

How Trade, the WTO and the Financial Crisis Reinforce Each Other

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WTO meeting on financial crisis only about more financing of trade

On 12th November 2008, the WTO held a selective conference about impact of the financial crisis on trade. The main issues discussed were the lack of credit and finance for traders, and the slow down of the economy resulting in slowing down international trade. The main responses advocated, and already used, were having more co-sharing of risks by the international financial institutions and export credit agencies (ECAs).

As is not always revealed, the risks of ECAs ultimately have to be paid by developing countries, thus increasing the debt burden of developing countries. This would also mean that less risk is to be taken by the private sector, some of whom were attending the meeting –including some of the banks that have already received government support such as ING and Royal bank of Scotland while having a bad social and environmental record.

The wrong arguments used for pushing to finalise the Doha Round of WTO negotiations

Of course, the WTO Director General Mr Lamy, has in his many speeches during the last weeks often argued that the WTO is a solution to the crisis, that WTO rules prevent “protectionist measures” and beggar-thy-neighbour policies which led to the economic depression in the 1930s and the consequent wars, and that conclusion of the Doha Round means strengthening regulation. However, Mr Lamy has admitted that some losses of jobs and income over the last years are to be attributed to trade liberalization [speech of 29 October 2008] but that therefore “restoring citizens' confidence in trade requires governments to ensure that sound domestic policies are in place.” However, since those sound and distributive domestic policies are not in place, and the WTO rules are even undermining such policies, there is little argument to liberalise further.

There are many arguments why the WTO's rule based system is not sufficient and why finalising the Doha Round as currently negotiated would be disastrous to deal with the economic, social and environmental problems facing the world today:

- ❑ In the Doha Round, developing countries are asked to open up their markets much more than developed countries, so that they will have to bear more of the burden to cope with liberalization. This is contrary to the Doha Round principles and in contrast with the responsibility of the financial crisis which was created in developed countries: the latter should indeed show solidarity and take the responsibility to unilaterally provide financial support to allow developing countries to trade without undermining social and environmental needs worldwide.
- ❑ Opening up more markets would give even less chances to smaller producers and traders to be able to survive. In many countries employment and income losses cannot easily be replaced. The current world economic system has so many unequal players that liberalisation does not provide the claimed benefits of open trade as argued in the comparison with the 1930s. The multinationals would be the winners of the increased competition game and not the workers, poor and jobless. The Doha Round negotiation draft text show a protectionism of the rich and multinationals who lobbied for their interests, and would result in a wrong unequitable and unsustainable 'rule-based system'.
- ❑ The Doha Round is about deregulation and prohibiting governments' policy space, and is not about strengthening of regulation. The Doha Round would re-inforce a failed model of laissez-faire, based on the believe that markets can be left on their own and that the common good will come out of leaving everybody pursuing their own interest. The financial crisis has shown how the free market is based on a failed ideology and why the gap between rich and poor is increasing. Free markets are unable to take environmental and social concerns into account.
- ❑ Lamy's argument that "one protection is another ones lost opportunity" should be turned around by "each market opening is ones lost opportunity": the importance is that there should be no lost opportunity for "raising standards of living, ensuring full employment and a large and steadily growing volume of real income" and "the optimal use of the world's resources in accordance with the objective of sustainable development," "in a manner consistent with [countries'] respective needs and concerns at different levels of economic development," – as the preamble of the WTO says! However, the trade rules would need to change as well !

The WTO has so far not talked about how GATS and FTA commitments to liberalize financial services undermine the ability of governments to prevent, or deal with, the financial crisis as explained below.

Financial Services Deregulation in GATS and FTAs Promote Financial Crises

An important element is missing among the many discussions and proposals to reform the financial system and stop to financial crisis of spreading further. There is no

discussion about the broad liberalisation and deregulation of financial services, capital movements and the international financial industry through the GATS and the free trade agreements (FTAs). The call made by the WTO and some European leaders to finalise the Doha round at the same time of the financial reform talks (so-called Bretton Woods II) completely ignores that this would include further liberalisation and deregulation of financial products and all kind of financial service providers (banks, insurance, security traders, pension fund managers, ...), even the most risky ones (e.g. derivatives). The Northern countries such as EU, US and Canada, are very keen to further liberalisation of the financial services sector.

As is explained below, GATS and FTAs have been and will be taking away countries' ability to prevent a financial crisis, or take measures during a financial crisis, and improve regulation and supervision by:

- ❑ Liberalising financial services before due international regulation and supervision is in place;
- ❑ Further liberalising risky financial products and operations;
- ❑ Making legally binding commitments to deregulate;
- ❑ Not recognizing that financial services should be at the service of the whole of society, and not vice versa;
- ❑ Removing prudential measures during secret GATS negotiations.

