WTO Conflict with Financial Re-regulation

TODD TUCKER, JAYATI GHOSH

The General Agreement on Trade in Services does impose limits on many developing countries’ ability to regulate the financial sector. A response to the article “Regulatory Freedom under GATS: Financial Services Sector” which argued otherwise.

B

K Zutshi (“Regulatory Freedom under GATS: Financial Services Sector”, 12 November 2011), who has been India’s ambassador to the World Trade Organisation (wto) and a dispute settlement panelist, makes an unapologetic defence of the General Agreement on Trade in Services (gats) in terms of the possible impact on financial regulation in signatory countries. He critiques the growing concern that gats limits options for re-regulation and development banking, describing this argument as “misguided” and “meritless” “propaganda” that is coming “mostly from developed countries”. In the process, however, he displays a lack of awareness not only of concerns related to financial fragility in both developed and developing countries, but also of the implications of the actual reach of the gats restrictions.

This is a matter of concern because in fact gats does impose restraints on many developing nations’ ability to utilise capital controls, size limits and other regulations in the financial sector. This has been recognised not just by the groups quoted in the article, but also by the United Nations Commission of Experts on Reforms of the International Monetary and Financial System, the g-24 intergovernmental group of developing countries within the Bretton Woods organisations and the United Nations Conference on Trade and Development (unctad). This concern led to a modest proposal by Ecuador to have the wto’s December ministerial conference mandate further discussion of the intersection between re-regulation and the gats’ financial services terms, which was supported by many developing nations including India. However, it was opposed and blocked by a group of developed countries: the European Union, Canada and the United States, which has recently launched the first ever case against a developing country under gats financial services clauses (on China’s credit card policies). This context makes it all the more necessary to be clear about the possible implications of gats on financial sector regulation.

GATS Architecture and Regulatory Bans

GATS pertains to “measures by Members affecting trade in services”, and it contains an Annex on Financial Services that “applies to measures affecting the supply of financial services”. The wto’s Appellate Body has ruled that the word “affecting” indicates that the gats has “a broad scope of application” and does not require that a measure specifically “regulate” or “govern” services per se. Similarly, the meaning of “measures” is broad, and can include statutes, regulations, court decisions, agency determinations, and government actions to implement any of the foregoing. “Financial services” is also defined broadly as including everything from credit cards to bank deposits to derivatives and swaps.

GATS is a positive list agreement, meaning that countries pick which service sectors to commit to coverage, which “modes of supply” to commit (i.e., cross-border trade [Mode 1], consumption abroad [Mode 2], commercial presence [Mode 3], etc), and whether and how much to commit to the market access and national treatment disciplines. Once a service sector is committed, certain disciplines (such as most-favoured nation) apply across the board. This architecture means that gats obligations can and do vary considerably from country to country.

Despite Zutshi’s assertion, no one argues that gats prohibits every regulation. But it does prohibit several common policy tools. Article xvi(2) represents a ban on bans and size limits. While Zutshi details several aspects of the ruling of the panel he chaired in the us-gambling case, he fails to note that panel’s central conclusion: a ban in a sector and mode committed to gats (even if it is non-discriminatory) constitutes a “zero quota” impermissible under Article xvi(2). If there was any doubt as to the troubling reach of this decision, the panel decreed that wto members’
DISCUSSION

so a wide range of capital controls could constitute “restrictions”, including measures to prohibit capital flows, requiring permits for capital transactions, measures that tax or increase the cost of such transactions.

Second, are the only “restrictions” to be avoided those that do not “allow...movement of capital” at all, or could a broader range of restrictions be prohibited? In other words, what is the range of “restrictions” that can be imposed “consistently with specific commitments”? Here there is a range of possible interpretations. One interpretation of the phrase “that member is committed to allow such movement of capital” is that the only GATS-prohibited “restriction” would be an outright refusal to allow Mode 1 capital movements in a committed sector. This is a fairly extreme CMT that most countries do not utilise (although it is unfortunate that even that policy space would have to be given up). However, the rest of GATS provides context that suggests that a broader range of CMTs could be inconsistent with GATS specific commitments in Mode 1.

