

What is... the GATS?

The General Agreement on Trade in Services (GATS) is the only agreement at the multilateral level which regulates and liberalizes trade in financial services as well as investment of financial services companies. It was negotiated in the Uruguay Round (1986-1994), the multilateral trade negotiations round that also established the World Trade Organization (WTO). In 1995, the GATS went into effect for all WTO members (148 at the end of 2004), and consists of two elements: a text with GATS rules and a country-specific list of services sectors in which individual countries must open their markets. Since 2000, GATS negotiations have been taking place in the context of the 'Doha Round,' and include further liberalization of financial services and additional rules (e.g. emergency safeguard measures). Liberalization of financial services also occurs outside the GATS in bilateral or regional trade agreements.

Negotiating Liberalization of Trade in Services

The GATS identifies different types of trade liberalization for services:

Mode 1: cross-border movement of the service or "cross border trade" where a financial firm is allowed to provide services to individuals overseas, e.g. offering internet banking to foreign nationals so they can establish savings accounts.

Mode 2: cross-border movement of the service consumer or "consumption abroad": e.g. an Indonesian art trader is allowed to go to the Netherlands and get a loan from a bank based in the Netherlands to buy Dutch art.

Mode 3: cross-border movement of the corporate service provider through investments or "commercial presence," e.g. a country allows foreign banks to buy up domestic banks or to open up branches in its territory.

Mode 4: "cross-border movement of natural persons," e.g. a Brazilian manager of a Swiss bank is allowed to work at the offices of the bank in Zurich or New York.

In the GATS negotiation process, a country first decides what commitments it is willing to make, in other words, what sectors it wants to liberalize, and under what 'modes'. It can also indicate if it wishes to make exemptions to some GATS rules. During the negotiations, a country receives "requests" from other WTO members, that is, lists of services for which other countries demand market opening. A country can then reply with an "offer", a list of services it is prepared to liberalize. Subsequently, bilateral secret negotiations occur, in which countries bargain between each other's offers and requests.

The GATS Principles

The rules of the GATS agreement apply to financial services, and are applicable to all WTO members. Some general principles that apply to all members include:

- Most Favoured Nation principle. States undertake negotiations at a bilateral level. However, once they make commitments to another state, this must apply to all other WTO members (Art. II);
- Transparency: Countries commit to be open and notify other WTO members of all new measures and laws on (financial) services (Art. III);

When countries have committed to liberalize certain sectors, the following rules apply:

- fair treatment of foreign services suppliers when taking administrative measures or giving authorization to supply a (financial) service (Art. VI.1.,2.,3.);
- ensure that standards, licensing and qualification requirements do not constitute a barrier to trade (Art. VI.4.,5.)
- no restrictions on international payments for current transactions related to committed (financial) services (Art. XI), except in case of balance of payment problems (Art. XII);
- no measures that limit the operation or ownership of (financial) services e.g. limitation on the number of branches (market access obligations in Art. XVI);
- National Treatment: equal treatment of foreign and national financial service providers (Art. XVII);
- a GATS commitment to liberalize can only be reversed by a country after three years and in addition, the WTO trading partners can demand compensation (XXI).

The WTO has a Dispute Settlement Mechanism that members can invoke if they feel another country is not operating according to the rules.

In addition to these GATS rules, some additional rules apply to financial services: these rules can be found in: the Annex on Financial Services, The 'Understanding on Commitments in Financial Services', and the Fifth Protocol.

The Annex on Financial Services

The Annex on Financial Services is part of the GATS agreement and provides some specifics on how governments can operate under the financial services agreement. It (Art. 5.) provides a non-exhaustive list of insurance, banking and other financial services that are covered by GATS rules and commitments. It also describes which "services supplied in the exercise of governmental authority" are exempted from the GATS agreement (Art. 1), such as activities by central banks or by public retirement systems.

Prudential carve-out Art. 2 of the Annex specifies that WTO members can take measures for prudential reasons such as protecting investors and depositors, and ensuring the stability and integrity of the financial system, even if such measures do not conform with GATS rules. However, prudential measures should not be abused to circumvent GATS rules nor commitments made under GATS.

'The Understanding'

Another part of the GATS agreement is designed to promote the quick and full liberalization of the financial services sector: The Understanding on Commitments in Financial Services. If a WTO member agrees to open up its financial services according to the 'Understanding', then it must apply a set of market openings, and not exercise the exemptions allowed by the GATS agreement to financial services. This means for instance that public entities which buy financial services from private domestic companies should give equal opportunities to foreign companies (national treatment), even though this is not necessary under GATS (Art. XIII). All industrialized countries have accepted the Understanding and see it as a minimum for others, but only very few developing and emerging market countries have joined in. In total, only 30 countries have opened up their financial services according to this Understanding.

The Fifth Protocol to the GATS

At the end of the 1994 GATS negotiations, some WTO members, particularly the US, were not satisfied with the progress made in the financial services sector. Thus, further specific negotiations on financial services ensued, which lasted until the end of 1997. The result was the Fifth Protocol to the General Agreement on Trade in Services, which commits countries to additional market openings for financial services. Although the Protocol went into effect in 1999, several members, including Brazil, have postponed their acceptance of it.

Critical Issues:

- *Prioritizing swift liberalization.* Opening markets for foreign financial services and investment by foreign financial firms has been a priority in past and current GATS negotiations for the US and the EU. The 'Understanding on Commitments in Financial Services' ensures that no trade barriers or obstacles to profit-making by foreign financial firms are left.

