



GATS negotiations on financial services and assessment of the plurilateral requests

by Myriam Vander Stichele
Senior Researcher, SOMO

The plurilateral request on financial services in the current GATS negotiations aims at the fullest liberalization for foreign financial service providers in around 21 countries. This “collective” request on financial services was made on 28th February 2006 by 10 countries who mostly have a financial industry that is interested to expand or to consolidate their presence in especially emerging market countries. Under the lead of Canada, the request was made by: Australia, the European Communities, Ecuador, Hong Kong China, Japan, the Republic of Korea, Norway, the Separate Customs Territory of Taiwan, Penghu, Kinmen and Matsu, and the United States

FULLY OPENING MARKETS

First, the requesting countries want that countries who have already liberalized financial services outside the GATS agreement should commit those liberalizations under GATS “as appropriate”(point 6 of the request). This means that countries who have liberalized unilaterally, e.g. under pressure from donors, should make commitments to all WTO members and make them almost irreversible. However, under GATS there is the additional conditionality of abiding to certain rules e.g. national treatment. Also, all the effects might not yet be clear, or, of such a nature that governments need flexibility in the future which could not be allowed under GATS rules (see below under point : limitation in government regulation).

Secondly, very broad market opening is requested by asking for market opening in mode 3 in all financial services, in mode 2 in all non-insurance financial services and some insurance services, and in mode 1 in some insurance services and a few financial services without banking and asset management services.

The mode 3 request want to remove all restrictions of foreign ownership of any financial service, and want to allow foreign ownership through acquisitions of the domestic financial industry, new establishments or joint ventures.

In practice this means that the requesting countries ask countries to allow for the possibility that the foreign financial industry fully takes over the domestic private financial service providers. Experience has shown that as soon as developing country have opened their markets, foreign financial firms often rapidly take over a large part of the domestic financial industry. For instance, in Latin America the foreign financial industry increased its presence, through acquisitions etc., by 364% in four years (1996-2000). In Mexico, liberalisation has resulted in 90% of assets being in hands of foreign banks in 2002 (estimated 95% in 2005) from 19% in 1999.¹ In Central and Eastern European countries, the banking sector is mostly owned by foreign banks, up to 97% in Estonia (2004).² In Tanzania, after privatisation of many government owned banks since 1991, foreign banks now dominate the sector by around 70% (while there are still some governmental banks).³

Liberalization of mode 1 and 2 might in practice lead to capital flight which many developing countries want to avoid. Also, electronic cross-border banking needs many regulations and safeguards, and an effective supervision mechanism to provide safe electronic transfer of money.

ARGUMENTS OF EFFICIENCY ARE CHALLENGED BY CONCRETE EXPERIENCES

It is often argued that foreign financial service providers increase efficiency and improve the quality of the financial services in developing countries. Also, foreign banks are claimed to improve the allocation of savings, improve access to foreign capital, and provide capital in times of crisis. However, experiences show mixed results to that extend and the most recent research and literature give a much more nuanced view.

Developing countries opening up to foreign banks are faced with the following challenges because of the profit making strategies of foreign banks who do not really behave like domestic banks:

- Lack of credit to smaller domestic firms⁴

Foreign financial service providers first focus their, more efficient, services on rich clients and rich regions ('cherry picking'). The most recent research has found that this is especially the case in poorer countries, while in a few more developed emerging market economies, foreign

¹ CEPAL, La inversion en America Latina y el Caribe, 2002.

² D. Domanski, Foreign banks in emerging market economies: changing players, changing issues, in BIS Quarterly Review, December 2005, p. 72. See also: J. Cárdenas, J. P. Graf, Pascual O'Dogherty, Group Foreign banks entry in emerging market economies: a host country perspective.

³ M. Vander Stichele, Critical issues in the financial industry (referred to below as MVS report), SOMO, Amsterdam, p 180 (see: www.somo.nl: publications April 2005); see also: T. Andrew Satta, Foreign entry influence on bank lending to small firms in Tanzania, Paper prepared for the Annual DSA International Conference Themed: Globalisation and Development at The University of Strathclyde, Glasgow, 12 September 2003.

