage securitisation products which were bought by European banks, resulting in the financial crisis erupting in the EU in 2008. This new CRAs legislation contravenes GATS Art. VI.5 because it undermines EU commitments in financial advisory services and 'could not have been expected by a country at the time commitments were made'. Indeed, CRAs had remained unregulated in the past and Central Bankers officially accepted that their unregulated ratings were used by banks to make risks assessments.[19]

- The GATS Understanding on Commitments in Financial Services also has important implications for the EU's new financial regulations. For instance, the Understanding contains a standstill clause (Art. A) which prohibits any new limiting and qualifying measures which would contradict commitments and rules under the Understanding. This standstill clause goes against the grain of some possible new EU financial regulations such as banning short selling by hedge funds and private equity funds as proposed by the European Parliament.[20] Such a ban would be contrary to Understanding's requirement of efforts by the EU to curb non-discriminatory measures that limit the expansion of the activities of financial service suppliers its territory. The Understanding's restrictive rules could also contradict other new EU financial regulation. For instance, the Understanding also requires efforts not to take 'other measures' that, although respecting the provisions of the GATS, affect adversely the ability of financial service suppliers of any other Member to operate, compete or enter the Member's market.

The EU-Korea FTA and the Cariforum-EU EPA contain a separate chapter on the 'regulatory framework' which specifies domestic regulation in general and financial services in particular. This chapter in each FTA is different and includes disciplinary elements of GATS rules, new domestic regulation disciplines which are not yet decided during the current GATS negotiations, elements of the GATS Understanding, and new disciplines that are not included in the GATS.

Examples on how elements of the regulatory framework in FTAs affect regulation in scheduled financial sectors are:

- In the Cariforum-EU EPA, the signatory countries have to make an effort to provide information about proposed regulations or measures to interested persons to allow them to comment on the proposals before they are finalised. Similar procedures are being proposed but not agreed in the current GATS domestic regulation negotiations.[21] Such procedures not only impose a huge burden on any state, but also furnish resourceful international financial operators with the right to be heard which increases the chances of their lobby successfully bending new regulations to their interests in an undemocratic way in the host countries. This kind of lobby -called 'regulatory capture'- in the past has led to the deregulation of the financial sector, and has been recognised as a major cause of the financial crisis.[22]

- The EU and South Korea agreed[23] to implement, where practicable, internationally agreed standards for financial regulation and supervision, and for the battle against tax evasion - a clause which is not included in the GATS. Quite a few of these standards are mentioned in the FTA, including the Core Principles for Effective Banking Supervision of the Basel Committee on Banking Supervision (Basel II) and the Statement on Transparency and Exchange of Information for Tax Purposes of the G20. However, the Cariforum states had rejected such mentioning of specific international standards because they argue that some of these international standards are not appropriate for their domestic circumstances.[24] Also, Cariforum states have no say in many of these so-called 'international financial standard setting bodies'.[25]

The EU-Korea FTA (Art. 7.23.3) seems to consider the GATS rule on domestic regulation that standards and licensing etc. should be 'not more burdensome than necessary' inappropriate to deal with the kind of financial crises Asia and Europe already had to deal with. This controversial obligation is omitted from the FTA. The Cariforum-EU EPA has omitted any requirements regarding standards and licensing.

Prudential regulations in the financial sector hardly protected

Notwithstanding the above rules, the GATS Annex on financial services and the FTA sub-sections on the regulatory framework in financial services recognise that signatory countries can take prudential measures to ensure the integrity and stability of the financial system and to protect investors, depositors or clients of a financial service supplier. However, the GATS Annex and the EU-Korea FTA specify that prudential measures that are not compatible with other provisions in the agreements shall not be used to avoid commitments or obligations under the agreement. As explained above, those commitments and obligations include applying market access, domestic regulation rules and the 'Understanding', which restrict prudential regulations in liberalised financial services, and even prevent withdrawing liberalisation commitments.

