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The WTO as barrier to financial regulation

In most parts of the world today, most policy makers talk about imposing regulations on the financial sector.

Without such changes, the world economy will continue to lurch from crisis to crisis, necessitating ever larger bailouts and leading to even greater damage to the citizenry. But the question is: are they feasible, given the legally binding commitments made with respect to financial services liberalisation by the US and several other WTO members?

The General Agreement on Trade in Services (GATS) limits the ability of countries to regulate financial services. While GATS is still the most flexible of the various Uruguay Round WTO agreements, in that it is based on a request-offer process in which individual countries can determine the extent and pace of liberalisation in particular sectors and modes, there are some important caveats.

As for all other services, member countries are required to provide their own GATS schedules of financial services commitments. However, the Annex on Financial Services already makes some crucial limitations on countries' ability to be flexible on these commitments. The Annex applies to all WTO member countries, irrespective of the extent to which they have individually or collectively decided to make liberalisation commitments in financial services.

The section on domestic financial regulation in the Annex makes the following point: "Notwithstanding any other provisions of the Agreement, a 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 owed 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**" [emphasis added].

So, if countries have already made commitments to allow certain kinds of financial activities of foreign financial institutions, they cannot impose any prudential regulations if they run counter to such commitments! Thus, much of the regulation now being proposed or enacted in developed countries runs counter to this provision. Any such regulation could be opposed by another member country whose financial firm is affected by such rules. Given the cross-border proliferation and complex entanglements of financial institutions, such challenges seem bound to occur.

It gets even worse. The US NGO Public Citizen[1] notes that the financial services liberalisation commitments that have already been made are apparently irreversible under various GATS rules. This makes new regulations required to deal with finance next to impossible in strictly legal terms.

The GATS Market Access rules (contained in Article XVI(2) of the GATS text) prohibit government policies that limit the size or total number of financial service suppliers in "covered sectors", i.e. where liberalisation commitments have been made. So, if countries have already committed to certain kinds of deregulation, they cannot easily undo them, even in relation to critical issues like bank size. Under the same rules, a country *may not ban a highly risky financial service* in a sector (i.e. banking, insurance, or other financial services) once it has been committed to meet GATS rules.

The case law on this matter is disturbing to say the least. A WTO tribunal has already established the precedent of this rule's strict application: the US Internet gambling ban – which prohibited both US *and* foreign gambling companies from offering online gambling to US consumers – was found to be a "zero quota", thus violate GATS market access requirements. This ruling was made even though the US government pleaded that internet gambling did

not exist when the original commitment was made, and therefore could not have been formally excluded from the commitment list!

For the 33 countries that signed a further WTO "Understanding on Commitments in Financial Services" in 1999, the situation is worse. These 33 countries include almost all OECD members, as well as a few developing countries like Nigeria, Sri Lanka and Turkey. This Understanding established further deregulation commitments by specifying a "top-down" approach to financial liberalisation, which means that sector is, by default, fully covered by all of the agreement's obligations and constraints *unless* a county specifically schedules limits to them.

For the US, UK and the other 31 countries that signed on to the Understanding, there is effectively a standstill on further financial regulation of any kind: "Any conditions, limitations and qualifications to the commitments noted below shall be limited to existing non-conforming measures." And there is no possibility of any kind of ban on specific financial products deemed too risky—like certain derivatives, etc.—because the signatories to the Understanding have promised to ensure that foreign financial service suppliers are permitted "to offer in its territory any new financial service."

Hence, most new financial sector reform proposals, in these countries, are effectively illegal given their GATS commitments. This has implications for other countries, since all of us will be affected by the volatile functioning of unregulated financial markets. And since GATS rules tend to prevent backtracking on liberalisation commitments made, developing countries need to be doubly careful before making such commitments.

While this situation may appear to be bizarre, it reflects the lobbying power of finance. Most of these specific financial agreements were signed without the knowledge or understanding of the public at large in the countries concerned. For example, the US Congress normally vets international economic agreements, but this did not occur in the case of the Understanding on Financial Services.

Obviously, these GATS rules now constitute a major constraint on necessary financial sector reforms. There are now two possibilities. First, that such rules are more or less ignored and become a bit like the "Maastricht rules" for European economic integration, which tend to be more honoured in the breach, especially by the large countries. Second, GATS and the FSA – specifically these provisions – gets renegotiated, eliminating all provisions which demand and insist on comprehensive financial deregulation even when undesirable.

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[1] http://www.citizen.org/documents/PrudentialMeasuresReportFINAL.pdf