

Free trade in financial services contributes to the conversion of crises

Myriam Vander Stichele*

Financial services have a special role in society

The financial crisis that started in the US in 2007, has exposed what a central role the financial sector plays in the economies and societies of most countries. It also has shown that leaving this sensitive sector to the markets on the assumption that markets can correct themselves has had disastrous consequences. Indeed, financial companies have been treated as if they were any other company while only weak regulations and supervisions were supposed to deal with their special status and public function. Indeed, the financial services, banks and the financial system have an important role to play in providing credit the agricultural, industrial and services sectors and their trade. The current crisis shows that lack of credit creates many problems and has an important impact on trade and companies producing for exports, as well as on employees and workers within these sectors. The economic crisis that is a result of the financial crisis is estimated to rise unemployment massively worldwide. The working poor and those living on less than a dollar a day are estimated to be increasing by 40 million and those on 2 dollars a day by 100 million in the next years.

But also, unregulated financial markets serviced by the financial industry have pushed companies to ever more short term profit. In addition, the financial sector has developed very speculative financial instruments that have had more and more destabilizing effects on society. The most visual example is the speculation in food prices that was amongst others a result of the financial crisis and investors in search of ever greater or equal profits. When developing food speculation financial services, the financial industry did not care if a food crisis with high food prices and hunger would be a consequence. Equally, the huge financial instruments to speculate with exchange rates, are de-stabilizing exchange rates – sweeping away in one day many gains that might have been made by export growth.

* The author is Senior Researcher, SOMO/Foundation for Research on Multinational Enterprises.

The financial sector is also responsible for creating an unsustainable and unequitable society by giving credit and a range of other financial services to projects and companies that were producing and trading in an unsustainable way pursuing short term profits while squeezing the incomes of those alongside the supply chain, including workers and employees. In addition they were often selling consumption products that are unsustainable. No wonder an increasing gap between rich and poor, as well as a climate and environmental crisis are also occurring at the same time. A particular problem for workers over the last 5 years has been the operation of Private Equity and Hedge Funds, which are non regulated companies financed by the super-rich to gain extraordinary profits through speculation and over-lending (lending 10 to 30 the capital they owned). They bought companies with huge loans provided by banks –who got a good profit out of it- and then transferred the debt upon the company which was then cutting costs and jobs to repay the debt and sell the company in a short period of time, with huge profits.

Swift expansion of foreign financial services

The high profits made by large financial banks and insurance companies allowed them to expand world wide to make even more profit. During the second half of the 1990s, there has been a dramatic and very rapid increase in foreign ownership of banks and foreign banking activities in many developing countries. Figures indicate that the presence of banks in Latin America increased by 364% during the period 1996-2000, while it increased by more than 59% in East Asian countries in the same period 1996 and 2001.

This expansion was possible because developing countries allowed foreign banks to enter their markets. This often happened often under pressure from the loan conditionalities by the World Bank and the IMF who required national banks to be privatised. This resulted in foreign banks buying these privatized banks and merging them with their conglomerates. In the process, foreign banks often cut jobs of privatised banks to make them more profitable, as was the case in Brazil. Also, employees in Latin America were not treated as well as in the home country for instance of ABN AMRO.

One of the arguments used to open up the banking and insurance sectors to foreign financial operators was that foreign banks and insurance companies are more efficient. However, this argument did not take account of particular situations in countries and the particular ways of operation by foreign banks and insurance companies. A case study of Banco Real at the time it was owned by the Dutch bank ABN Amro in Brazil, in 2002, showed that it was not more efficient than domestic banks which had survived many financial crises. However, many people trusted its status as a foreign bank which attracted richer people who were willing to pay more.ⁱ In Mexico foreign banks controlled more than 85% of the total banking sector but provided too little lending to local companies to stimulate economic growth. Households and SME's hardly had access to credit at reasonable rates. Politicians and supervisors expressed their doubts on the past decision to open their banking sector up to foreign competition. During times of crisis in Latin America, foreign banks are even less likely to offer their services to smaller clients like households and SME's economies, which highlights one of the risks of the presence of foreign banks. Also, foreign banks often withdraw capital in times of financial crises. In the Argentinean crisis at the beginning of the century, foreign banks refused to recapitalize their branches and subsidiaries.ⁱⁱ