The WTO Secretariat[26], quite some WTO members and GATS proponents assume that all new financial reforms are a priori allowed under the Annex in Financial Services, which they call a 'prudential carve-out.' However, the formulation of GATS Annex on prudential measures results in many uncertainties and an increasing number of concerns by international lawyers and critics on how new financial reforms are protected against GATS rules. What constitutes a prudential measure is not defined and indeed some WTO members have insisted on a tighter definition of its permissible scope, while others prefer to keep the current broad and undefined formulation to allow more policy space.[27] It needs to be noted that during the GATS negotiations, draft texts that were much more protective of governments' rights to apply prudential regulations were not adopted.[28] Also, the standard WTO formulation to carve out measures from WTO dispute settlement, e.g. GATT Art. XX and GATS Art. XIV, is not used in the GATS annex and FTAs. This means that prudential measures can be brought before a WTO dispute settlement panel, which undermines the priority to be given to the stability of the financial system and even the economy, and could deter new prudential regulation. Only when members abstain from such dispute settlement, will prudential regulation not be challenged. So far, there is no guarantee that a prudential measure will not be challenged by a GATS or FTA signatory country.

The uncertainty about what measures, taken by individual WTO members or FTA signatories, are 'prudential' or not, has already arisen regarding a ban on naked short selling. Germany has already implemented such bans temporarily and intends to legislate[29] a ban on naked short selling in particular bonds and shares as a prudential measure to protect investors and increase the stability of the financial system. However, this ban has already been attacked by some[30] as not being prudential (since the German ban in Spring 2010 sharply increased volatility on the financial markets), being in contravention of Germany's market access commitments and protecting German banks from being taken over.

The WTO Secretariat claims[31] that in case of a WTO dispute settlement procedure, the Annex would provide a defence to prove that a challenged prudential measure is not taken to abuse commitments and obligations. Since no prudential measure has yet been tested in a dispute settlement, it remains very uncertain and very debatable which measures are prudential and which are protectionist, discriminatory or otherwise going against commitments and obligations.
Some examples are:

- Discriminatory regulations can be prudential, e.g. if a host country wants to diversify the countries of origin of the foreign banks operating in its country, in order to avoid that too many banks are in trouble when the dominant home country is in financial crisis. However, when a country would consequently reject banks from particular countries, this would contravene the GATS MFN rule, as well as the market access rule that prohibits 'limitations on the participation of foreign capital' (see GATS rule Art. XVI.2.f).

- The current international discussions on financial reform (such as in the Basel Committee and the G-20) show that under the disguise of prudential regulation, countries and even regulators or supervisors aim to protect the financial industry of their countries – or what is perceived as their countries' interests – while others consider those measures against 'their' interests. Already before the financial crisis many so-called prudential measures were taken to promote the domestic industry while these measures caused financial instability and ultimately the financial crisis. Accordingly, there are many different interpretations of when a measure is 'discriminatory' and promoting the competitiveness of the domestic financial industry, as forbidden by GATS Art. XVII, and when a measure is 'prudential'.

- There seems to be no guarantee that prudential measures can be taken which do not particularly protect clients or the stability of the financial system, but do protect particular groups in society. If the EU would introduce, in similar ways as the US new financial reform act or beyond, limits on speculative trading in food commodity derivative markets through quantitative limits or even bans on speculators and speculative products, this would be considered to contravene its GATS commitments on derivative trading and other GATS obligations. Such measures would not be taken to avoid instability of the financial system because trading in food commodity derivatives is relative small.[32] The EU's argument that it would avoid too high or volatile food prices that resulted in more hunger for the poor as in 2008[33] would be denied by derivative traders and proponents who argue, contrary to other experts, that there is no link between food price spikes and derivative trading. Thus, even the general exception in GATS Art. XIV and FTAs to allow measures necessary to protect human life and health, could hardly be used. This raises the question whether banning committed financial products which are considered as 'socially useless' would be allowed.

The EU-Korea FTA adds an obligation that prudential measures shall not be more burdensome than necessary to achieve their aim. This can result in a challenge to prudential regulations by the EU and South Korea to prove that prudential measures are the least trade restrictive option available and really necessary to protect consumers or the stability of the financial system. The Cariforum-EU EPA has omitted this additional obligation which prevents the signatory countries from challenging and undermining many financial reforms.

Introducing new services or avoiding more risks?

