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The Connection between the World Trade Organization's Extreme Financial Service Deregulation Requirements and the Global Economic Crisis

Amidst breathless calls from all quarters for expansive new global financial services regulations addressing the global economic crisis is a seemingly total lack of awareness that **most of the world's countries are bound to expansive World Trade Organization (WTO) financial services deregulation requirements.** The WTO's Financial Services Agreement (FSA) locked in domestically, and exported internationally, the model of extreme financial service deregulation that most analysts consider a prime cause of the current crisis. Deregulation (not only liberalization) of the financial service sector – including banking, insurance, asset management, pension funds, securities, and more – is among the most important, but least discussed, aspects of the WTO.

Yet, to date, the only connections most policymakers are drawing between the WTO and the current crisis are of the red-herring variety: panicky warnings about countries increasing tariffs to block imports in response to dire economic conditions. Consider the communiqué issued from the November 15 Washington G-20 Summit, a meeting ostensibly convened so that countries could agree to new domestic and international financial sector regulations needed to respond to the crisis. The declaration called for the completion of WTO Doha Round negotiations, which includes as one of its three central pillars further financial service sector deregulation. The communiqué also called for countries to "refrain from raising new barriers to investment or to trade in goods and services… or implementing WTO inconsistent measures" for 12 months.

Yet, in recent months, the Bush administration and governments worldwide have taken various measures to counter the crisis that contradict the fundamental precepts of the current globalization model – and indeed in some cases violate the rules implementing this model, such as those of the WTO. Many of the most basic national and international remedies now being proposed to fix the mess and avoid future meltdowns occupy policy space that governments have ceded to the WTO.

Remedying the crisis will require significant changes to the WTO's General Agreement on Trade in Services (GATS), and specifically its 1997 Financial Services Agreement and numerous countries' commitments under these pacts. Further, unless the Obama administration takes speedy action to remove the outrageous new, additional deregulation commitments now on the Doha Round negotiating table, this Bush trade-policy hangover will undermine attempts to remedy the financial crisis here and abroad.

Many people still assume our trade pacts are about traditional matters, such as tariff cuts; in fact, today's "trade" pacts like the WTO require signatory countries – including the United States – to conform their domestic policies to an expansive *non-trade* deregulatory agenda. One of the most controversial WTO agreements is GATS, which sets out rules for how countries can regulate the "service sectors" of their economies. The WTO Secretariat was unusually direct in describing the implications of the GATS rules: *"Governments are free in principle to pursue any national policy objectives* ***provided the relevant measures are compatible with the GATS****.*"

One of the most controversial service sectors covered by the GATS is the financial sector. When many countries initially rejected the extreme banking and insurance deregulation agenda being pushed by U.S. and European governments and corporations, special additional negotiations were launched after the WTO was established. Thus, the WTO's limits on domestic financial service regulation are contained not only in the original GATS, but in the subsequent Financial Services Agreement, which went into effect in 1999 with 105 countries signed on, as well as the Understanding on Commitments in Financial Services, to which the OECD countries also signed. Domestic policies which do not conform with the extensive regulatory limits in these agreements are subject to challenge in the WTO's powerful despite resolution system. Policies that are judged by WTO tribunals to violate the rules must be eliminated or trade sanctions can be imposed on the non-conforming country until the policy is changed.

In the case of the United States, WTO commitments to stay out of regulation of "banking," "other financial services" and "insurance" are extremely broad.[1] The United States signed on to extra WTO obligations agreed to by OECD countries that include a "standstill" commitment – meaning we are forbidden from rolling back deregulation (or liberalization) of the expansive financial services we bound to comply with WTO rules.[2] Translated out of GATS-ese, <u>this means that the United States has bound itself not to do what Congress, regulators and scholars deem necessary – create new financial service regulations.</u> This agreement also includes a commitment for signatories to eliminate domestic financial service regulatory policies that *meet* GATS rules, but that may still "*adversely affect the ability of financial service suppliers of any other (WTO) Member to operate, compete, or enter*" the market.[3] The United States is also bound to ensure that foreign financial service suppliers are permitted "to offer in its territory any new financial service,"[4] a direct conflict with the various proposals to limit various risky investment instruments.