⁴ Zie MVS report; D. Domanski, Foreign banks in emerging market economies: changing players, changing issues, in BIS Quarterly Review, December 2005, p. 77.

banks also try to make profit through broader lending.⁵ However, in all countries, small and medium sized domestic companies and farmers have difficulties in obtaining credit from foreign banks. This restrictive lending leads to lack of financial support to vital sectors in many developing countries or even to stifling of a whole economy due to a lack of credit ('credit crunch') to the domestic industry as was the case in Mexico⁶. This has been the result of the introduction of standardised credit evaluation systems by foreign banks, and loss of capacity to assess local enterprises, as well as fears of lending that is considered risky by financial analysts who assess the foreign banks' value on the stock market. Such practices stimulate the gap between rich and poor.

- **What improvements in efficiency? The risks of negative impacts on the domestic financial industry**

The proponents of foreign financial service liberalization often indicate where competition by foreign banks have proved to be an incentive for local banks to improve their operation⁷. However, actual experience also shows that some local banks have little chance to survive the foreign competition or acquisitions. Because foreign banks attract the richest clients, they leave the poorer clients to the domestic financial services. Although the latter are much better in serving local small companies and poorer clients, not all can make enough profit from such clients. Chinese statistics have shown that 80% of the banks' profits come from the richest 20% of the clients.⁸ In addition, new international standards about capital reserves that banks need to set aside when providing credit (Basle II) are making foreign banks much more competitive because they have their own risk assessment system which local banks often do not have. In order to survive the foreign competition, local banks might take too much risks, which can result in destabilisation of a country's banking system. Also, in order to operate well in new markets, foreign banks attract the best managers from local banks to the foreign banks. The result is that expertise goes from local to foreign banks, contrary to the claims of transfer of know how. In such cases, how much efficiency gains can be made? The collective request on financial services explicitly asks for the removal of discrimination between domestic and foreign suppliers while foreign suppliers have advantages from their operations abroad and the domestic financial industry might require special, but transparent, support to become competitive or to be able to finance poorer clients.

- **Profits to be made in the banking sector go abroad**

Foreign ownership of banks does not only lead to other behaviour and less propensity to invest in the domestic economy while linking more with the international financial markets. It also means that a sector with potentially high profits is not developed at the national level and

⁵ E. Detragiache, T. Tressel, P. Gupta, Foreign banks in poor countries: theory and evidence, IMF Working Paper, WP/06/18, January 2006; MVS report p. 191 : In Sub-Saharan Africa, the presence of foreign banks increases loans by both domestic and foreign banks, but the variability of the loan supply decreases.

⁶ See for instance: J. C. Moreno-Brid, J. C. Rivas Valdivia, J. Santamaría, Mexico: Economic growth exports and industrial performance after NAFTA, CEPAL - Serie Estudios y perspectivas, N° 42, December 2005, p. 30 (seen on 27 March 2006 at: <http://www.cepal.org/publicaciones/Mexico/0/LCMEXL700/L700.pdf>)

⁷ G. Bies, Financial liberalisation in Latin America, in Developing countries and GATS, Ed. C. Jepma & E. Kamphuis, University of Groningen, 2003, p. 64.

⁸ MVS report, p. 177.

by domestic entrepreneurs. Profits made by the financial industry can so repatriated abroad by foreign financial services (Art. XI of GATS requires transfer of all current payments), taxes are paid to home country authorities and dividends paid to foreign shareholders. Profits made off rich clients in poorer countries are so siphoned off to the home countries in the North.

- **Withdrawing if not making enough profit**

While foreign financial firms are in constant search for new markets and expand their business to many countries, they also withdraw from countries if they do not make enough profit or cannot gain large market shares. This has for instance been the case in different Latin American countries and recently in Brazil and Indonesia where foreign banks and insurance companies resell their business because of unprofitable business. In Brazil, competition with domestic banks has been tough because of the experience and efficiency of domestic banks (who have learned to operate in financial crises and developed in a large domestic market with a Central Bank making sure they can have enough money reserves). When foreign financial firms cannot make enough economies of scale and do not belong to the top 5 in their category, analysts exert pressure to withdraw from a country. This often leads to instability and social unrest at the financial service provider. It can also influence the overall provision of financial services in the host country, especially if foreign ownership is highly concentrated⁹.