The EU and other WTO members that have subscribed to the GATS Understanding on Commitments in Financial Services have agreed (paragraph 7) to permit 'any new financial service' by any other WTO Member, as long as the new financial service is supplied in another WTO country and the provider is established in their territory (and the Understanding also guarantees the right of establishment (paragraph 5 & 6)).

This provision contrasts with the current knowledge that new and innovative financial services can be very risky and trigger a financial crisis, as was the case of the US collateralised debt obligations (CDOs) of sub-prime mortgages, which were sold in the EU.

The riskiness of such a provision seems to have been recognised in the FTAs negotiated by the EU with the Cariforum[34] and South Korea.[35] The respective articles on how to treat new financial services by foreign financial service providers include additional prudential safeguards as compared to the Understanding. Although this article in the Cariforum-EU EPA (Art. 106) applies not only to financial services providers established in the country but to any mode of supply which is scheduled, the new financial service must be similar to those services that a signatory host country permits its own financial service suppliers to provide. The EU-Korea FTA defines a new financial service almost in the same way as in the GATS Understanding, except that the new services has to be already offered in the home country. However, the text adds 'provided that the introduction of the new financial service does not require a new law or modification of an existing law'. In addition, under both FTAs, the signatory countries have the right to determine the juridical form of, and to require authorisation for, new financial services. Such authorisation needs to be reasonable and can only be refused for prudential reasons.

Many restrictions on controls on cross border capital and currency flows

In addition to specific financial services rules, GATS and EU FTAs have general rules that guarantee freedom of capital movement in order to ensure full international operation of the liberalised service and profit repatriation, among others.[36] Financial services and their providers can move huge amounts of capital across borders, for instance to invest for clients abroad or for speculative currency trade. Large cross-border capital movements can negatively impact on the value of exchange rates and the monetary and financial stability policies of governments, especially in developing countries.

The GATS (Art. XI) prohibits restrictions on international payments for current transactions related to all financial services (sub)sectors listed in the schedules. This Art. XI is an 'indispensable' GATS discipline according to a WTO dispute settlement panel.[37] In addition,[38] a country must permit inflows and outflows of capital related to listed cross border financial services trade and permit capital inflows 'related' to listed financial sectors in which it allowed commercial presence. In case of serious (upcoming) balance of payment problems (Art. XII), a country can restrict cross-border money transactions and commitments but only when it fulfils fifteen restraining conditions and criteria, such as: being temporary and non-discriminative, not being more excessive than what is needed and not causing unnecessary damage to commercial or economic interests of other WTO members. The so-called prudential carve out is not likely to be used to justify capital flow restrictions.[39]

Even less restrictions on capital movements are possible in the FTAs concluded by the EU with Cariforum and South Korea, from which financial services providers can greatly benefit. All legal current payments between residents of the contracting parties have to be allowed. No restrictions are allowed to capital transfers related to all legal and scheduled direct foreign investments, including repatriation of the investments themselves. This also applies to credit and loans by all investors, and portfolio investment[40] in the EU-Korea FTA. Only in 'exceptional' circumstances when exchange rate and monetary policies are in 'serious' difficulties can measures be taken, which are strictly necessary, for not more than six months, according to both FTAs. The EU-Korea FTA stipulates even more restrictive conditions than GATS to be fulfilled before implementation of such exchange rate policies is allowed.

This ever growing freedom of capital movements in FTAs contrasts with the increasing official arguments, even by the IMF[41], in favour of using capital and currency controls, especially in times of financial crisis and huge speculation. It also contrasts with different forms to control capital moves by foreign investors recently introduced by Brazil, Taiwan and Indonesia. Examples of how new anti-crisis measures contradict FTA and GATS rules are:

- EU leaders endorsed in mid June 2010 the introduction of a bank levy and a tax on financial transactions that could compensate losses due to bank failures, increase government income and restrain volatility in financial markets. However, the EC has expressed doubts whether a tax on financial transactions would be compatible with GATS Art. XI. This indicates how restrictively GATS or FTA rules could be interpreted as there are no clear definitions and experts disagree on whether transaction taxes are defined as restrictions on international transfers.[42]

- In June 2010, South Korea curbed cross border capital flows by setting limits on currency derivative trading and bank loans in foreign currency.[43] These measures are in breach of the EU-Korea FTA rules on capital movements related to derivative trading, which South Korea has liberalised. The FTA prohibits currency restrictions that are not strictly necessary for exchange rate policy, not temporarily, and not taken in exceptional circumstances. South Korea does not fulfil these conditions because the measures prevent long term exchange rate problems and overly volatile or expensive currencies that damage its exports. The currency and capital controls aim of avoiding asset bubbles in the future by preventing short term cross border flows.