Countries that liberalise financial services under GATS and free trade agreements will experience among others negative impacts of foreign financial services providers in many sectors, especially in developing countries:

- ❑ In **agriculture**, foreign banks in developing countries have not been financing small farmers nor have they been providing services in the rural areas. The food speculation through banks offering trading in derivatives in food commodities has contributed to high food prices that made many poor suffer.
- ❑ In the **industrial sector**, foreign banks have been reluctant to provide credit to smaller local companies or even the domestic industry as a whole – even more in times of crisis that also leads to less financing for trade. This means that the domestic industry becomes less competitive, which is especially problematic if an agreement on NAMA would increase foreign competition in developing country markets.
- ❑ The impact on the **environment and climate change** of foreign banks have been enormous. Internationally operating banks have financed many companies and projects that damaged the environment and increased climate change.

Talking points in GATS negotiations on financial services for civil society and activists

1. GATS liberalises financial services without due supervision and regulation

A major reason for the financial crisis has been the lack of regulation and supervision especially of financial conglomerates and financial service providers that operate world wide. The securities and derivatives based on US sub-prime mortgages were being sold and bought worldwide especially by internationally active financial services providers (e.g. banks, insurance companies, investment banks). The GATS has contributed to crisis by liberalising financial service providers as well as trading in (risky) financial products without any guarantee that the necessary regulation and supervision was in place at national, regional and international level.

Consumers have been some of the victims of the financial crisis. GATS has contributed to fierce international competition whereby (international) banks were only interested in serving profitable clients and were providing less or expensive services to poorer clients, including small farmers. Now it has become clear that consumers cannot be sure anymore whether foreign banks established in their country are safe, as is clear for instance in the losses by savers at the Icesave bank in the UK and in the Netherlands. Icesave was a branch of Landsbanki from Iceland. Iceland was part of a free trade agreement with the EU. Once a country has liberalised under GATS or a free trade agreement, foreign banks have the right to establish branches in that country but savers' interests are not taken into account. For instance, the host country supervisor is dependent on information of the supervisor in the home country to see whether the branch is stable and meeting conditions set by the host supervisor. This system failed in the case of Icesave.

2. GATS liberalises dangerous trading in risky financial products

Once a WTO member has fully liberalised a financial sector or sub-sector under GATS, this 'commitment' is very difficult to reverse i.e. the government cannot prohibit and stop a foreign service provider from entering the country and offering financial services that have been committed.

One example of what this might mean in practice is that it could be difficult for the authorities to prohibit speculation through trading in risky derivatives. Derivative trading in key agricultural commodities has contributed to the high food prices, making food unaffordable to many of the poor. Over the past year, India has banned this financial trading, which it could do because it had made no GATS commitments in derivative trading. South Africa would have more difficulties to do so because it has already

liberalised derivative trading with only a condition on how to establish themselves in South Africa.¹

Another example of the risks of derivative trading is the worldwide trading in sub-prime mortgage credit derivatives, which has clearly shown to have been a major cause of the current financial and credit crisis.

Also the EU and other industrialised countries will have difficulties to fundamentally reform and regulate their financial markets. They have liberalised according to a GATS model called 'Understanding on Commitments in Financial Services'², which requires that any new financial service can be offered by foreign financial service providers. No conditions attached! This means that when some EU member states and the US were prohibiting 'short selling' or 'naked short selling'³, this might be in breach of their commitments to liberalise innovative securities trading.

If a government wants to reverse its liberalisation commitments-which it can only do three years after the GATS commitments are in force- it has to negotiate compensation to those countries which request so because they consider they will be affected, i.e. their financial industry will be loosing business and profit opportunities. This can be a very costly, time consuming and politically difficult exercise. As a result, countries have so far been very reluctant to reverse commitments.

3. GATS and FTAs contribute to deregulation

While there is currently much talk about more regulation and supervision, GATS in fact restricts regulation. Although GATS⁴ allows that prudential measures are taken by the authorities to protect customers and avoid financial instability, the question is which prudential measures will be seen as acceptable and which not. GATS stipulates that prudential measures should not be seen as to undermine the GATS commitments - which is difficult to assess and might have prevented some governments in the past of taking particular prudential regulations. Countries could use the GATS article XIV that allows them not to implement their commitments arguing that public health is at stake,

¹ The condition that South Africa has imposed when it liberalised derivative trading is that such trading on licensed exchanges requires capitalised incorporation as a South African company and registration with the supervisory authority. South Africa's commitments on financial services were finalized separately in document GATS/SC/78/Suppl.3, dated 26 February 1998.

