Ignoring the Crises? How Further GATS Liberalisation Impacts the Financial and Food Crises

By Myriam Vander Stichele

In Spring 2008, during efforts to finalise the WTO negotiations on agriculture and market access for non-agricultural goods (NAMA), the European Union (EU) and the United States (US) have insisted that commitments on further liberalisation of trade in services in WTO General Agreement on Trade in Services (GATS) be part of any Doha negotiation deal that comes out. Previous experience of negotiations under GATS, including on the 'collective request' process, and free trade agreements (FTAs), have shown that the EU, the US, as well as Canada, are very keen to get more commitments in financial services. However, a deal that further liberalises financial services could exacerbate the likelihood of future crises, not only in the financial markets but also the food markets.

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On 12 April 2008, the WTO Director General argued that in a period of increased financial uncertainty around the world, "counting on the WTO and on concluding the Doha Round is the nearest available message of reassurance for world financial markets." This statement reflects how the role of liberalisation in financial services and regulatory restrictions under GATS and FTA agreements in the financial crisis are not being recognized, not even through many proposals that have been made to deal with the financial crisis.

The impact of FSI commitments in GATS on financial markets

The risky behaviour through new, complex and untested products by the internationally operating financial services industry (FSI) has been highlighted in the analyses of the current financial turmoil. International competition among the financial industry and the drive to make more profits (not only to increase shareholder value, but also to further expand internationally) has been a major driver for the risky behaviour that led to the financial crisis. It is not the first time that international competition among the financial industry has led to a financial crisis. For instance, the Asian crisis was created by risky lending of the foreign financial industry to emerging markets to conquer such markets ahead of competitors. GATS liberalisation in financial services promotes such international competition, but without any guarantees that governmental supervision and regulations will deal with the risky behaviour.

The current financial crisis revealed the deficiency of current liquidity and risk assessment management mechanisms that were unable to prevent an international financial industry-wide crisis. This weakness comes from rules that allow the financial industry to combine different financial activities such as banking, insurance and trade in securities, and also from their rapid expansion into many countries, including developing countries. GATS negotiations that result in financial services commitments promote these expansionary strategies. They do not take into account that the large size and complexity of international financial conglomerates make them incapable of avoiding financial crises. The report of the Joint Forum on Financial Conglomerates specifies how many still lack conglomerate-wide risk management mechanisms to avoid risk and liquidity problems due to concentration in complex products.

The current lack of regulatory and supervisory capacity

A major issue emerging from the current financial crisis is the inadequacy of regulations and supervision. This has allowed risky behaviour from international operations without sufficient control or risk mitigation instruments. The ten pages of recommendations proposed by the Financial Stability Forum (FSF) demonstrate that many regulatory issues still need to be resolved. It recommends that "supervisors and central banks will examine the scope for additional steps to promote a more robust and internationally consistent liquidity approach for cross-border banks". [iv] The FSF recommendations[v] also indicate the need for strengthening international cooperation among regulators and supervisors of internationally operating banks and other financial conglomerates. The problem is that it is not yet clear how the recommendations for regulatory reform will be implemented.

Governments, financial industry branch organisations and experts have often stated that adequate regulation needs to be in place before liberalisation can be properly undertaken and made beneficial. Within a context where financial regulation and supervision are clearly inadequate, efforts by the chair of the services negotiations and WTO Director General to ensure more liberalisation commitments with "no priority exclusion of any service sector or mode of supply"[vi] is not appropriate. The continuing push from developed countries in the GATS negotiations requiring developing countries to

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bind current levels of market access completely ignores the risks of increased financial instability that would result from their proposals. The EU and US demands are based on appeals from the financial industry lobby to create more permanent market access, as well as to introduce GATS rules that prevent governments from intervening in their profit making strategies. The financial industry has developed an expansion strategy as the most important way to increase its profits and this lobby is very influential in the financial services negotiations. This 'regulatory capture' has in the past also made financial regulators reticent to introduce the necessary regulations. [vii]