Continued negotiations and new EU investment mandate

GATS continue risky negotiations

EU politicians and negotiators still fail to recognise that liberalising financial services based on the pre-crisis deregulatory model contradicts with the re-regulation agenda of the EU, and many other countries, whose perspective on how the financial sector actually works have changed after the recent financial crisis.

They continue to call for an end to the WTO and GATS negotiations. EU negotiators have continued to require more market access for financial services during GATS negotiations in 2009 and 2010. The EU's negotiation mandate on financial services has not changed since the crisis. Nor has the EU withdrawn its requests tabled in 2002 to WTO members. These GATS negotiation requests for substantial market opening in financial services were factually serving to increase the international competitiveness of the EU's financial industry.[44] They incorporated demands to 'eliminate' particular prudential regulation that WTO members put in place after the 1997 financial crisis, and which are currently being considered as a remedy against future financial crisis, such as capital requirements. The most glaringly audacious case is the EU's requests to countries like Brazil, Chile and India to liberalise according to the GATS Understanding on Commitments in Financial Services with far-reaching liberalisation and deregulation clauses as explained above.

The WTO has a Committee on Trade in Financial Services and in this committee some developing countries have tried to discuss the legality of the bail outs in the financial sectors by developed countries, their impact on developing countries, as well as the policy space available under GATS to enact financial reforms. The discussions have been met with fierce resistance by the US, the EU, the WTO Secretariat and others. In February 2010, a WTO background paper refused to make a connection between the GATS rules and commitments on financial services, the global economic crisis and financial reforms.[45] The paper dodged many uncertainties raised by various international trade lawyers about the potential GATS challenges against new financial regulations. Any concerns about conflicts between financial reforms and GATS rules are being answered by the WTO Secretariat, the EU and some WTO members with the argument that the 'prudential carve-out' of the GATS Annex can always be used. At least, the fact that – based on that argument – most if not all new financial regulations that are being introduced would need to be exempted from GATS rules through the so-called 'prudential carve-out', indicates that something is seriously wrong with applying the current GATS model to financial services.

New FTAs and new EU mandate on investment

After concluding the FTAs with Cariforum and South Korea, the EU is undertaking many efforts to conclude new FTAs that include financial services liberalisation in the same way as before the financial crisis. This is not only the case with African countries (full EPAs), but also with Canada, and with Asian and Latin American countries whose markets are profitable to the EU financial industry.

Since December 2009, the EU collectively has the exclusive competence under the Lisbon Treaty to negotiate foreign direct investment agreements, which removes the competence of EU member states to negotiate bilateral investment treaties (BITs). Although the way in which this new EU mandate will be handled is still under debate, the EU is already trying to integrate more protection for foreign investors in current FTA negotiations with India and Canada. This could mean that investment in financial services sectors would also receive more far-reaching protection under FTAs in the same way as under BITs, among others through rules on fair and equitable treatment, full security and protection, protection and compensation in case of expropriation, and freedom of capital movements.[46] However, the EC is aware that under the EU Treaty, limitations on capital transfers relating to third countries can be imposed.[47]

Conclusions and recommendations

In 2010, the compatibility between new financial regulations and GATS have increasingly been questioned inside and outside the WTO, leaving many uncertainties whether prudential financial reform measures are subject to WTO and FTA dispute settlement. Experts' comments that Germany's ban on speculative naked short selling violates GATS commitments and EC's questioning whether the financial transaction tax can be justified under GATS article XI on free capital flow, are examples among many others of the contradictions presented in this paper.