How free trade agreements have increased the risk of financial crises

Since the current financial crisis started in 2007 in the US, an important element is missing among the many discussions and proposals to reform the financial system and to stop the financial crisis from spreading further. There is no discussion about the broad liberalisation and deregulation of financial services, capital movements and the international financial industry through the World Trade Organisation (WTO) and the bilateral or regional free trade agreements (FTAs). These free trade agreements have made liberalisation and market opening for the foreign financial industry almost permanent in many countries. This means for instance that countries can only decide to go back to only state banks e.g. for basic banking services, if they compensate all countries which complain that their private banks are losing future business.

In addition, these free trade agreements actually impose an extreme deregulation of financial services and capital controls, which support the profit making and expansion strategies of large financial companies. While even countries who previously implemented neo-liberal policies and left the financial sector to the free markets, call for

new regulations and supervision, none of the governments, experts or media who have called for new regulations for the financial industry have taken into account how much the rules of the WTO's General Agreement on Trade in Services (GATS) and free trade agreements actually have almost made deregulation permanent. Worse, the heads of the G-20 country governments who met on 15 November 2008 to discuss how to reform the financial system, called for finalising the WTO's current 'Doha Round' of negotiations to liberalise trade. Western countries they have so far ignored that liberalisation and deregulation of financial services is part of the ongoing GATS negotiations that are slowed down because these negotiations' progress are awaiting progress in negotiations in agriculture and the industrial sector (NAMA). When a high level official of the European Commission, which negotiates free trade agreements for the European Union (EU), was asked in February 2009 whether the EU would continue to negotiate liberalisation of financial services under the GATS, the answer was "of course", since the EU's strategy is to open up more markets, including for its profitable financial industry. Also the US has been pushing very hard during GATS and FTA negotiations to open markets in a deregulated way for its large and expanding financial industry that once made huge profits (Citigroup profits in 2004 were US\$ 17bn).

Liberalisation without regulation

GATS encouraged fierce competition among the financial industry for ever more profit. The EU financial industry want to compete with the especially the US financial sector which had already a lead by having a large home market, sophisticated investment banks and a low level of regulation. The European financial industry was competing to make the same enormous profits as its American counterparts. In the name of competitiveness, huge lobbying efforts were undertaken to convince home and host governments to deregulate, not in the least for speculative products that have contributed to the crisis. The argument that regulation were costly barriers is now lost on taxpayers who have to pay the bill of deregulation !

GATS and FTA negotiations include opening financial services markets but have no mechanisms to ensure that at the same time there is sufficient regulation and supervision. Nor was there much pre-occupation to ensure that liberalisation would improve universal access for all to financial services. In the current international financial architecture, foreign banks are mainly supervised by the home supervisor at the expense of the interests of the host country. Moreover, there is no one supervisor

who has all information about worldwide transactions of a financial conglomerate which operates in banking, insurance and/or securities' trading activities.

Banning risky financial products is forbidden by GATS

Many WTO member countries have already agreed to permit foreign banks or insurance companies originating from any other WTO member country to establish themselves and offer (some of) their financial services and products in accordance with rules of the GATS agreement. This WTO agreement on 'trade in services' also liberalises foreign presence and foreign investment in the financial sector as well as services being traded over borders (e.g. providing credit across the border through internet).

Some developing countries such as Argentina, Ghana and South Africa, have also agreed to permit foreign financial operators offering very risky financial service products although such trading in derivatives is widely recognised as a major cause of the financial crisis. Derivative trading in food has resulted in huge speculation on future food prices and has contributed to the high food prices and the food crisis. Some countries even have subjected financial services that have an important social impact, such as health insurance or pension fund management, to GATS restrictions on regulation. Those countries seeking to ban any risky product or risky financial operator may well find themselves in conflict with GATS rules.

Also, financial services offered by foreign financial service companies can include large cross-border financial transfers which can have a destabilising effect on the foreign exchange of a country. However, GATS rules require that the host country has to permit all financial transfers that are linked to a liberalised financial service that the country has liberalised. This undermines that for instance measures are taken to avoid sudden withdrawals to avoid a crisis.