² The GATS Understanding on Commitments in Financial Services includes a rule (Art. B.7.) that "A Member shall permit financial service suppliers of any other Member established in its territory to offer in its territory any new financial service."

³ The definition of short selling according to Wikipedia: the short-seller will "borrow" or "rent" the securities to be sold, and later repurchase identical securities for return to the lender. If the security price falls as expected, the short-seller profits from having sold the borrowed securities for more than he or she later pays for them but if the security price rises, the short seller loses by having to pay more for them than the price at which he or she sold them. < http://en.wikipedia.org/wiki/Short_selling>; 'naked short selling' means that the securities are even not first rented or borrowed by the short seller; see < http://en.wikipedia.org/wiki/Naked_short_selling>

⁴ In the Annex on Financial services

but WTO member are afraid to use that article for fear that would be too difficult to prove or that Article XIV would be abused in their disadvantage in the future.

Countries that have fully liberalised under GATS or FTAs with the EU, without attaching conditions, are prohibited⁵ to introduce particular measures or laws, such as laws that limit the number of service suppliers or limit the value of the service transactions – which could be useful to ensure the stability of the financial markets in particular countries or particular circumstances. Also, capital flows have to be allowed to move freely⁶ if they are related to foreign financial services' cross border trading and establishment and are liberalised under GATS. This restricts authorities to intervene to prevent or deal with instability on financial markets.

Worse, the fierce international competition that was encouraged through GATS, made national regulators and supervisors reluctant to curtail their financial industries through (international) regulations. Stricter regulation and supervision was considered a cost and to make their financial industry less competitive. For instance when a government would have introduced measures whereby banks would have been prevented from becoming too big to fail, such measures would be seen as not allowing banks to become big enough to be competitive (through economies of scale and larger profits). National regulators and supervisors have failed to ensure that interests of consumers, particular circumstances or sustainability needs of each country were taken into account.

4. Lack of recognition of the impact of GATS and FTAs and in the discussions about reforms of the financial system

Although there is a recognition that the markets have failed to regulate themselves, that public intervention is needed and that adequate financial regulation needs to be in place before liberalisation, too little has been done so far. There is a dangerous lack of discussion about the impact of liberalisation under GATS and FTAs on the financial system and on the capacity of countries to regulate and supervise according to the needs of their population. For instance, the 10 pages of recommendations⁷ proposed by the Financial Stability Forum (FSF)⁸, among others, do not make any reference to GATS or FTAs but demonstrate that many regulatory issues still need to be resolved. The FSF

⁵ See Art. XVI of GATS, and identical article in the EPA (FTA) between the EU and Caribbean countries.

⁶ See GATS Art. XI and XII.

⁷ Financial Stability Forum, *Enhancing market and institutional resilience*, April 2008, Annex A: available for downloading at: http://www.fsforum.org/publications/FSF_Report_to_G7_11_April.pdf;
see also the review of its recommendations on 10 October 2008
<http://www.fsforum.org/press/pr_081009f.pdf>

⁸ The FSF was created in the aftermath of the 1998 Asian financial crisis and brings together on a regular basis national authorities responsible for financial stability in significant international financial centres, international financial institutions, sector-specific international groupings of regulators and supervisors, and committees of central bank experts

also indicates how international cooperation among regulators and supervisors of internationally operating banks and other financial conglomerates is still very inadequate.

5. Financial services needs special attention as they are a 'public good'

The fact that industrialised countries have been willing to bail out the risky and speculative behaviour of the financial industry and the financial markets is providing a formal recognition how financial services are in fact a 'public good'. It is finally recognised that financial sector is to service the economy and society as a whole, and can have economic and social effects all over the world. The huge costs of the bail out, with amounts that would save millions from poverty and hunger, means that all measures must now be taken to avoid making the same mistakes. It also means that financial services liberalisation should be carefully looked so that it does not at least undermine the public function financial services have. The mandate of regulators and supervisors should be to ensure to that the financial system fully and entirely contributes to a sustainable and equitable society.

6. Dangerous continuation of the negotiations

The current calls to finalise the Doha Round during the reforms of the financial system, e.g. by Mr Lamy and UK Prime Minister Gordon Brown, completely failed to mention that this would include further liberalisation of financial services. The EU and other industrialised countries have always pushed and argued that further liberalisation of financial services would need to be part of the Doha Round. Developing countries have already been asked to liberalise all kind of financial services without having the necessary regulations in place. This includes a request to permanently open their markets for trade in "derivative products" as well as investment banking. The EU has since 2002 requested different developing countries to remove specific prudential regulation which was put in place to deal with a financial crisis.⁹ 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 which requires that foreign financial service providers be given permission to introduce any new financial service.