Rather than integrating the lessons of the financial crisis, the GATS negotiations and EU FTAs continue to use and even reinforce the pre-crisis deregulatory model to liberalise financial services. Thus, any conclusion of GATS negotiations and new EU FTAs will continue to contribute to financial instability or undermine any financial reform. In addition, such liberalisation of financial services seriously limits the additional policy space needed to make the financial sector serve the interests of the economy and society.

Different proposals ranging from modest steps to more long term changes that are needed in the GATS and FTAs are:

Rolling back commitments

- Developing countries with comprehensive financial services liberalisation commitments that pose a risk to financial stability and their economy, should be allowed to withdraw their current GATS commitments without compensation. According to GATS article XXI this is possible if the EU and other WTO members do not request to be compensated for such withdrawal of commitments.
- Under FTAs already concluded by the EU, developing countries should be able to withdraw their financial services sectors commitments without compensation.
- If the EU, or any other developed country would like to withdraw their financial services commitments to allow essential financial reforms, they should compensate developing countries and not developed countries. The latter after all pushed the incorporation of the deregulatory model into services free trade agreements.
- No compensation should be offered or sought if withdrawal of commitments is fully based on (new) international financial standards established by international standard-setting bodies in which all members of the WTO (or relevant FTAs) have a say.

Prudential regulation to be fully applied and not abused

- Countries should be allowed to fully use their right to regulate and introduce prudential regulations that are not only based on widely accepted international standards, but also those needed given the circumstances in the country or resulting from democratic decisions and not from financial industry lobbying.
- A new external panel of independent supervisors and financial regulatory experts should be established to avoid that (new) financial and prudential regulations and withdrawal of commitments are abused to prevent the financial industry from developing countries to enter other WTO member markets. It would have to determine what are genuine financial prudential regulations, and what are abusive protective regulations. This panel could also be used to settle similar differences of view in the GATS (request and offer) negotiations, which currently take place behind closed doors between WTO members bilaterally.[48] In addition, this should be an alternative to demands by some WTO members to make the disciplines on domestic regulation stricter, which fails to protect the policy space for financial regulation in their home market.

No deal on Doha Round without new global financial reform

No Doha Deal nor any EU FTAs should be concluded which includes liberalisation of financial services and capital movement, until new global financial regulation and supervision, set by international standards setting bodies and the UN, have become operational. Also, lessons from the financial crisis that full trade liberalisation and unregulated free markets contain many risks and create economic crises, should reverse the non-interventionist approach in all free trade negotiations.

Financial services out of the GATS and FTAs

Financial services and free movement of capital should ultimately be taken out of GATS and FTAs. Regulating trade in financial services and capital movements should be integrated in global financial reforms and decided upon by much more democratic international financial and standard setting bodies. This flexibility should be used to reform the financial system that integrates the public function of financial services, to stop the financialisation of the economy and make the financial sector act fully in the service of environmentally and socially oriented sustainable development world wide, (rather than, as up until now, contributing to social exclusion as well as climate change by predominantly financing projects, trade and production, and companies that put profit before people).

[1] Commission of Experts of the President of the UN General Assembly on Reforms of the International Monetary and Financial System, September 2009 Report, at 38-39, <http://www.un.org/ga/econcrisissummit/docs/FinalReport_CoE.pdf> (July 2010); see for an overview of highlights of the report: <http://www.citizen.org/documents/StiglitzCommissionHighlights.pdf> (July 2010).

[2] P. Lamy, "Continued policy and regulatory reform in favour of services trade will be vital to supporting economic recovery", Speech to the Global Services Summit, Washington, 14 October 2009, <http://www.wto.org/english/news_e/sppl_e/sppl138_e.htm>, (July 2010); WTO, "Financial Services", Background Note by the Secretariat, S/C/W/312 and S/FIN/W/73, 3 February 2010: discussed by: T. Tucker, That's All They've Got?":, Public Citizen, March 2010, <http://www.citizen.org/documents/That%27sAllTheyGot.pdf> (July 2010).

[3] C. Reinhart, K. Rogoff, "Banking Crises: An Equal Opportunity Menace", Discussion Paper, December 2008, p.23, <http://www.economics.harvard.edu/files/faculty/51_Banking_Crises.pdf> (July 2010).