- *GATS fits neatly with the interests of the Western financial industry.* The US and EU financial industry heavily lobbied during the GATS negotiations. As a result, the GATS agreement and current GATS negotiations fit neatly with the expansion ("consolidation") and profit-making strategies of the top financial conglomerates. As expected, the GATS agreement has no provisions to strengthen universal access to financial services, to tackle 'cherry picking' (when foreign companies selectively take over the strongest domestic financial institutions), nor to improve the quality of financial services for all customers. The GATS agreement does not reference intergovernmental treaties or

initiatives that promote sustainable development, poverty eradication or corporate social responsibility.

- *Increasing competition and concentration.* Increased competition following further GATS liberalization is likely to reinforce the existing trend within the financial industry toward high profit making, concentration and consolidation. The GATS agreement only has a weak mechanism (Art. IX) for tackling market abuse and restrictive business practices that will likely occur with more concentration and consolidation. There is no discussion within GATS on how far financial services concentration can go and when financial conglomerates will become 'too big to fail'.

- *Unbalanced requests for transparency.* The GATS agreement focuses on more transparency from governments but fails to improve the transparency of the complex financial industry. GATS should compel all WTO members to legislate the transparency of financial firms operating in their country. This would somewhat promote fair competition.

- *GATS aggravates the gaps between rich and poor.* The liberalization of financial services is supposed to improve efficiency in the financial industry and the economy. However, the experiences of liberalization in developing countries show that there is much more at stake than increased efficiency, choice of products and access to capital.

- Foreign financial firms widen the gap between rich and poor by targeting the richest clients, the most developed regions and the best personnel from their host countries. This undermines the competitiveness and efficiency of developing country banks that have more expertise to meet the needs of poorer clients or to invest in the domestic industry.
- As soon as developing country governments open their markets, foreign firms often rapidly take over a large part of the domestic financial industry. Due to rapid foreign expansion, host countries must spend additional resources to regulate, supervise, and handle changes and risks.
- Profits made off rich clients in poor countries are siphoned off to the home countries in the North. GATS prevents government restrictions on profit repatriation. In addition, foreign firms provide rich clients in poor countries with more opportunities to channel their money to the North and invest in Western companies, potentially diverting local investment in domestic enterprises.
- Host country governments have less leeway in directing the development of their domestic market, and have much less influence in integrating sustainable development practices.

- *GATS increases the risks of financial crisis.* The liberalization of financial services as such poses many threats to the financial stability of the host developing countries and the international financial system, especially when capital flows are already liberalized. GATS reinforces those threats, and it both limits and challenges governments and central banks to develop independent policy to regulate their financial sectors. While GATS is not supposed to liberalize capital flows, in practice GATS liberalization of financial services does.

The risks to financial instability come from:

- *New financial services* can have significant destabilizing effects on a developing country's financial system. Increasing cross-border capital flows or risky financial strategies require that the right regulatory and supervisory systems be in place.
- *GATS articles* promote cross-border capital movements and financial instability by limiting government restrictions on profit repatriation and capital flows related to committed (financial) services (see Articles XI.1. en XVI (footnote 8)).
- *GATS rules permitting restrictions* on unstable capital flows and (financial) services are *limited* by many conditions. These conditions prioritize the interests of foreign-service providers rather than the capacity of a developing country to deal with problems in its financial system (see 'prudential carve-out' of the Annex on Financial Services). The vagueness of financial prudential measures which

GATS permits leave many developing countries' regulations open to challenges by WTO disputes, or to bullying by the hardliners during the secret bilateral GATS negotiations (such as the EU is doing). The vagueness surrounding GATS interpretation could also prevent countries from introducing national legislation such as the Tobin Tax for fear of future WTO disputes

- *Trade negotiators prevail: Where are the International financial safeguards?*

The lack of coordination between the trade negotiators and the institutions responsible for the national and international financial system is a problem in most countries. What is worrying is that Western negotiators brush aside concerns raised by developing countries while the risks of financial instability in developing countries are not fully analysed or discussed. Moreover, lessons learned from the Asian financial crisis, from the IMF Financial Sector Assessment Programme or other financial scandals in the West (e.g. mismanagement of pension funds' capital) have not informed the GATS negotiations. For example, the liberalization of cross-border financial flows and of financial services in developing countries needs to be gradual and well sequenced; building capacity and institutions to monitor the financial system – particularly complex financial conglomerates -- is costly and also takes time. In addition, there exist no adequate safety nets or international financial safeguards against the increasing instability risks from GATS liberalization. Some Northern countries have promoted the use of international financial standards, developed by supervisors and regulators, in the GATS. However, various southern countries feel these standards (e.g. Basel 2) do not address their needs, as they were originally developed by Northern countries.

Better coordination between the GATS negotiations and the international financial stability institutions is necessary, but with the reforms of the global financial architecture far from complete, it is most important to support capacity building and increased participation from developing countries at all these fora. The negative consequences felt by the poor and the environment due to financial crises are so significant that reducing the risk of liberalization GATS rules is paramount.

- *Limiting policy space.* In countries where the domestic financial sector needs improvement or is not yet capable of competing with foreign competitors, GATS articles XVI, XVII and VI limit the government's ability to make this a priority. Governments can set out exemptions to GATS articles which would allow regulators and central banks to maintain their policy space. However, the process to do so is complicated and difficult for some developing countries when they are negotiating financial services commitments.

Web references:

www.polarisinstitute.org

www.gatswatch.org

www.somo.nl (->financial sector report)

www.wto.org