Meanwhile, the list of reasonable financial service regulations that actually do *not* meet even the core GATS requirements is lengthy, demonstrating why altering this agreement is a necessary aspect of remedying the current crisis. For instance, consider the use of "firewalls" between various financial services so that trouble in one sector does not contaminate the entire system. The Glass-Steagall Act of 1933, which forbid bank holding companies from operating other financial services, applied such firewalls so as to avoid a repeat of the financial collapse that occurred during the Great Depression. While the law applied to domestic and foreign banks alike, it had the effect of

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[1] Under WTO definitions "other financial services" include trading in foreign exchange, derivatives and all kinds of securities, securities underwriting, money broking, asset management, settlement and clearing services, provision and transfer of financial information, and advisory and other auxiliary financial services. "Banking" covers all traditional services provided by banks – acceptance of deposits, lending of all types, and payment and money transmission services.

[2] WTO, *Understanding on Commitments in Financial Services,* A. "Any conditions, limitations and qualifications to the commitments noted below shall be limited to existing non-conforming measures." (The Understanding is a supplemental agreement to the FSA which governs all U.S. GATS financial service commitments.)

[3] WTO, *Understanding on Commitments in Financial Services,* B.10(d).

[4] WTO, *Understanding on Commitments in Financial Services*, B.7.

preventing foreign banks that combined commercial and investment banking services from entering the U.S. market. But various U.S. GATS "market-access" commitments in banking services guarantee such access. The Clinton administration, which conducted WTO Financial Service agreement negotiations, recognized this conflict and indeed made a commitment explicitly listed in the U.S. GATS schedule to "fix" this problem.[5] The provisions of Glass-Steagall that prohibited a bank holding company from owning other financial companies were repealed with passage of the Gramm-Leach-Bliley Act in 1999, the year the WTO Financial Service Agreement went into effect.

Sorting out exactly what modicum of policy space remains under these rules requires reviewing the more than 30 pages of financial service sector commitments made by the United States. However, consider just one sector that has been a focus of considerable attention as a source of the financial meltdown: "Trading of Securities and Derivative Products and Services Related Thereto." The only carve-out that the United States listed regarding regulation of derivatives is for *onion futures* – seriously.[6]

Few in Congress even reviewed the thousands of pages comprising the Uruguay Agreements Act in 1994 which implemented the WTO. With this Fast Tracked vote, Congress bound nearly 100 sectors of the U.S. service economy to GATS constraints with little understanding or discussion. The 1997 WTO FSA, which imposed drastic new limits on Congress' regulatory authority over financial service, was never even sent to Congress. Meanwhile, creating worldwide limits on domestic regulation of financial services via the WTO was the project of the large financial service firms that Congress was supposed to be regulating for the public interest. "An important distinguishing feature of the FSA relates to the degree of support and the political legitimacy it generated through a shared sense of transatlantic purpose and commitment on the part of the financial services industry itself. The sector was truly unique in that respect, and there is little doubt within the trade policy community that financial sector support in the European Union and the United States was a determining force in concluding the FSA."[7]

Over the past century, U.S. financial regulation has shifted from strict financial controls over banking and capital markets following the Great Depression to deregulation in the 1980s and 1990s. The WTO locks in the U.S. status quo at a time of unprecedented financial liberalization and foreseeable damage wrought by this model to the U.S. and global economy.

Altering the WTO financial services rules is critical for creating domestic policy space to address the crisis. The United States – and U.S.-based financial service firms – used WTO negotiations to export the U.S. model of extreme financial service deregulation to 105 other WTO signatory countries who are bound under the Financial Service Agreement. For these countries to establish new financial service regulations – and to further the goal of new global regulations – the existing WTO limits must be eliminated. However, even in the face of this crisis, the push for further financial services liberalization continues at WTO. <u>On the table now in the WTO Doha Round negotiations are proposals for *further* financial services deregulation – tabled by the United States, the European Union and other countries that have been busy ignoring *existing* WTO terms because doing so is the necessary to counter the crisis.</u>

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[5] WTO, *United States of America Schedule of Specific Commitments Supplement 3*, Additional Commitments Paper II, WTO document GATS/SC/90/Suppl.3.

[6] GATS/SC/90/Suppl.3, at C-26. "Federal law prohibits the offer or sale of futures contracts on onions, options contracts on onions, and options on futures contracts on onions in the United States, and services related thereto."

[7] Pierre Sauve and Karsten Steinfatt, "Financial Services and the WTO: What Next?," Brookings Institution, 2001, at 353.