[4] See for instance: E. Gould, Financial Instability and the GATS Negotiations, Briefing paper, Canadian Centre for Policy Alternatives, Volume 9, Number 4, July 2008, <http://www.iatp.org/tradeobservatory/library.cfm?refID=103596> (September 2010).

[5] See for instance the 'dodgy deals' mentioned on <http://www.banktrack.org>.

[6] K. Singh, M. Vander Stichele, Rethinking Liberalization of Banking Services under the India-EU Free Trade Agreement, SOMO September 2009, <http://somo.nl/publications-en/Publication_3220> (September 2010).

[7] The first part of the paper is based on research by K. Singh, India-EU free trade agreement - Should India open up banking sector?, Madhyam, 2009, < http://www.madhyam.org.in/Special%20Report%20on%20India-EU%20FTA.pdf> (September 2010).

[8] J. Kelsey, "Reflections on the Financial Crisis", Speaking Notes to the Trade in Services and Human Rights panel at the American Society of International Law conference, Washington, 24-27 March 2010, <http://web.me.com/jane_kelsey/Jane/Financial_crisis_&_Trade_files/SPEAKING%20NOTES%20ASIL%20PANEL.doc> (September 2010).

[9] The GATS 'schedules of specific commitments are the lists per country which indicate what (sub) sectors in services a country has 'committed' or 'bound' i.e. liberalised and subject to all GATS rules; these list often include financial services' (sub) sectors; the list also includes exemptions which excludes a country from applying particular GATS rules.

[10] For an explanation of these financial products, see SOMO, EU financial reforms glossary, <http://somo.nl/dossiers-en/sectors/financial/eu-financial-reforms/glossary>, (September 2010).

[11] The GATS Understanding on Commitments in Financial Services is an optional GATS protocol that has only been adopted in 1997 by thirty, mostly developed WTO members. The Understanding fosters the most extensive liberalisation commitments possible in the schedules of the signatory countries. In addition, it adds more disciplines on financial regulation as will be explained below.

[12] GTZ, "Cutting the Regulatory Edge? Services Regulation Disciplines in the Cariforum EPA", 2008, p. 23, <http://www.gtz.de/de/dokumente/en-epa-cutting-the-regulatory-edge-2008.pdf> (September 2010).

[13] See Art. "EP and Council disagree over 'third country' issue in hedge fund regulation", in Newsletter – EU Financial Reforms, published by SOMO and WEED, June 2010, <http://somo.nl/dossiers-en/sectors/financial/eu-financial-reforms/newsletter-finance/june-2010/renderTextHTML?footer_url=http://somo.nl/dossiers-en/sectors/financial/eu-financial-reforms/newsletter-finance/june-2010/xxx>.

[14] Trading in derivatives is a financial service often listed in GATS and free trade agreements' schedules. Large (investment) banks often offer derivative contracts and are party to them.

[15] Clearing is a process by which trading and managing a derivative contract is done through a central counter party, i.e. a specialised company that protect against risk of default of payments.

[16] See the ruling on Antigua's challenge of the US ban on internet gambling on 10 November 2004 as discussed by T. Tucker, "Answering critical questions about conflicts between financial reregulation and WTO rules hitherto unaddressed by the WTO Secretariat and other official sources", Public Citizen Memorandum briefing, 22 June 2010, <http://www.citizen.org/documents/Memo%20-%20Unanswered%20questions%20memo%20for%20Geneva.pdf> (September 2010).

[17] See for instance CARIFORUM-EU EPA Art. 87 and Art. 105 (under the regulatory framework); EU-Korea FTA (under Sub-Section on Financial Services): Art. 7.37.

[18] "The draft GATS domestic regulation disciplines – potential conflicts with developing country regulations", South Centre Analytical Note (SC/AN/TDP/SV/12), October 2009, <http://www.southcentre.org/index.php?option=com_content&view=article&id=1092:the-draft-gats-domestic-regulation-disciplines-potential-conflicts-with-developing-country-regulations&Itemid=1&lang=en> (September 2010); R. Stumberg, "Plain Language Guide: GATS Negotiations on Domestic Regulation", Discussion draft produced in collaboration with Heinrich Boehl Stiftung North America and Forum on democracy and trade, 19 May 2010, <http://www.boell.org/downloads/Stumberg_-_Guide_to_GATS_Dom_Reg_5-19-10.pdf> (September 2010).