Risks of instability due to liberalisation

By making commitments in financial services, developing countries might engage in swift liberalisation that poses many threats to financial stability and would be contrary to experts' recommendations for gradual and well sequenced capacity building of national financial authorities. A deal on the Doha negotiations might push developing countries to liberalise financial services without having the right regulations in place. For instance, a group of developed countries led by Canada have made individual and collective requests to different developing countries to permanently open their markets for trade in "derivative products including, but not limited to, futures and options." However, these financial services products have been shown during each financial crisis to contribute to financial instability. Other financial services negotiated under the GATS such as "all money transmission services", investment banking, asset management and pension fund management can also result in financial instability because such services are likely to use transborder transactions and speculative instruments. The most glaring case is provided by the EU's request that some countries such as Brazil, Chile and India liberalise according to the far-reaching GATS *Understanding on Commitments in Financial Services*[viii] and allow foreign financial service providers to introduce any new financial service.

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Once governments have made a GATS market access commitment on a particular service sector, the jurisprudence from the *US-Gambling* case makes it clear that they violate their obligations if they reverse liberalisation and ban the supply of any part of that service sector. In the financial services sector, this ruling means that GATS commitments prevent governments from prohibiting particular financial activities they believe are having negative effects. Government interventions on financial markets to curb speculative activities in times of high prices would be open to challenge if that government had committed financial sectors under the GATS.[ix] Only if governments foresee all possible problems and make explicit exemptions under market access and national treatment rules during the GATS negotiations can they ban disruptive financial services.

Challenges to prudential regulation in GATS rules and negotiations

Although the Annex on Financial services of the GATS agreement allows for prudential regulation in the financial sector, e.g. to protect depositors, this cannot be done in a way that appears to undermine liberalisation commitments. The vagueness of this prudential clause has resulted in many developing countries facing GATS requests to eliminate the regulatory measures they have put in place in order to prevent a financial crisis. For instance, the EU has requested that many countries remove measures that oblige foreign banks to keep money reserves in the host country. Such provisions are aimed at contributing to financial stability and avoiding liquidity problems in times of crisis. Many of the regulatory reform proposals made in 2008 by the Financial Stability Forum (FSF) require banks to increase their capital reserves. If the GATS negotiations had been concluded according to the EU request, some countries might have become more vulnerable to the financial crisis, as banks do not want capital to remain locked in different countries around the world.

The current draft GATS text on disciplines in domestic regulation related to sectors liberalized under GATS indicate that financial regulations could be challenged in the future on a variety of grounds, such as not being "objective", "relevant", or acting as a disguised restriction on trade. Since the negotiators have failed to ensure that these domestic disciplines are not applied to prudential regulation in financial services, prudential measures may become severely restricted. Licensing procedures for banks, for example, would have to be made "as simple as possible.[x] There remains an uncertainty that measures introduced to avoid a financial crisis, even when they are based on international recommendations may not be considered by the financial industry and their home countries as barriers to trade.

In addition, GATS rules can increase financial instability once commitments in financial services are made. For instance, GATS Art. XI.1.[xi] does not allow countries to restrict interna-

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tional transfers and payments for current financial transactions that are related to services in sectors that were liberalised under the Agreement. GATS rules permitting restrictions on unstable capital flows and financial services are limited by many conditions in Art. XI.2, Art. XII and Art. XII.2. This restricts the manoeuvrability of Central Banks, such as of Chile's Central Bank which requires authorization before dividends can leave the country, a policy forbidden under Art. XI.

Impact on food markets and development

Many studies (e.g. by the World Bank[xii] and the IMF[xiii]) have shown that the opening of developing countries' markets to the establishment of foreign banks often leads to the weakening of access to credit for small and medium sized industries, thus stifling domestic economic development. The EU has even made GATS requests that some developing countries remove existing requirement of mandatory lending to small and medium enterprises (SMEs).