- **Loss of supervision and regulatory control**

Subsidiaries of foreign banks are supervised by both the home country and host country supervisors which implies good coordination and information exchange between the two authorities, which is not always the case. Because decision-making at many foreign banks is being centralized at the headquarters and in order to reduce costs, many foreign banks just establish branches in other countries¹⁰ – a practice that is reflected in the GATS plurilateral requests. However, branches are only supervised by the home country authorities and subject to foreign financial standards and capital requirements. Because foreign authorities do not have the same objectives and knowledge about the impact on the local economy domestic supervisors loose grip on foreign banks, which can have serious implications. Also, less information about a foreign bank's operation in a country is available for the market, the authorities and the public because acquired or merged banks are now longer listed as individual banks and the information of operations per country are incorporated as general figures in the annual report of the internationally operating mother bank. Therefore, bank supervisors often prefer subsidiaries that are legally organized as a domestically chartered bank – which is seen by the financial industry as a restriction they wish to remove in the GATS negotiations. Because foreign banks have global strategies that might be less adapted to the local needs of the host countries in which they operate, host country governments have less leeway in directing the development of domestic industries. They might have less influence in making sure that foreign banks integrate economic objectives of the country, let

⁹ D. Domanski, Foreign banks in emerging market economies: changing players, changing issues, in BIS Quarterly Review, December 2005, p. 78.

¹⁰ Ibidem, p. 79.

alone integrate sustainable development practices such as no lending to environmentally destructive projects.

- **Additional resources needed for regulatory and supervisory measures**

The request to commit mode 3 for all financial services sectors and the requests in mode 1 and 2 do not mention that the authorities should have all the necessary regulations and supervision instruments in place for the diverse financial services involved. Experience and research have found that risks of financial instability can only be avoided when there are enough institutions to monitor the financial system and regulate complex financial conglomerates. This is costly and takes time. Each country has its weaknesses that should not be exploited to its disadvantage by the private financial institutions. Even in the home countries, supervision of the allfinanz conglomerates is not fully operational and adequate yet. The need for supervising financial conglomerates can be seen from the several scandals in the US which resulted in fines of more than \$ 1.5 bn for many of the top financial conglomerates. An other example are the condemnations of practices by Citigroup over the last years in different countries.¹¹ The US Federal Reserve has banned Citigroup from making major acquisitions until it has changed its governance.¹² Citigroup is the largest bank in the world, which is likely to be a major beneficiary of the collective GATS request and has been part of the financial lobby in the WTO. Also, the international financial architecture has not been reformed so as to be able to prevent a new financial crisis or to act very decisively against a speculative wave; this leaves a heavy burden on regulation and supervision at the national level.

The many financial services mentioned in the collective request require monitoring and regulation because they can be risky for the stability of the financial system. Examples of such services are:

- Financial leasing (vii in collective GATS request): for instance the leasing of shares has caused serious debt problems by some customers with serious loss of savings. Governments in the West had to intervene to allow for more warning against the risks of leasing.
- All money transmission services (viii): in times of financial crisis, governments might need to have a control mechanism to avoid capital flight.
- Derivative products (x (C) -(D)): The key risk to derivatives trade is volatility, unknown spill over effects in different parts of the financial markets and the resulting financial instability. Derivatives are already unregulated, with limited requirements to set aside capital reserves when the deal goes wrong. Liberalization will make it more difficult to control, especially if the two parties of a deal are in different countries. While derivatives allow for risk mitigation, they can be used to bypass regulations by complying with investment rules but taking bets on prohibited assets.

¹¹ V. Marsh, Australian watchdog attacks Citigroup, in the Financial Times, 1-2 April 2006, p. 8.

