Session 17: The future of trade in financial services: Safeguarding stability

Sub-theme IV: What next for the multilateral trading system?

Moderator
Mr Daniel Owoko, Counsellor – Trade, Permanent Mission of Kenya to the WTO

Speakers
Ms Lori Wallach, Director, Public Citizen's Global Trade Watch Division
Mr Andrés Arauz, General Banking Director, Central Bank of Ecuador
Ms Sanya Reid Smith, Senior Researcher, Third World Network
Mr Etienne Vlok, Director of South African Labour Research Institute (SALRI); Teselico Convenor for the Congress of South African Trade Unions (COSATU)

Organized by
Our World Is Not For Sale (OWINFS)

Report written by
Ms Melinda St. Louis, Public Citizen's Global Trade Watch division

Tuesday, 20 September 2011 – 9.00-11.00

Abstract

This session explored questions emerging among government regulators, civil society organizations, and trade and finance experts about WTO financial services rules in the context of the global trend towards enhanced financial regulation.

1. Presentations by the panellists

(a) Ms Lori Wallach, Director, Public Citizen's Global Trade Watch

Increasingly, government officials and trade and finance experts are questioning whether the General Agreement on Trade in Services (GATS) rules and financial services commitments negotiated in the 1990s pose obstacles to post-financial crisis efforts to enhance regulation underway, both domestically and internationally.

More than 100 countries have GATS financial services commitments, including 40 developing countries with Mode 3 commitments, 26 with unlimited commitments and 22 with significant Mode 1 commitments. Countries that did not schedule exceptions (and that now, following the financial crisis, seek to re-regulate in committed sectors using mechanisms prohibited by GATS rules) could face a WTO challenge, choose not to institute a necessary regulatory tool to avoid a threatened challenge, or be required to negotiate compensation terms with affected member states to alter their commitments, which may be unfeasible, especially for developing countries.

Four main concerns were raised.

The first was the GATS market access rules (Article XVI(2)), under which countries made liberalization commitments prohibit the maintenance or establishment of specific types of non-discriminatory regulation in committed sectors. The Appellate Body ruling in Antigua's challenge of the US Internet gambling ban established that a ban is an Article XVI(2)-forbidden "zero quota." This poses threats to countries' bans of risky financial practices or instruments in a committed sector. Provisions forbidding limits on size and legal entity are ambiguous, leading some countries to schedule limitations for the right to address firm-specific regulation or to firewall cross-sectoral risk. Many others, however, did not schedule these limitations and may face GATS constraints on their ability to address too-big-to-fail banks.

Second, GATS rules forbidding limits on capital and current account flows could undermine developing countries' use of macro-prudential measures, such as capital controls. Also implicated, as noted in a European Commission staff paper, is the GATS compatibility of financial transaction taxes. A footnote to GATS Article XVI(2) requires that countries with Mode 1 commitments allow unrestricted capital flows in and out, and that countries with Mode 3 commitments allow unrestricted capital flows in. GATS Article XI "Payments and Transfers" requires countries to allow capital flows in committed sectors. These rules apply to all GATS-committed sectors and no exceptions may be scheduled. They pose unique risks when applied to financial services, where capital flows are not merely incidental to provision of a service, but rather large, potentially destabilizing movements of capital. GATS Article XII provides a limited exception for short-term limits on flows with IMF approval in a balance of payments emergency. However, this exception does not provide for the use of standing restrictions on in-flows as a prophylaxis against crises. The IMF has written favourably about the growing use of such mechanisms by countries to avoid destabilizing capital flows. But countries that committed to liberalize financial sectors under GATS may face constraints on their use.

Third, Article VI "Domestic Regulations" subjects non-discriminatory technical qualifications, licensing, permissions, and other commonly used policies to review and challenge. Ms Wallach questioned why the Working Party on Domestic Regulation would continue seeking to establish disciplines that further constrain domestic financial regulation, especially in the post-crisis era.

A fourth concern relates to the GATS Annex on Financial Services Article 2(a). The first sentence provides a defence for a range of prudential measures, but the second sentence states that a country cannot use such measures to avoid their GATS commitments. Some argue this defence is self-cancelling, and everyone agrees that it is ambiguous. Numerous scholars, including WTO panellists, have discussed the need for clarification. This provision is not a carve-out that forbids challenges of countries' prudential financial policies. A review of GATS negotiating history shows that a bloc of Asian countries proposed a true prudential carve-out, but this was rejected. Five defence provisions were proposed, with the weakest version ultimately adopted.

To date, preliminary discussions held at the request of member countries have reviewed the trade impact of measures taken after the crisis. A critical next step is a review of WTO rules with respect to their compatibility with regulatory proposals now being discussed at other global fora, and also with members' general need for the policy space to regulate for enhanced stability. During the previous era in which financial deregulation was in favour, WTO challenges of financial regulation did not arise. However, now that countries are beginning to re-regulate, conflicts are emerging with some member countries questioning whether others' financial reregulation violates GATS commitments.

(b) Mr Andrés Arauz, General Banking Director, Central Bank of Ecuador

Mr Arauz commented that the legal analysis related to the GATS and the related annexes must include the historical context of the international financial system and the current juncture in which we find ourselves since the global financial crisis, given that the G20, the UN Commission of Experts and others are proposing reforms to the international financial system.

The reason Ecuador, along with other countries, has been highlighting the need to rethink WTO rules in the wake of the crisis is that there is an emerging consensus that the financial crisis was due in large part to financial deregulation. The Bank of International Settlements reported that conventional theory was not sufficient to understand what was happening during the financial crisis; there was a lack of understanding of system-wide risk. In the context of a regulatory vacuum, excessive risk-taking before the crisis created a shadow banking system, where companies established offshore subsidiaries, taking advantage of countries' mode 1 commitments to engage in "regulatory arbitrage." The G20 is now calling for regulation of offshore financial centres, but prohibiting banks from setting up subsidiaries in these tax havens could contradict some countries' GATS commitments.