Third, when is “capital...an essential part of the service itself”? This is most clearly the case for financial services. In core financial service sectors, there is no service transaction unless it is accompanied by a capital flow. For instance, it would be difficult to supply lending services if there were no loans (i.e., capital). Further, distinction between Mode 1 (cross-border trade) and Mode 2 (consumption abroad) has collapsed with the emergence of online banking. A recent paper by US Federal Reserve economists calls the classification system “particularly useless when addressing prudential concerns, fears of contagion and capital flows”, and notes that the distinction is especially “blurry, because it is not clear whether the consumer or the service crosses the border”. There are many nations who have deep Mode 2 but shallow Mode 1 commitments, including most developed nations and more than a handful of developing countries. Add this to the countries with substantial Mode 1 commitments, and you have around 60 developing nations that have a particular interest in clarifying (and expanding) the permissible policy space for CMTs.

In sum, countries with deep “market access” commitments are right to be concerned that the GATS goes beyond even countries’ obligations under the International Monetary Fund’s (IMF) Articles of Agreement. It is foolhardy to be complacent on these matters in the absence of clear case law through dispute settlement, which is yet to be developed. This provides additional support for the argument that these GATS provisions ought to be re-examined.

Defence against GATS Obligations?

Zutshi makes much of a provision in the GATS Annex on Financial Services Article 2(a) known as the “prudential measures defence”, or PMD. This reads:

Notwithstanding any other provisions of the Agreement, a Member shall not be prevented from taking measures for prudential reasons, including for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial service supplier, or to ensure the integrity and stability of the financial system. Where such measures do not conform with the provisions of the Agreement, they shall not be used as a means of avoiding the Member’s commitments or obligations under the Agreement (italics added).

This sui generis provision has a formulation that is distinct from other provisions of trade law, and presents unique interpretative puzzles that cannot simply be rushed through. A careful analysis shows that the provision is not, and logically cannot be, the sweeping carve-out that Zutshi makes it out to be.

The PMD’s first sentence establishes the scope of the article as “measures taken for prudential reasons”. Zutshi is correct that the word “including” indicates that this is an indicative list, which does not mean that any measure is included in its scope. Some measures that affect financial services are taken for other reasons, such as measures against commodity speculation that are taken to address rising food prices and hunger. A WTO panel interpreting the PMD would be tasked with discerning “the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose”. As legal scholars have noted, a WTO panel would likely consult general and specialised dictionary definitions of the word “prudential” to establish its “ordinary meaning”, and then examine the list of illustrative examples in the PMD as “context”.

regulatory “sovereignty ends” whenever GATS is violated. While this case did not deal with financial services per se, the panel’s interpretation of the content of the Article XVI requirement (upheld by the Appellate Body) would undoubtedly be imported into future cases in the absence of any political-level ministerial directive to the contrary.

Article XVI has severe implications for developing countries. Unlike developed nations that may possibly have the administrative capacity to make finely drawn distinctions between core banking sectors and purely speculative activities, developing countries often find it easier simply to ban economically harmful services. Yet if the government of a country has made deep Article XVI commitments, such bans would be seen as GATS-illegal in terms of Zutshi’s own jurisprudence. Further, the ongoing negotiations pursuant to GATS Article X(4) may subject every regulation (including those not covered by GATS market access and national treatment requirements) to a series of tests that are likely to push further deregulation.

Limitations on Capital Management Techniques

Capital management techniques (CMTs) or capital controls are used in many developing countries. Yet countries with deep Article XVI market access commitments may find their ability to engage in these curtailed. Countries list their “specific commitments” pursuant to GATS. A footnote to Article XVI notes that if a Member undertakes a market-access commitment in relation to the supply of a service through [Mode 1] and if the cross-border movement of capital is an essential part of the service itself, that Member is thereby committed to allow such movement of capital.