¹² D. Wighton, V. Marsh, B. White, Legal snag on road to reputational rescue, in the Financial Times, 1-2 April 2006, p. 8.

- Investment banking (xi): Investment bankers promote mergers and acquisitions without guarantees that the new company leads to value added, while many jobs are often shed. The underwriting of shares does not screen the social and environmental record of companies that will get additional funds. The combination at banks between investment banking and securities advisory functions has in lead to many scandals. In the US, top global banks had to pay more than \$ 1bn of fines during the last 3 years because of such scandals.
- Asset management and pension fund management (xiii): lack of regulation in investment banking and securities' trading has lead to irrational investment and a bubble in the stock market, and its bursting at the end of 2001. In different countries, regulators issued new laws for pension fund managers to avoid too much losses due to too risky investment in shares. The plurilateral request argues that there "can be advantages" in additional liberalization of securities services in mode 1 and 2 for institutional investors in shares, such as pension funds. But there might be quite some disadvantages for financial instability if they are not well regulated!

In general, foreign firms provide rich clients in poor countries with more opportunities to channel their money to the North and invest in Western companies. In times of financial crisis, such as in Argentina, these are important factors that can increase a difficult situation. The argument that foreign banks will provide capital to their subsidiaries or branches in a country in a financial crisis, has not always proven to be so in practice.

LIMITATIONS IN GOVERNMENT REGULATION

For the purpose of market access opening, there are a few government regulations and policies under attack in the collective request on financial services: monopolies, numerical quotas, economic needs tests (whose removal was agreed in Annex C of the Hong Kong declaration) and mandatory sessions. These can be measures that help the development of a domestic financial industry and keep financial stability in times of crisis. Especially the economic needs test can be useful as it depends on the situation in a country whether foreign financial services can lead to improvement of the economy. The collective requests does not go as far as the many EU's bilateral requests which has long lists of governmental measures that the EU (read: its financial industry) wants to be removed in each country. More specifically, this plurilateral request does not go as far as the GATS model for financial services liberalization, i.e. the "Understanding on Commitments in Financial Services" which also requires WTO members to permit any new financial service that a foreign financial service provider wants to initiate, and which covers mode 4. However, if bilateral negotiations on financial services continue alongside the plurilateral requests, many governmental measures might still be targeted in a non transparent way.

The collective request mentions that regulators are enabled to protect stability and integrity of the financial system. However, many **GATS rules undermine prudential regulations**, or are not clear how much protection can be provided:

- GATS articles promote **cross-border capital movements** and financial instability by limiting government restrictions on profit repatriation (Art. XI) and controls on capital flows related to committed financial services (see Articles XI.1. en XVI (footnote 8): see also appendix 1 to this paper). For instance, Chile has been asked by the EU to do away with its requirement that approval by the Central Bank is needed before dividends can be transferred abroad. Such a Central Bank intervention is not allowed under GATS Art. XI. Footnote 8 of GATS Article XVI (“Market Access”) requires that a country which makes a commitment in a services sector, including financial services, to allow all *inflows* and *outflows* of capital that is considered “essential” for (financial) services in mode 1 (e.g. e-banking) and allow *inflows* “related” to mode 3. Thus, countries can only regulate the *outflow* of capital except for mode 1, if they have not already deregulated capital flows by liberalizing the capital account as many developing countries have done.
- GATS rules permitting restrictions on unstable capital flows and financial services are limited by many conditions in Art. XI.2, Art. XII and Art. 2 of (see appendix 2 of this paper). 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. As no Emergency Safeguard Mechanism has yet been agreed, the possibility of governments to immediately intervene before a crisis erupts is very limited.
- The vagueness of financial **prudential measures** permitted by GATS, e.g. in the prudential carve out integrated in the GATS Annex on Financial services, leaves many developing countries’ regulations open to challenges by WTO disputes. This uncertainty about the interpretation some GATS rules could result in countries refraining from introducing national legislation for fear of future WTO disputes. The major problem is how, during the (bilateral) negotiations on financial services, some governmental measures will be identified as trade restrictive and be removed in the commitments or some rules will be allowed and considered as being prudential. The EU bilateral requests are targeting many governmental measures whose interpretation is left to the power games and bargaining of the negotiations.