If countries want to withdraw sensitive service sectors from GATS' restricting measures, GATS requires that countries compensate the loss of future business opportunities to other WTO countries requesting compensation. Thus, India was able to tackle speculation in food prices by banning trade in speculative food derivatives while South Africa or Argentina can hardly do so because, under GATS, they have committed to keep their governments out of the business of regulating derivative trading.

GATS rules that deregulate

WTO member countries can choose whether or not to liberalise or deregulate financial services under GATS, but many developing countries have done so. This choice is much less possible during FTA negotiations because a GATS rule determines that an FTA that covers services must include substantial liberalisation and deregulation commitments although developing countries can liberalise somewhat less than developed countries. The EU and the US are always pushing hard to have financial services covered by FTAs so that countries have to admit more foreign banks and other financial services.

Many GATS rules that liberalise financial and other services are repeated in FTAs. 'Liberalisation' and 'market access' means that governments are restricted in selecting which financial operators they want in their territory and how they may regulate foreign financial operators and products. Unless explicit exemptions were taken at the time of negotiation, WTO member governments and countries who are signing FTAs with the EU are required:

- To allow 100% foreign ownership of financial operators and the financial sector;
- not to impose restrictions on the size and number of financial operators, nor on the volume of their financial transactions;
- to treat foreign financial operators *at least as favourable as* domestic financial operators (while foreign financial services and their providers can get better treatment than national ones!).

One of the consequences is that the size or the volume of the transactions of the foreign financial industry can hardly be limited. If no restrictions on the percentage of foreign ownership can be imposed, foreign banks can take over the whole banking sector of a country and become too big to fail.

As part of the GATS negotiations that have already taken place under the Doha Round, the EU has requested that many developing countries take away particular prudential regulations which had been put in place after the Asian financial crisis or which are now seen as solutions to the financial crisis. Such secret trade negotiations without participation of regulators and supervisors, let alone parliamentarians and civil society representatives, who now are working on new regulations and supervision must be avoided.

GATS and FTA rules require foreign banks to be treated as the domestic banks even though foreign banks behave differently in many ways, also in times of crisis, as explained above (e.g. less credit provided, withdrawal of capital). In case the WTO further liberalises (processed) agricultural and non-agricultural products (NAMA) this lack of credit further undermines the ability of domestic producers to compete with imported products, mostly produced or traded by multinationals (One-third of international trade is now between multinationals and another one-third of trade is between affiliates of multinationals).

During the current financial crisis, developed countries have bailed out or financially supported their largest banks that also operate in developing countries. This means that foreign banks are supported and subsidised at home in a way that banks of developing countries are not. So requiring that foreign banks are treated not less favourable than domestic banks under GATS/FTA rules treatment result in unequal competition that might weaken domestic banks, their services and their employment.

Special GATS and FTA rules undermine new regulations

In addition to the GATS rules itself, most developed countries have committed to a yet-more-extreme set of financial service sector deregulation. This GATS “Understanding on Commitments in Financial Services” forbids further regulation and requires that foreign investors must be permitted to offer any new financial service. As a consequence, proposals raised in the US to re-regulate or ban risky financial products that sparked the financial crisis, such as stopping short selling of shares (borrowing shares to sell with profit), sub-prime loans or screening risky financial products, would go against those rules. This would also be the case for potential proposals in the EU to regulate Hedge Funds, which have systematically contributed to financial crises. Although another GATS Annex on financial services allows government to implement ‘prudential measures’, that clause is limited in that it also requires that such measures should not undermine the GATS market openings. These provisions prohibit governments to implement regulations, or even bans, which are necessary to prevent or deal with a financial crisis. The EU and other developed countries have asked during the Doha Round negotiations that the larger “emerging” developing countries also liberalise according this ‘Understanding’.