Background and more in-depth description of WTO rules: Prior to establishment of the North American Free Trade Agreement (NAFTA) in 1994 and the WTO in 1995, the scope of trade agreements was limited to setting the terms of exchange of goods across borders, namely cutting tariffs and lifting quotas. The WTO and NAFTA were called "trade agreements," but they are more accurately understood as international commercial agreements. More broadly, they can be understood as delivery mechanisms for a comprehensive package of neoliberal policies, many unrelated to trade.

These pacts include binding rules that limit the parameters for signatory nations' service-sector, investment, procurement, intellectual-property, environmental and product and food-safety policies. Each WTO signatory country is required to "ensure the conformity of its laws, regulations and administrative procedures with its obligations."[8] In contrast to the operation of most other international agreements, this new generation of "trade" agreements is strongly enforced. Signatory countries that fail to conform domestic laws to the pacts' terms may be challenged before dispute resolution bodies established by the pacts. These enforcement bodies are empowered to authorize trade sanctions against nations that fail to bring their policies into conformity with the pacts' rules. To date, approximately 90 percent of laws challenged at the WTO have been found to violate the pacts' requirements. In all but one case, regarding the European Union's ban on artificial growth hormones in meat, developed and developing countries have changed laws ruled WTO-illegal to bring them into conformity. Given this record, often the mere threat of a WTO challenge by a government or the claim by the private sector that a policy violates the WTO results in countries modifying their laws or in a policy initiative being chilled.

Understanding how U.S. WTO commitments could affect domestic and international financial service regulatory proposals now being put forward to address the financial crisis requires reference to several WTO texts.[9] Taken as a whole, the WTO's limits on financial service-sector regulation are expansive. These rules not only guarantee foreign financial firms and their products access to U.S. markets, but also include numerous additional rules that limit how our domestic governments may regulate foreign firms operating here:

- **No new regulation:** The United States agreed to a "standstill provision" that requires that we not create new regulations (or reverse liberalization) for the list of financial services bound to comply with WTO rules.[10] Given that the United States has made broad WTO financial services commitments – and thus is forbidden by this provision from imposing new regulations in these many areas – this provision seriously limit the policy space available to address the current crisis.

- **Removal of regulation:** The United States even agreed to eliminate domestic financial service regulatory policies that meet GATS rules, but that may still "*adversely affect the*

[8] WTO, Agreement Establishing the WTO, Art. XVI-4.
[9] The text of the GATS itself contains a series of binding rules which are supplemented by rules contained in a GATS "Annex on Financial Services." The Annex is part of the original WTO text and applies to all countries with 105 countries making specific commitments in the context of the FSA, which was completed in 1997 and went into effect in 1999. In addition, the United States and other OECD countries signed a WTO Understanding on Commitments in Financial Services which contains further deregulation and liberalization commitment. Thus, the U.S. service sectors listed in the U.S. schedule of commitments must comply with the requirements of GATS, the Annex on Financial Services and the Understanding.
[10] WTO, *Understanding on Commitments in Financial Services*, A. "Any conditions, limitations and qualifications to the commitments noted below shall be limited to existing non-conforming measures."

ability of financial service suppliers of any other (WTO) Member to operate, compete, or enter" the market***.***[11]

- **No bans on new financial service "products":** The United States is also bound to ensure that foreign financial service suppliers are permitted "to offer in its territory any new financial service,"[12] a direct conflict with the various proposals to limit various risky investment instruments, such as certain types of derivatives.

- **Certain forms of regulation banned outright:** The United States agreed that it would not set limits on the size, corporate form or other characteristics of foreign firms in the broad array of financial services signed up to WTO. These expansive "market-access" obligations are why the Clinton administration agreed as part of GATS negotiations to "fix" Glass-Steagall's "barrier to entry." The law's firewall requirement that commercial banks not provide investment services meant that foreign firms that combined both activities would not have been able to operate in the U.S. market.

- **Treating foreign and domestic firms alike is not sufficient:** The GATS market-access limits on U.S. domestic regulation apply in absolute terms; that is to say, even if a policy applies to domestic and foreign firms alike, if it goes beyond what WTO rules permit, it is forbidden. And, forms of regulation not outright banned by the market-access requirements must not inadvertently "modify the conditions of competition in favor of services or service suppliers" of the United States, even if they apply identically to foreign and domestic firms. Might aspects of the recent Wall Street bailout eventually "change the conditions of competition" in favor of U.S. firms?