These issues are too much ignored in the collective requests.

INFLUENCE BY THE FINANCIAL LOBBY

The short collective requests ends with requesting transparency in “development” and application of laws. This is an issue that needs to be discussed in the negotiations about Article VI on domestic regulation and not when negotiating plurilateral or bilateral requests among a few WTO members. This demand for transparency comes from the international financial industry who wants to ensure it can lobby rule-making in the host country before it is faced with laws to be implemented. Clearly, the EU’s reason to participate in the request is

following the wish of its financial industry that wants to expand in order to avoid the limits to growth it faces in the EU markets. "For EU financial services companies, the fast-growing emerging economies will become a major source of activity that will help to offset slower growth in the more mature financial services markets" according to the European Commission.¹³ This is hardly a perspective in the interest of development and the constituency in developing countries. Even in Europe, the benefits of an ever more concentrating, expanding and share value driven financial industry are not clear. In some countries like the Netherlands, the services provided by the Dutch global financial conglomerates are declining and many jobs are lost (e.g. 10,000 between 2000 and 2004 at ABN Amro). After acquisitions or mergers abroad, they also shed jobs in the host countries.

CONCLUSION

The concrete experiences of liberalisation of financial services and the lessons learned from their role in financial crisis need to be at the basis of the decisions by WTO member states about financial services liberalisation, not the interests of the global financial industry. Liberalisation of financial services of developing countries needs to be gradual and well sequenced. The plan for instance of Malaysia to do so over a period of 10 years needs to be respected, and not be challenged by a collective or bilateral GATS request. There needs to be coordination between the trade negotiators and the institutions responsible for the stability of the national and international financial system, which is now lacking for instance in some European countries.

The limitation of policy space due to GATS rules needs to be taken into account in the negotiations. 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 negotiations on the plurilateral and bilateral requests on financial services will put pressure to limit these exemptions as much as possible.

Last, but not least, there is little proof in the literature that binding liberalisation of services in trade agreements leads to additional investment in the committed sectors.

18 May 2006

Myriam Vander Stichele can be contacted at the SOMO (Centre for Research on Multinational Corporations):
email: mvanderstichele@somo.nl
phone: + 31 20 639 1291
website: www.somo.nl

¹³ Website of the EC, summary of collective requests: Collective requests in which the EU is participating under the DDA Trade in Services negotiations. Annex. Brussels, 28 February 2006 http://europa.eu.int/comm/trade/issues/sectoral/services/pr280206b_en.htm (viewed on 27 March 2005)

APPENDIX 1

GATS articles promote cross-border capital flows and capital account liberalisation¹⁴

Some articles of the GATS agreement play a role in increasing the risks of destabilising financial flows related to foreign financial service providers.

GATS Art. XI.1.¹⁵ does not allow countries to restrict international transfers and payments for current financial transactions that are related to services in sectors that were liberalised under the Agreement. That means, first of all, that a country cannot prevent profit repatriation by foreign service providers in sectors in which a country has made GATS commitments. For instance, the EU requests from Chile in the current financial services negotiations that Chile eliminates the "restriction" that prior authorization by the Central Bank is required before transferring dividends from Chile abroad because this is in breach of Article XI. Thus, if a country has liberalised the financial sectors, foreign banks and insurance companies can transfer their profits abroad without reinvesting them in the country. In countries that have small economies and/or large foreign investors in all sectors, profit transfers affect negatively the balance of payments and exchange rate.

Moreover, Art. XI.1. has a special effect in relation to financial services provided by foreign banks, insurers, investment bankers and asset managers which have established themselves in countries that made GATS commitments in these services (Mode 3). These financial service providers might view cross-border financial flows as "related to" or essential to their services in cases such as:

- ❑ lending in foreign currency;
- ❑ buying securities abroad to balance the risks in pension fund management or to increase the rate of return of asset management services (e.g. mutual funds) for local clients or insurance companies;
- ❑ providing investment bank services related to foreign stock exchanges (underwriting shares of domestic firms listed abroad) or related to foreign companies (acquisitions abroad);
- ❑ offering international derivatives; and
- ❑ using international credit risk mitigation mechanisms.