In addition, Article X(9) of GATS states that a country “shall not impose restrictions on any capital transactions inconsistent with its specific commitments regarding such transactions”.

The strictness of these disciplines turn on several interpretative and technical questions that have yet to be resolved by a WTO panel. First, how widely would a panel construe the notion of “restriction” in Article XI? WTO panels and legal scholars all agree that it should be construed broadly.
Utilising the interpretative principle of ejusdem generis, we can delineate the types of policies captured by the first sentence. The various dictionary definitions of “prudent” congeal around the notion of individual agents’ risk aversion, caution, circumspection and judiciousness. The context provided by the illustrative examples of prudential motivations in the PMD include: “for the protection of investors, depositors, policyholders or persons to whom a fiduciary duty is owed by a financial service supplier...” These illustrative examples seem geared towards the so-called “principal-agent problem”, i.e., rules that discourage management (agents) of an enterprise from acting against the interests of the other stakeholders (principal). Thus, it is unsurprising that one of the most commonly cited “prudential measures” is minimum capital or reserve requirements that keep financial managers from making decisions to become more indebted or have more loans outstanding than would be wise to keep the enterprise intact as an ongoing concern.

The final illustrative example provided in the PMD’s first sentence is something of an outlier, referring to the “financial system” as a whole. This example could be seen as widening the scope of the PMD considerably, so it is worth dissecting the phraseology in some detail. The Oxford English Dictionary defines “integrity” as “the condition of having no part or element taken away or wanting”, while “stability” is “immunity from destruction or essential change”. “Ensure” is defined as “to make certain the occurrence or arrival of (an event), or the attainment of (a result)...” Taken together, this illustrative example should be read as “to make certain that the financial system does not lose any part or element and is immune from destruction or essential change”. The GATS negotiators could have used a weaker formulation, such as “contribute to protecting the financial system”. Instead, the use of the word “ensure” suggests an outcome-oriented test: that the measure not merely be motivated by prudential concerns, but that total stability and integrity actually be achieved as a result of the measure.

In sum, four out of five of the PMD’s illustrative measures relate to rules that contribute to the minimisation of harm brought by agents on principals, which would seem to indicate the “centre of gravity” of the definition of “prudential” under the PMD. Only one of the five illustrative examples goes beyond this to examine rules that relate to systemic risks. Policies taken for the more traditional “prudential” reasons examined by the first four examples would likely have an easier time falling under the scope of the PMD, while the fifth type of policy would be subject to greater scrutiny.

Even if a measure comes within the scope of the PMD’s first sentence (no easy task), it must also be within the scope of the second sentence, which imposes limitations on the ability to invoke it as a defence: “Where such measures [i.e., those ‘taken for prudential reasons’] do not conform with the provisions of the Agreement, they shall not be used as a means of avoiding the Member’s commitments or obligations under the Agreement.” Much of the existing academic literature on the PMD interprets the second sentence as so-called “anti-abuse language”, and Zutshi echoes this sentiment repeatedly and in especially unrestrained terms. But there are several reasons to doubt the soundness of this interpretation.

First, this interpretation goes against the “ordinary meaning” of the verbs “to use” and “to avoid”, in violation of Article 31 of the Vienna Convention on the Law of Treaties (VCLT). Advocates of the anti-abuse interpretation seem to be reading the PMD as saying “used with the intent to avoid” rather than the formulation actually utilised: “used as a means of avoiding”. The verbs “to use” and “to avoid” do not require a demonstration of intent on the part of the subject. For this reason, legal invocations of the verb “to use” are often modified to “used with intent” when actions resulting from unique motivations are meant to be differentiated from generally prevailing customs. Whether a WTO member “uses a measure to avoid” its GATS obligations is determined by the fact of the GATS obligations not being fulfilled, not because the WTO member was motivated by the intent to avoid its GATS commitments.

Second, Zutshi’s interpretation goes against the principle of effective treaty interpretation, which requires that two treaty obligations described using different words be given different meanings. Treaty negotiators and interpreters are familiar with the standard anti-abuse language of the so-called chapeau of GATT Article XX. They chose not to utilise that language, and instead create sui generis language of the PMD. Interpreters would have to accordingly apply a different legal standard.