Practice shows that small and poor farmers are also left behind by foreign banks and insurance companies. Such practice is in contradiction to a broad agreement in the international community, that increasing agricultural production in developing countries will be a key step towards addressing the root causes of the 2008 food crisis.[xiv] Improving farmers' access to credit is one key measure to make that possible. In times of crisis and credit crunch, banks tend to lend less, especially to poor and "risky" farmers, thus further undermining food production and aggravating the food crisis. GATS National Treatment and Most Favoured Nation rules also forbid targeting incentives to those banks that are willing to support small farmers.

The promotion and use of futures trading in key agricultural commodities by the financial industry contribute to the high prices that make food unaffordable to the poor. Over the past year, India has banned futures trading in key agricultural commodities over concerns that it has caused sharp increases in the price of food staples like lentils, wheat, and rice. However, such an intervention in financial markets to curb speculations on food staples by India or by any country that makes commitments on these financial services, could be challenged under the GATS dispute settlement.[xv]

Conclusion

The arguments that the foreign financial industry will contribute to greater efficiency and development in developing countries can be challenged by many practices that lead to misallocation of resources (for instance to food futures rather than in agricultural production), and financial instability.

As the world is still assessing one of the most violent shocks in international financial markets ever, measures to avoid future financial crises are still not in place. Therefore, developing countries should be cautious of dangers associated with further liberalisation of their financial sectors. Drawing from the lessons of the recent financial crisis and given the regulatory status in most developing countries, it would be unwise to commit to further liberalising of financial services under GATS or FTAs at this time. Such liberalisation should instead be left to financial regulators and supervisors after reforms have been introduced.

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[i] "Lamy: Doha Round conclusion will reassure world financial markets", WTO News : Speeches [at IMF],12 April 2008 < http://www.wto.org/english/news_e/sppl_e/sppl88_e.htm>
[ii] "Cross-sectoral review of group-wide identification and management of risk concentrations", 25 April 2008, see< http://www.bis.org/press/p080425.htm> and A Cornford, Art. "Risk concentraiton in financial conglomerates", in SUNS, nr. 6480, 23 May 2008.
[iii] *Enhancing market and institutional resilience*, April 2008, Annex A: <http://www.fsforum.org/publications/FSF_Report_to_G7_11_April.pdf>
[iv] Ibidem: see recommendation II.11s.
[v] Ibidem; see recommendations V.5 to V.13.
[vi] WTO Council for Trade in Services, "Report by the Chairman – Elements required for the completion of the services negotiations: Annex", WTO New Items, 26 May 2008.
[vii] M. Vander Stichele, "Critical issues in the financial industry", SOMO, April 2005, < http://www.somo.nl/html/paginas/pdf/Financial_sector_report_05_EN.pdf>
[viii] http://www.wto.org/english/tratop_e/serv_e/21-fin_e.htm
[ix] Ellen Gould in a forthcoming analysis for the Canadian Centre for Policy Alternatives.
[x] Ibidem.
[xi] Art. XI.1. " Except under the circumstances envisaged in Article XII, a Member shall not apply restrictions on international transfers and payments for current transactions relating to its specific commitments."
[xii] World Bank, Finance for All? Policies and Pitfalls in Expanding Access, Washington, 2008: see pages 77-83 <http://siteresources.worldbank.org/INTFINFORALL/Resources/4099583-11943735 12632/FFA_book.pdf>
[xiii] E. Detragiache, T. Tressel, and P. Gupta, "Foreign Banks in Poor Countries: Theory and Evidence", IMF Working Paper WP/06/18, January 2006.
[xiv] See for example UN Secretary General Ban Ki Moon's speech at CSD on May 14, 2008: <http://www.un.org/apps/news/story.asp?NewsID=26670&Cr=sustainable&Cr1=development>
[xv] Ellen Gould in a forthcoming analysis for the Canadian Centre for Policy Alternatives.