The GATS negotiations might actually have surprising negative impacts on regulation. The negotiators have so far not been able to ensure that the draft new GATS disciplines on 'domestic regulation' will not undermine prudential regulation in financial services. If financial prudential measures would fall under the current draft text on 'disciplines in domestic regulation', this would mean that measures and standards in the financial sector could be challenged in the future on a variety of grounds, such as being not "objective", "relevant", or acting as a disguised restriction on trade. Also, licensing

⁹ See paper by M. Vander Stichele, GATS negotiations in financial services: The EU requests and their implications for developing countries (see www.somo.nl)

procedures for banks would have to be made "as simple as possible". Committing financial services before the new domestic regulation text is finalized may endanger domestic financial regulation. This would increase the uncertainty whether measures that are introduced to avoid a financial crisis and adapted to a country's circumstances, will not be considered as restrictions to trade.

7. A few urgent demands to be made, among many others

7.1 Rolling back commitments

Given that some developing countries (like South Africa) have already opened up so much of their financial services market according to GATS rules, including for risky and volatile financial services, such countries should be allowed to reverse their current GATS commitments on financial services without having to give compensation for their withdrawal of commitments. According to GATS article XXI, if no country asks for compensation, the country withdrawing its liberalisation commitments does not have to give any compensation for the withdrawal of its financial services commitments under GATS.

7.2 Prudential regulation to be fully applied

Countries should be allowed to fully use their possibility to introduce prudential regulation under the current GATS rules (Annex on Financial Services). However, they have to consider that this should not so much advantage the financial industry who lobbied to undertake ever more risky and speculative financial operations, but should support the general public, small producers, farmers and sustainable development.

7.3 No deal on Doha Round during the discussions on a new international financial order (often called Bretton Woods II conferences):

There should certainly be no Doha Deal that includes liberalisation of financial services, since the necessary national and international regulation and supervision is not yet in place and GATS as well as FTAs will curtail regulation.

Given the failure of the markets and the recognized need for regulation and supervision before liberalisation, no commitment on further liberalisation in the services sector should be considered. This also means that there should be no inclusion of liberalisation of financial services and capital movements in free trade agreements, as currently negotiated or being submitted for ratification.

7.4. Financial services out of the GATS and free trade agreements

The discussions on a new international financial order should consider how the public function of financial services can be sufficiently guaranteed. This cannot be done under

GATS and liberalisation of financial services under FTAs, and should take place in an other institutional setting and manner -if it all- which could be done through a public financial sector if that is the best way. The public good function of the financial services sector should include to ensure that it fully contributes to sustainable development world wide, rather than up till contributing to social exclusion as well as climate change through financing the wrong projects, the wrong trade and production, and the wrong companies. In practical terms, this means completely changing the mandate and decision-making of regulators and supervisors.

7.5. Some general demands relating to ensure a financial system at the service of people and the environment

- ❑ Democratisation of decision making on financial regulation and accountability of supervision and central banks, at local, national, regional and international level. This means involvement of those interested in defending the public interest and involvement of developing countries.
- ❑ There should be a ban on dominant, secret and dominant lobbying by international financial conglomerates, including in trade talks.
- ❑ The 'financialisation' of the economy has to be stopped. Financial services should prioritise the poor, marginalized and small farmers or companies, not the profits of the shareholders and managers of the financial industry. This could include giving a duty to regulators, supervisors and the financial industry to only provide financial services to operations, projects, investments, companies, production, trade, housing and consumption that are promoting equity and sustainability. Financial service providers, including credit rating agencies, should not be treated as 'normal' companies and be in public hands where necessary.
- ❑ Governments should reverse their policies to only support the competitiveness of their own financial industry, and push for market opening, at the expense of regulation and supervision that provides protection and improved services for the majority of the population and small entrepreneurs and farmers.
- ❑ There should be strong regulations that prevent any financial service providers to become too big to fail, or too interconnected to fail. Further liberalisation of financial services and the mergers & acquisitions during the current crisis are exacerbating such problems rather than solving the 'moral hazard' problem of ever increasing bail outs.
- ❑ Financial conglomerates should be split up again so that none covers banking, insurance, equity trading, investment advice and investment banking at the same time.
- ❑ No financial product should be offered until it has been officially approved to be safe for consumers (no predatory lending) and not causing instability or "toxic" risks.
- ❑ Tax havens and financial services for tax evasion should be banned.