**Application of Chapeau**

The chapeau comes into play when a panel has sided with a complainant that a respondent country has violated their WTO obligations, but has sided with the respondent that the policy nonetheless is taken for some permissible objective (such as protection of human life) and that the policy is (for instance) “necessary” to achieve the objective. The chapeau represents a “final cross-check”, to show that the permissible violation of a WTO obligation is not taken for protectionist reasons or in an arbitrary manner not expressly prohibited by the violated obligation itself. In contrast, the “final cross-check” PMD is simply a return to the initial test, of whether a violation of an obligation or commitment occurred. Only one respondent has survived the chapeau test in the history of the WTO, and it is hard to see how a respondent could ever survive the PMD test.

This raises the question of whether the PMD as a whole can be left with any legal effect. Zutshi rightly identifies this interpretive quandary, and notes that interpreters should ensure that “no text or expression is rendered inutile”. While he worries that we would leave the PMD inutile, his interpretation would lead Article XVI (or any other claimed violated provision) effective- ly inutile. He writes (without interpretive support) that the PMD allows regulatory interventions that “result in violation of a specific commitment”. And: “As to the application of the caveat in practical terms, the facts and circumstances of individual cases under dispute will show whether or not a challenged measure was for prudential reasons or taken with the intent of avoiding a commitment.”

Aside from such interpretation going against the ordinary meaning of the English text of the GATS, there is the issue of whether any policy (be it related to trade in goods, services, investment or intellectual property) could ever be said to be taken “with the intent of avoiding a
commitment”. There is little WTO jurisprudence that delves deeply into how “intention” is ascertained for the purpose of trade law, but recent panels have examined the architecture, design, structure and characteristics of legislation. In practice, this has meant that they examine the preambles and legislative history of the challenged measure.²³

By Zutshi’s evidentiary standard, if a country claims a measure is prudential, this defence could only be invalidated if a parliament was so guileless as to include a provision in the preamble of legislation along the lines of, “While we are claiming this financial reform is for prudential reasons, the real reason is because we seek to violate the GATS commitments”. We know of no instance in the history of the WTO where a legislature has taken action so capricious that it stated the motivation as violating WTO commitments. Rather, a nation takes action that is intended towards some other goal (protection of jobs, consumers or environment), and is unaware of or unconcerned about violating its WTO commitments. By Zutshi’s reading, the PMD would render other GATS provisions inutile, which would be even more unacceptable for an agreement that has as its stated objective “the reduction or elimination” of barriers to services trade.²⁴

PMD and Capital Controls?

All of the foregoing could be moot in the instance of CMTs. The lex specialis interpretative principle suggests that Article XII (which establishes certain limited permissible deviations from Article XI) is rather the governing exception for CMTs. This was the conclusion of two University of Zurich scholars whose writings tend towards supportive of the current WTO regime. In their study of the provisions, Rolf Weber (a WTO panelist) and Christine Kaufmann wrote:

The right of a member to issue or maintain such prudential regulation seems to find its limits in Article XI GATS. Indeed, paragraph 2 of the Annex on Financial Services underlines that the prudential carve-out should not be used to avoid commitments or obligations under the GATS Agreement. This sheds uncertainty on the relationship between the Annex on Financial Services and the GATS, in particular Article XI GATS. The issue is well illustrated by the current request from the EC to Chile to lift its requirement that a prior authorisation by the Central Bank is necessary before profit repatriation to be allowed. Such restrictions are indeed considered by the EC to be in breach of Article XI. If this provision is interpreted as prevailing over the prudential carve-out, it seems to prevent countries from taking prudential measures with respect to payment in transfers, in fact measures, which could be “nevertheless very effective for dealing with financial stability”.²⁵