[19] This was accepted under certain conditions by the "Basel II" accord on capital requirements, see: <http://www.bis.org/publ/bcbsca.htm> (September 2010).

[20] See Art. "EP and Council disagree over 'third country' issue in hedge fund regulation", in Newsletter – EU Financial Reforms, published by SOMO and WEED, June 2010, <http://somo.nl/dossiers-en/sectors/financial/eu-financial-reforms/newsletter-finance/june-2010/renderTextHTML?footer_url=http://somo.nl/dossiers-en/sectors/financial/eu-financial-reforms/newsletter-finance/june-2010/xxx> (September 2010).

[21] "The draft GATS domestic regulation disciplines – potential conflicts with developing country regulations", South Center Analytical Note (SC/AN/TDP/SV/12), October 2009, <http://www.southcentre.org/index.php?option=com_content&view=article&id=1092:the-draft-gats-domestic-regulation-disciplines-potential-conflicts-with-developing-country-regulations&Itemid=1&lang=en> (September 2010); GTZ, "Cutting the Regulatory Edge? Services Regulation Disciplines in the Cariforum EPA", 2008, p. 24-25, <http://www.gtz.de/de/dokumente/en-epa-cutting-the-regulatory-edge-2008.pdf> (September 2010).

[22] See among others: D. Igan, P. Mishra, T. Tressel, "A Fistful of Dollars: Lobbying and the Financial Crisis", Paper presented at the 10th Jacques Polak Annual Research Conference hosted by the IMF, Washington DC, 5-6 November 2009, < http://www.imf.org/external/np/res/seminars/2009/arc/pdf/igan.pdf> (September 2010).

23 See Article 7.24 on governance in the EU-Korea FTA.

24 R. Chaitoo, "Services and Investment In the Cariforum-EC Economic Partnership Agreement (EPA)", draft text for presentation at the Conference "CARIFORUM/EC EPA: One Year On - Regional Integration and Sustainable Development", Barbados, 22-23 April 2010, <http://www.delbrb.ec.europa.eu/en/epa/one_year_on/EPA_conference_paper_Ramesh_Chaitoo.pdf> (September 2010).

25 GATS therefore stipulates in Art. VI.5.(b), footnote 3: The term 'relevant international organisations' refers to international bodies whose membership is open to the relevant bodies of at least all Members of the WTO.

26 WTO, "Financial Services", Background Note by the Secretariat, S/C/W/312 and S/FIN/W/73, 3 FebRUARY 2010.

27 A. Cornford, The WTO negotiations on financial services: current issues and future directions, UNCTAD discussion paper, June 2004, <http://www.unctad.org/en/docs/osgdp20046_en.pdf> (September 2010).

28 T. Tucker, "Answering critical questions about conflicts between financial reregulation and WTO rules hitherto unaddressed by the WTO Secretariat and other official sources'" Public Citizen Memorandum briefing, 22 June 2010.

29 Art. "Commission presents new proposals to make derivatives markets less risky" in Newsletter - EU Financial Reforms, June 2010, <http://somo.nl/dossiers-en/sectors/financial/eu-financial-reforms/newsletter-finance/june-2010/renderTextHTML?footer_url=http://somo.nl/dossiers-en/sectors/financial/eu-financial-reforms/newsletter-finance/june-2010/xxx> (September 2010).

30 See the European Centre for International Political Economy, in: Art. "Germany seen risking WTO challenge over shortselling", Reuters, 20 May 2010, <http://www.reuters.com/article/idUSLDE64J25920100520> (September 2010).

31 WTO, "Financial Services", Background Note by the Secretariat, S/C/W/312 and S/FIN/W/73, 3 February 2010: discussed by T. Tucker, That's All They've Got?", Public Citizen, March 2010, <http://www.citizen.org/documents/That%27sAllTheyGot.pdf> (July 2010).