Such cross-border capital flows can go beyond current account transfers and undermine management of the capital account aimed at avoiding financial instability and crises (see box). If certain capital account restrictions frustrate the transactions of committed services sectors, they could be challenged under GATS XI (see also below). In countries that have already

¹⁴ Source: M. Vander Stichele, Critical issues in the financial industry, SOMO Financial sector report, Amsterdam, 2005, p. 185-187.

¹⁵ Art. XI.1.: " Except under the circumstances envisaged in Article XII, a Member shall not apply restrictions on international transfers and payments for current transactions relating to its specific commitments."

liberalised their capital account, GATS commitments in certain financial sub-sector will increase instable capital flows. They might also discourage reversing capital account liberalisation where considered necessary to avoid financial crises. Developing countries that keep a high level of capital control are not likely to attract foreign financial firms as the latter avoid unpredictable local currency convertibility and capital withdrawals.¹⁶

Market opening in financial services and its impact on international capital movements and financial stability

Article XI of the GATS is intended to guarantee the primacy of IMF rules in the area of international capital movements. Obligations as to the liberalisation of cross-border transactions in the WTO are linked to the commitments to market access included in a country's schedule and are designed to prevent their frustration in practice through restrictions on the capital transactions necessary for their fulfilment. However, the decoupling in the GATS of market opening for financial services from liberalisation of capital-account transactions generally none the less leaves substantial scope for connections in practice. This is most easily seen for the hypothetical example of a country which enters into commitments to no limitations regarding Modes 1, 2 and 3 for all the activities mentioned in the Annex on Financial Services. To ensure effective implementation of such commitments the country would be obliged to undertake comprehensive liberalisation of capital-account transactions. Moreover a country - not the one just described in the hypothetical example - whose commitments were made through the Understanding on Commitments in Financial Services would also be making an open-ended commitment to the liberalisation of such transactions required by its obligation to "permit financial service suppliers of any other Member established in its territory to offer in its territory any new financial service". Although commitments as to market opening for financial services often carry associated obligations as to the liberalisation of capital transaction, the country making them will have to depend on guesswork for the estimation of the size of the capital movements which are likely to ensue.¹⁷ The difficulty of reaching estimates here is increased by the pace of change in the financial sector, which is adding to the range of possible transactions under the different modes of delivery of the GATS.

Source: A. Cornford, The multilateral negotiations on financial services: current issues and future directions, 2003.

GATS Article XVI ("Market Access") includes **footnote 8** that commits a country to allow a number of cross-border flows when it has opened up its market for particular (financial)

¹⁶ Yun-Hwan Kim, Financial opening under the WTO Agreement in selected Asian countries: progress and issues, Asian Development Bank, Economic and Research Department, Working Paper No.24, September 2002.

¹⁷ On the basis of his personal assessment for the activities in the Annex on Financial Services an IMF observer attributes "major importance" to "capital flows for virtually all financial services delivered through mode 3 (commercial presence), as such presence by its nature implies some form of cross-border investment". Indeed, the only activities under the heading of banking and financial services (excluding insurance) to which he does not attribute such importance are financial leasing, provision and transfer of financial information, and advisory, intermediation and other auxiliary services. See A.Kireyev, Liberalization of trade in financial services and financial sector (analytical approach), IMF Working Paper WP/02/138, August 2002, pp. 10-14.

services: the country must allow *inflows* and *outflows* of capital that are considered "essential" for (financial) services in mode 1 (e.g. e-banking) and allow *inflows* "related" to mode 3 (i.e. foreign services provided by firms established in the country). Thus, countries can only regulate the *outflow* of capital except for mode 1, if they have not already deregulated capital flows by liberalizing the capital account as many developing countries have done.