The regulatory limits imposed by GATS rules cover not only all actions taken by all levels of government – "central, regional, or local governments or authorities" – but also actions of "non-governmental bodies in the exercise of powers delegated by" any level of government.[13] Thus, GATS regulatory constraints cover private-sector bodies that have a role delegated by or approved by government, such as professional associations or industry bodies whose professional qualifications or voluntary "code of conduct" rules are recognized by governments.

There is a common misunderstanding that GATS only affects domestic policies that discriminate against foreign service-sector firms. In fact, GATS does much more than curb discriminatory laws, such as citizenship and residency requirements. GATS – through its Article XVI "market-access" rules noted above – creates certain absolute rights for foreign investors who acquire, invest in or establish service-sector operations within the United States in sectors covered by U.S. GATS commitments. These market-access requirements are extraordinary, as they simply ban certain types of policies – unless a country originally listed them as exceptions in their GATS schedules in the 1990s – even when they are applied equally to foreign and domestic services or suppliers. The following are forbidden: *"limits on the number of service suppliers, including through quotas, monopolies, economic needs tests or exclusive service supplier contracts; limits on the total value of service transactions or assets, including by quotas or economic needs tests; limits on the total number of service operations or the total quantity of a service; limits on the total number of natural persons that may be employed in a particular service sector; policies which restrict or require*

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[11] WTO, *Understanding on Commitments in Financial Services*, B.10(d).
[12] WTO, *Understanding on Commitments in Financial Services*, B.7.
[13] WTO GATS Article I-3-a-ii.

specific types of legal entity or joint venture through which a service supplier may provide a service."[14]

There is nothing quite like the GATS market-access rules in any other international commercial treaty. These market-access rules are framed in absolute, rather than relative terms, pre-judging certain types of public policies and practices whether they are discriminatory or not. In other words, non-discriminatory regulations (such as the now defunct Glass-Steagall Act) can violate GATS rules even if they treat domestic and foreign firms identically but happen to result in preventing from some foreign firms from entering or operating in the U.S. market.

GATS contains a "carve-out" provision that supposedly ensures that the agreement will not undermine domestic laws or regulations – such as those designed to protect investors, depositors, and policyholders, or to ensure the safety and integrity of the financial system.[15] However, this ostensible guarantee is largely eviscerated by several significant loopholes. First, the putative carve-out contains a classic WTO circumvention clause that negates the ability of countries to actually safeguard a domestic policy that conflicts with WTO obligations. The clause starts by noting that countries shall not be prevented from establishing financial service regulatory policies for "prudential reasons," but then continues by stating: "Where such measures do not conform with the provisions of the Agreement, they shall not be used as a means of avoiding the Member's commitments or obligations under the Agreement." That is to say, even if regulatory measures are taken for prudential reasons, they are subject to challenge if they in effect undermine the regulatory constraints otherwise established in the agreement. Moreover, the definition of "prudential" is left undefined in the GATS. Thus, the question of what constitutes a "prudential" regulation is subject to interpretation by WTO dispute resolution panels were a domestic law to be challenged. Moreover, the financial service industry has been lobbying in the context of ongoing GATS negotiations for a narrow interpretation that would limit "prudential" measures to regulations concerning only solvency and financial disclosure.[16]

Public Citizen is a national nonprofit advocacy organization based in Washington, D.C. This primer is prepared by Public Citizen's Global Trade Watch division. For more information, please visit www.tradewatch.org. Our blog, EyesOnTrade.org, provides breaking news an analysis on an array of globalization and trade matters.

[14] WTO GATS Article XVI.

[15] *Annex on Financial Services*, paragraph 2(a) states that "Member shall not be prevented from taking measures for prudential reasons, including for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owned by a financial service supplier, or to ensure the integrity and stability of the financial system. Where such measures do not conform with the provisions of the Agreement, they shall not be used as a means of avoiding the Member's commitments or obligations under the Agreement."

[16] The Commission on the Future of Health Care in Canada, summary report on Globalization and Health, *Putting Health First: Canadian Health Care Reform, Trade Treaties and Foreign Policy* (prepared by the Canadian Centre for Policy Alternatives), October 2002. Available at http://www:healthcarecommission.ca.