The Planck commentaries provide support for this conclusion, stating that members may not use prudential measures to “actually avoid any obligations under the GATS (including the obligation to liberalise international transfers and payments relating to services for which specific commitments have been made)”.²⁶ Also, arbitrator Mark Kantor has a similar interpretation of the non-applicability to capital and current restrictions of a nearly identical PMD clause in bilateral US trade and investment agreements.²⁷

GATS: A Special Problem

Zutshi sets up a straw man when he concludes that “Specific commitments of members in the financial service sector were in no way responsible for the crisis”, since no one has argued this in the first place. Rather, the apprehension is that commitments under GATS may prevent both developed and developing countries from putting in place financial sector policies that are seen to be in society’s interests. Some of the issues with respect to CMTs and banking requirements have already been highlighted. There are further areas of concern for developing countries, most strongly with respect to development banking and directed credit. The requirement of national treatment may affect countries seeking to develop their own domestic financial sector in particular ways, especially to generate greater financial inclusion. The importance of public sector banks in maintaining stability and furthering an economic growth strategy has become evident in the light of the role played by successful development banks such as BNDES in Brazil. Such options may be constrained in some countries depending upon the exact nature of their Article XVI commitments. Similar concerns apply to the possibility of directing credit to certain sectors for developmental or societal purposes. Since no country has developed without some recourse to directed credit, this is a serious limitation.

Two underlying axioms imbue Zutshi’s analysis. The first is that GATS generally provides a framework for trade liberalisation that is generally favourable to developing countries and that therefore it is in their interests to promote and further strengthen the agreement. This issue is not so clear cut, and Zutshi’s own discussion of the cost-benefit equation suggests that subjective perceptions play an important part in such a judgment. The second is an excessive faith in the ability of the IMF to serve as the objective arbiter in case of disputes with respect to restrictions imposed by a member in case of balance of payments difficulties. He notes approvingly that the “IMF has a decisive say in the assessing the balance-of-payment and the external financial situation of a consulting member under Article XII”. But in fact this power has been asymmetrically applied by the IMF, often to the detriment of developing countries, as has even been recognised by the Independent Evaluation Office of the IMF.²⁸

We have raised several areas where GATS disciplines are at best ambiguous, and at worst, could pose barriers to financial services reform. There are still other areas we have not explored, such as the worrying implications of the proposed disciplines on the accountancy sector, or even the overly expansive interpretation of non-discrimination rules. This discussion should underline that developing countries’ efforts to further discuss these intersections should be encouraged, not discouraged. Indeed, if there had been more honest engagement on these issues the first time around, proponents of GATS would not currently confronting difficult questions for which they have no good answers.²⁹
dianenot to a defence in balance-of-payments of the treaty as a whole is the primary context, and in the light of its object and purpose”. The text to be given to the terms of the treaty in their context good faith in accordance with the ordinary meaning that “A treaty shall be interpreted in AB/R, para 8.235.

Asbestos and Asbestos-Containing Products

International Law


It is unclear whether Zutshi fully understands the implications of his own ruling in the US-Gambling case. On p72 of the special article, he notes that GATS Article XII is a provision that countries can “if the measure is applied on a non-discriminatory basis between foreign and domestic suppliers, in cases of full market access commitments”. In fact, a measure need not be discriminatory to provide market access commitments, as the panel noted. See WTO Dispute Settlement Body, “United States – Measures Affecting the Cross-Border Supply of Gambling and Betting Services”, WTO Document WT/DS58/AB/R, 10 November 2004, at paragraph 6.278-79, and 6.426.