While this GATS rule on allowing new financial services is now mostly applicable to developed countries, NAFTA or an FTA with the EU (eg. with Chile, Mexico, Caribbean countries) also require developing countries to permit new foreign financial service within their territory in those financial sectors they have liberalised under these agreements. This means that very risky financial products such as speculative derivative trading can be introduced– a practise which contributed significantly to the financial crisis. Although the agreements allow some regulations and supervision, it is left to trade tribunals to decide what regulation are allowed. FTAs therefore can equally make it very difficult for countries to ban speculation in food prices through banning trade in food derivatives that contribute to the food crisis.

Moreover, the EU seeks to impose through its FTAs, the implementation of many non-binding international norms for financial regulators in developing countries. Yet, these norms completely failed to prevent the financial crisis, are currently being reviewed, while most developing countries have had, and will have, no say in their design.

FTAs stop capital controls

During a financial crisis, or in order to prevent it, it is important that countries are able to control capital inflows and outflows, which mainly move through banks. Yet, the FTA model employed by both the EU and the US requires countries to remove restrictions on capital movement and facilitate cross-border capital flows, beyond what is agreed in the GATS. In the EU-Caribbean EPA, no restrictions on capital transfers between residents of the signatory countries are permitted, not even on large capital account transfers related to investments. Only in “exceptional circumstances“ are countries allowed to stop destabilising capital transfers. Also, any prudential measures taken to stop capital or trade flows that are financially destabilising are restricted by many conditions, which undermines many domestic policies to protect economies and societies.

The dangerous mix of FTAs and BITs

What is often forgotten is that foreign financial investors that enter a country under an FTA, can use already existing bilateral investment agreements (BITs) to sue host governments that introduce new social or environmental regulations. For instance, Argentina has been sued by more than 30 companies for its measures taken during its

financial crisis (2000-2001). Foreign investors have already used a BIT to sue South Africa for its policies to reverse the legacy of apartheid and increase black ownership in the mining sector. This could also happen in the financial sector where such “black empowerment” policies have also been decided and aim at better access to financial services by the poor and black communities. In the past, the financial industry has often lobbied against obligations to service poor communities, such as against the US law to reinvest in the communities in which banks operate.

The forgotten contribution of GATS and FTAs to the financial crisis needs to be reversed

The currently negotiated GATS and FTA rules means that liberalisation and deregulation of financial services result in banks can expand worldwide, become too big to fail, and then require bailouts by public funds while a huge financial crisis is spreading around the world. Unless countries regain policy space to regulate the financial industry, the bail out problem remains! These agreements were protecting the interests of the big financial industry while they did not contain instruments to hold the financial industry accountable when huge mistakes were made with vast consequences in the societies in which they were allowed to operate. There is therefore an urgent need to raise awareness among citizens, political decision-makers and international fora that deal with new financial regulations and supervision about the impact of GATS and FTA rules on financial services.

In addition, the discussions to reform the financial sector should focus on establishing rules to shift finance to productive rather than speculative ends and halt investment in companies and projects that are socially and environmentally disruptive. In order to stop the financial sector’s contribution to the world’s food, climate/environmental and social crises, the extreme deregulation and market opening by FTAs and GATS must be reversed. Any new rules should support the financing of a sustainable society with decent and sustainable jobs.

Concrete measure that can be taken to that purpose and which are being requested by civil society groups such as “Our World is not for Sale” (OWINFS) are:

- All negotiations in financial services in GATS and FTAs have to be stopped.

- Countries should be permitted to reverse their existing GATS and FTA liberalisation commitments of financial services (a roll back) without having to pay compensation for it.
- Countries should be permitted to take all necessary measures to prevent financial, social and environmental crises without retaliation threats based on GATS and FTA rules.
- Financial services and capital liberalisation are to be taken out of the WTO/GATS and all FTAs.
- Financial services need to be regulated to urgently support the shaping of sustainable societies – including by serving the poorest communities first. This should be supported by new GATS and FTA rules rather than be undermined by these rules as is currently the case.

ⁱ M. Vander Stichele, Liberalisation in Banking Services Does not Have the Stated Effects - Summary of a case study of ABN Amro in Brazil, SOMO/Amsterdam, December 2001 (www.somo.nl).

ⁱⁱ L.R. Reynoso, Argentina: la justicia inhibida, la Argentina de pie, in *Correos para la emancipacion*, nr. 234, 12 February 2004.