32 See T. Kerckhoffs, R. van Os, M. Vander Stichele, Financing Food, SOMO briefing, April 2010, <http://somo.nl/publications-nl/Publication_3471-nl/>.

33 See Ibidem.

34 The last year of EPA/Cariforum FTA negotiations was 2007, during which the problems with innovative financial products such as securised debt (CDOs) were already disrupting the US financial markets.

35 The negotiations ended after the financial crisis had already erupted in 2008 in the EU whose banks etc. were affected by CDOs.

36 For instance, in the current GATS negotiation on financial services the EU requests Chile that Chile eliminates the 'restriction' that prior authorisation by the Central Bank is required before transferring dividends from Chile abroad because this is in breach of Article XI: M. Vander Stichele, "GATS negotiations in financial services: The EU requests and their implications for developing countries", SOMO, 2006, <http://somo.nl/publications-en/Publication_601/at_download/fullfile> (September 2010).

37 See among others: T. Tucker, "Answering critical questions about conflicts between financial re-regulation and WTO rules hitherto unaddressed by the WTO Secretariat and other official sources", Public Citizen Memorandum briefing, 22 June 2010.

38 See GATS Article XVI ('Market Access'), footnote 8.

39 T. Tucker, "The WTO conflict with financial transaction taxes and capital management techniques, and how to fix it", Public Citizen Memorandum briefing paper, 9 July 2010, <http://www.citizen.org/documents/MemoonCapitalControls.pdf> (September 2010).

40 See: EU-Korea FTA Art. 8.2: "capital participation in a juridical person with no intention of establishing or maintaining lasting economic links".

41 J. Ostry, e.a., "Capital Inflows: The Role of Controls", IMF Staff Position Note, 19 February 2010 (SPN/10/04), <http://www.imf.org/external/pubs/ft/spn/2010/spn1004.pdf>, (September 2010).

42 T. Tucker, "The WTO conflict with financial transaction taxes and capital management techniques, and how to fix it", Public Citizen Memorandum briefing paper, 9 July 2010.

43 For details about the measures and relationship with EU-Korea FTA, see: J. Kelsey, Art. "Are Trade in Financial Services Instruments an Impediment to Restoring Financial Stability? Reflections on South Korea's New Capital Controls and Its Obligations in the US and EU FTAs", Paper to the Second Biennial Conference of the Society for International Economic Law, Barcelona, July 2010, http://web.me.com/jane_kelsey/Jane/Financial_crisis_&_Trade_files/JK%20SIEL%20Paper.doc (September 2010).

44 See paper by M. Vander Stichele, "GATS negotiations in financial services: The EU requests and their implications for developing countries", SOMO, 2005. <http://somo.nl/publications-en/Publication_601/at_download/fullfile>, (September 2010).

45 WTO, "Financial Services", Background Note by the Secretariat, S/C/W/312 and S/FIN/W/73, 3 February 2010: discussed by: T. Tucker, That's All They've Got?", Public Citizen, March 2010, <http://www.citizen.org/documents/That%27sAllTheyGot.pdf> (July 2010).

46 European Commission, Communication from the Commission to the Council, the European Parliament, the European Economic and Social Committee and the Committee of the Regions - Towards a comprehensive European international investment policy, COM(2010)343 final, Brussels, 7 July 2010, <http://trade.ec.europa.eu/doclib/docs/2010/july/tradoc_146307.pdf>.

47 M. Vander Stichele, Art. "How BITs restrict policy space to prevent or alleviate financial crises", in EU Investment Agreements in the Lisbon Treaty Era: A Reader, Seattle to Brussels Network, 2010, p. 29-30, <ttp://www.s2bnetwork.org/s2bnetwork/download/eu_investment_reader.pdf?id=381> (September 2010).

48 See paper by M. Vander Stichele, "GATS negotiations in financial services: The EU requests and their implications for developing countries", SOMO, 2005, <http://somo.nl/publications-en/Publication_601/at_download/fullfile>, (September 2010).

Colophon

Business as Usual?
How Free Trade in Financial Services Works Against Public Interests and Jeopardises Financial Sector Reform
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