So far, the interpretation and impacts of Art. XI.1. and footnote 8 of Art. XVI in relation to financial services are a little discussed area about which experts do not always have a clear answer. This is reflected in discussions that have taken place¹⁸ in the WTO about opening up financial services that do not have a presence in the country but rather provide their services from abroad (mode 1). Financial "products" such as lending of all types and asset management provided by financial firms abroad can have a destabilizing effect because they involve cross-border financial flows in foreign currency. In the view of Brazil, the above mentioned footnote 8 of the GATS agreement could be tantamount to capital account liberalisation and deregulation of major transfers of money, even if a country has not fully liberalised its capital account system. Such cross-border capital transfers could affect the balance of payments and the whole financial stability of a country. The European Union, the US and other western countries downplay the importance of the impact of opening up Mode 1 in financial services, but too little research has been done to date on this issue.

GATS articles undermine measures to deal with destabilizing capital flows

Financial authorities need to have the capacity to carefully monitor changes in cross border capital flows that result from financial services liberalisation. They may want to take measures to prevent too much financial instability, especially in small countries where swift flows can have a major impact. But GATS rules do not only influence what cross-border capital flows are permitted, they also influence how restrictions on those flows are managed.

Formally, GATS does not prevent any country from taking prudential measures to protect depositors, investors or to ensure the integrity and stability of the financial system.

Art. XI.2. states that *"nothing in the GATS agreement shall affect the rights and obligations of the members of the international Monetary Fund under the Articles of Agreement of the Fund"*. This legitimates controls over capital transactions since the IMF's articles continue to permit policy autonomy regarding such controls.ⁱ These rights and obligations, however, are subject to the condition that *"a member shall not impose restrictions on any capital transactions inconsistently with its specific commitments regarding such transactions"*. In other words, IMF rights cannot undermine GATS commitments.

¹⁸ See WTO - Committee on Trade in Financial Services, Report of the meeting held on 2 December 2002; IDEM, Report of the meeting held on 26 February 2003.

WTO members are allowed to **not** apply Art. XI.1-2. In case of serious balance of payment problems, **Art. XII** allows countries to restrict their market opening in (financial) services sectors (financial or other services sectors) for which they made liberalisation commitments, and to restrict cross-border money transactions related to committed sectors. However, a country that invokes these restrictions is bound to fulfil a number of **conditions**, including:

- ❑ use criteria of non-discrimination and least-harmful effects on foreign service providers;
- ❑ be consistent with the Articles of the IMF;
- ❑ limit the period the measures are in place;
- ❑ undertake consultations with WTO members.

Ultimately, the assessment of the IMF of the financial situation of the country determines whether the restriction measures are to be allowed (Art. XII.5.(e)).

APPENDIX 2:

GATS articles undermine prudential measures and regulations

Art. 2 of the GATS Annex on Financial Services (see above) permits domestic regulations and prudential measures that protect a country against financial instability and foreign exchange exposure. This article does not define prudential measures but stipulates that such measures are authorised to contravene other GATS provisions ("prudential carve-out"). However, the article states that prudential measures should not be used to avoid market openings or obligations under the GATS agreement. These conditions attached to the prudential carve-out measures may prevent countries from taking measures, which, while contravening GATS commitments, are nevertheless the most effective for dealing with financial instability.

The vagueness of what a prudential regulation may entail allows a WTO member to challenge a measure of another WTO member as being not a prudential measure, but rather a way to avoid GATS commitments or obligations. For instance, Western countries robustly challenge prudential measures by China during current negotiations and WTO reviews with the argument that they undermine financial services commitments.ⁱⁱ In case of disputes brought before the WTO, a panel must in such case decide what prudential measure is permitted or trade restrictive to the foreign financial industry. Although the GATS Annex on Financial Services (Art. 4.) specifies that a panel must have the financial expertise necessary for the dispute, still, central banks and other regulators lose their full freedom to impose the prudential regulations they see as essential.

ⁱ A. Cornford, The WTO negotiations on financial services: current issues and future directions, Paper for Financial Markets Center, [2004], p. 6.

ⁱⁱ WTO, Committee on Trade in Financial Services, Report of the meeting held on 1 December 2003, part D.