The BIS also pointed to financial "innovation" as a contributor to the crisis. In the 1990s, when countries made GATS financial service commitments, governments could not have foreseen such "innovations." The book values of derivatives, interest rate swaps, etc. are ten times larger than the size of the real economy, which can create bubbles and instability. It would be wise to regulate these derivatives markets without worrying about conflicts with GATS agreements.

Ecuador and other countries advanced a conversation about the measures taken after the financial crisis by developed countries and the asymmetries involved between developed and developing countries, related to transparency, fiscal space and privileges with respect to issuing reserve currencies.

Director-General Lamy has rightly supported the need for more and better regulation. For this re-regulation to be successful, there must be much better communication and coordination between regulators and trade negotiators. Crises can be avoided with adequate regulation, and avoiding crises helps to avoid trade distorting measures. Therefore Mr Arauz suggested that the WTO should monitor the impacts of the crisis and measures taken and ensure the public policy space for regulation.

(c) Ms Sanya Reid Smith, Senior Researcher, Third World Network

Ms Smith shared research on the successful use of capital management techniques in the Asian context, summarizing a Third World Network study directed by a former chief economist at UNCTAD in cooperation with eminent local economists in each country.

Capital management techniques are important because large capital flows help facilitate the spread of the crisis to developing countries. Since the crisis, there has been an emerging consensus that capital management techniques should be available as a tool to help developing countries avoid incipient crises and help them get out of crises when they occur.

Ms Smith described in some detail how China, Malaysia and Thailand have successfully used capital controls, according to the study. In contrast, careless capital account liberalization in the Republic of Korea led to severe damage from the Asian financial crisis. After the recent crisis, the Republic of Korea's use of capital controls helped to stabilize the Korean economy. Some observers have noted that the Republic of Korea's recent capital controls would not have been permitted under the Free Trade Agreements negotiated by the Republic of Korea with the United States and EU if these pacts had been in force at the time.

(d) Mr Etienne Vlok, Director of South African Labour Research Institute (SALRI); Teselico Convenor for the Congress of South African Trade Unions (COSATU)

A lack of regulation of speculative activity and the rise of "innovative" financial instruments intensified volatility in the financial system, increasing inequality and leading to financial crises and unemployment. Mr Vlok described unionists' concerns that the current global "trade" rules do not provide the domestic policy space needed for re-regulation based on the specific contexts each country faces. South Africa's measures to protect consumers from reckless lending practices and pro-active steps to reduce potential risks in the financial sector were possible because South Africa took limited Uruguay Round financial services commitments. However, workers are concerned that much of this space would be eroded were South Africa's Doha Round offers to become new binding WTO commitments.

Mr Vlok highlighted South Africa's Doha Round offer on derivatives, made in 2006, before the crisis demonstrated the dangers of an unregulated derivatives market. The use of speculative financial instruments covering key food commodities contributed to a staggering increase in food prices in South Africa, where inflation in food prices reached 20 per cent in 2008. This has devastated the poorest families, for whom one-third of income is spent on food. Policy-makers, civic organizations, unions, and others in civil society in South Africa have called for more regulation of food commodity derivatives and perhaps even bans on some risky instruments. Mr Vlok warned that the South African Doha Round offer now on the table would hinder the country's ability to implement the range of policy options needed to counter damaging derivatives trading.

In closing, Mr Vlok noted that countries are told not to be concerned about potential WTO challenges because there has not been a WTO challenge in this area to date. However, he noted that the policy constraints imposed by GATS could have a damaging, chilling effect without recourse to formal dispute resolution. When Walmart attempted to purchase a South African retailer, both workers and government attempted to condition Walmart's entry into South Africa on its meeting local procurement terms that could promote the domestic manufacturing sector. During the hearing process, Walmart's lawyers warned that those conditions might conflict with South Africa's GATS commitments in retail trades. The result was that the merger went forward without the procurement conditions, and the threat of a potential GATS challenge was certainly a contributing factor in freezing the pro-development, pro-jobs policy.

2. Questions

A representative from Permanent Mission of Pakistan to the WTO asked: given the inverse relationship between the risk-taking of financial service institutions and the level of regulation, did the panellists think regulation was a good idea?

A representative from Kenyan Parliament asked: what is the intersection between the WTO and other institutions such as IMF, World Bank, BIS, and Basel in relation to the international financial system?

Mr Alfredo Calacgno of UNCTAD said that in UNCTAD's 2011 Trade and Development report, they had mentioned the necessity of capital controls and of re-regulation of the financial system, and they shared the analysis that there could be possible contradictions between GATS and BITs and this need for re-regulation. He asked what the panellists through the solution was.

3. Conclusions

Ms Wallach's final comments were that WTO rules clearly affect financial regulation and they reflect the deregulatory period in the past when the current rules and commitments were made. While these WTO rules remain static, other institutions, such as the IMF, are responding to recent crisis' lessons. The crux of the question is: how can the WTO support the global agenda of reregulation by ensuring that its rules from the 1990s are not a hindrance?

Mr Arauz said that if risk-taking puts the entire financial system at risk, then strong regulatory measures are needed to dissuade that behaviour. Every regulator in every country must assess that balance of what risk contributes to systemic risk.

Mr Vlok summed up by saying that it is important to add that, in the negotiations on domestic regulations, the limitations could be made much worse.