The GATS text is available at: http://wto.org/english/docs_e/legal_e/e_26-gats_en	htm


The Vienna Convention on the Law of Treaties Article I(1) establishes the general rule of treaty interpretation that “A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of their object and purpose”. The text of the treaty as a whole is the primary context, available at: http://untreaty.un.org/ilc/texts/instruments/english/conventions/1_1969.pdf

A provision that countries can invoke as a defence in balance-of-payments (BOP) emergencies to get out of having to comply with Article XI. It states that (subject to over a dozen procedural and substantive hurdles, such as the requirement that CMTs be temporary rather than preventative) “…a Member may adopt or maintain restrictions (General Exceptions) if it has undertaken specific commitments, including on payments or transfers for transactions related to such commitments.” If the only prohibited form “a restriction” other than outright prohibition is to refuse to allow capital to flow, GATS Article XII would have been couched more narrowly than “restrictions on trade in services… including on payments or transfers for transactions…” Instead, it would have said “…a measure may also be justified in the light of capital movement of an essential nature in an area of interest to the country that is crucial to the functioning of the market in which it is applied, or is considered essential for the development of the country.” The panel notes in its judgment that “the present interpretation of the chapeau’s requirements are twofold. First, a measure provisionally justified under one of the paragraphs of Article XX must not be applied in a manner that would constitute ‘a disguised restriction on international trade’. Through these requirements, the chapeau serves to ensure that Members’ rights to avail themselves of exceptions are exercised in good faith to protect interests considered legitimate under Article XX, not as a means to circumvent one Member’s obligations towards other WTO Members.” See WTO Appellate Body, Brazil – Measures Affecting Imports of Retreaded Tyres, December 2004, at 25.


The lack of analysis of specific countries’ schedules may be one reason why ambassador Zutshi seems to view the GATS as a problem for developing nations. Zutshi makes much of the BOP defence provi- sions under Article XII, but fails to note that this is only for measures undertaken after a crisis has hit (and under DS58/R, B, subject to all sorts of limitations). The issue of most concern to policymakers is the absence of space to engage in forward-looking, crisis avoidance policies.


The OED defines “avoid” as “to keep clear of or uninvolve oneself in (a complex situation); to handle, especially to some useful or desired end”. A “distinction”, Stumberg, “Relevant Regulation of Food Derivatives”, Harrison Institute for Public Law at Georgetown University Law Center, 2007, available at: http://www.harrisoninstitute.georgetown.edu/pdf/Comment_Article_VI.pdf


Zutshi makes the point on page 77 that the WTO “should itself be interpreting such ‘interpretations’ of the GATS. This is exactly why the WTO members themselves should be taking such steps. 20 This provision reads in part: “Subject to the requirement that such measures are not applied in a manner inconsistent with GATS obligations, a country…if the only prohibited form of “a restriction” other than outright prohibition is to refuse to allow capital to flow, GATS Article XII would have been couched more narrowly than “restrictions on trade in services… including on payments or transfers for transactions…” Instead, it would have said “…a measure may also be justified in the light of capital movement of an essential nature in an area of interest to the country that is crucial to the functioning of the market in which it is applied, or is considered essential for the development of the country.” The panel notes in its judgment that “the present interpretation of the chapeau’s requirements are twofold. First, a measure provisionally justified under one of the paragraphs of Article XX must not be applied in a manner that would constitute ‘a disguised restriction on international trade’. Through these requirements, the chapeau serves to ensure that Members’ rights to avail themselves of exceptions are exercised in good faith to protect interests considered legitimate under Article XX, not as a means to circumvent one Member’s obligations towards other WTO Members.” See WTO Appellate Body, Brazil – Measures Affecting Imports of Retreaded Tyres, December 2004, at 25.

While it is difficult to know for sure how a panel would strive to give effect to the provision, it is probable that it is meant to excuse qualifying prudential measures from the necessity tests envisioned in Article VI. This concept is explored in more detail here: http://citizen.typepad.com/eyesontrade/2011/04/ reflections-on-meaning-of-prudential-language-in-the-wto.html


This interpretive problem seems especially pronounced in the GATS articles we have examined in this article. National treatment analysis scours the use of any (prima facie allowable) policy tools for possible impermissible protectionist intents or effects. Thus there is a clear conceptual distinction between the means, ends and intent. In GATS Articles XVI and XI, however, it is the policy tool itself that is prohibited, regardless of intent. Thus, establishing whether a Member’s GATS Articles XVI or XI commitments have been avoided is the policy tool is simply a box checking exercise that scrutinises the employment of a particular policy tool, not the end or intent.