

# **ETHIOPIA'S WTO ACCESSION AND FINANCIAL SERVICES LIBERALIZATION: STRIKING THE BALANCE BETWEEN TRADE LIBERALIZATION AND DOMESTIC POLICY SPACE**

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## **Abstract**

This article examines some of the main provisions of the General Agreement on Trade in Services (GATS) and the Annex on Financial Services to evaluate its impact on domestic financial regulation and macroeconomic policy. In particular, it analyzes whether Ethiopia can – upon accession and within the WTO's GATS framework – achieve the objective of liberalizing international trade in financial services while maintaining adequate domestic regulatory institutions and the normative framework needed in this regard. The article investigates whether GATS provides a flexible framework for Ethiopia to negotiate liberalization commitments while at the same time preserving a sufficient level of domestic regulatory space to achieve financial and economic stability.

## **Key words**

WTO accession, GATS, financial liberalization, domestic policy space, trade liberalization, Ethiopia

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## **Acronyms and Abbreviations**

BOP	Balance of Payments
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
IMF	International Monetary Fund
MFTR	Memorandum of Foreign Trade Regime
MFI	Micro Finance Institution
NBE	National Bank of Ethiopia
WTO	World Trade Organization

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## Introduction

The WTO was established as a successor of the General Agreement on Tariffs and Trade (GATT).<sup>1</sup> Built upon a broader legal and political base than the GATT, it can correctly be described as the mutated GATT.<sup>2</sup> The WTO covers numerous trade agreements, one of the most important being the WTO General Agreement on Trade in Services (GATS).<sup>3</sup> This accord which came into force in January 1995 is the first and only set of multilateral rules that cover trade in services, with a broad scope and coverage of all traded services including financial services.<sup>4</sup> Ethiopia has applied to accede to this system in 2003 and is now deeply involved in the multi-stage accession process whereby negotiations on trade in financial services will be one of the key issues that determine Ethiopia's WTO accession. This is due to both the role of financial services for the economy at large, the closed nature of the service against foreign investment and the nature of WTO negotiating trade in financial services considering potential market failures and regulatory issues in these services.<sup>5</sup> This article addresses these issues.

However, the article does not address broad questions on the economic and social benefits of financial market reform and liberalization. Nor does it deal with the benefits and positive externalities of financial market and trade policy reform for broader financial sector development, growth, income distribution

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<sup>1</sup> World Trade Organization (1999), *The Legal Texts, The Results of The Uruguay Round Of Multilateral Trade Negotiations*, Marrakesh Agreement Establishing The World Trade Organization.

<sup>2</sup> Michael J. Trebilcock and Robert Howse (1999), *The Regulation of International Trade*, Second Edition, Routledge, See Chapter 1; An Intellectual History of International Trade Theory And Policy, pp. 1-24.

<sup>3</sup> GATS, *supra* note 1.

<sup>4</sup> The word "trade in services" has earlier history since 1973 under the OECD framework. See OECD (1973), *Report by the High Level Group on Trade and Related Problems*, Paris: OECD.

<sup>5</sup> All this can be seen from various official and non official statements. See for instance the views of the Minister of Foreign Affairs who stated his belief that "existing differences on the telecom and financial sectors should not be impediments to the ongoing accession process as Ethiopia had expressed its readiness to work on these issues on a short-to-medium term basis."

<<http://www.mfa.gov.et/weekHornAfrica/morewha.php?wi=789>>. Also see Venture Africa which stated that "[k]ey issues pertaining to Ethiopia joining the WTO have surrounded the opening up of currently state-monopolised sectors, such as the telecommunications and finance sectors, while the country has also been called upon to allow investment by foreign entities."

<<http://www.ventures-africa.com/2013/01/ethiopia-set-to-join-wto-by-2014/>> .

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and poverty.<sup>6</sup> Without denying the importance of these questions, the study assumes that sufficient literature exists in this realm.<sup>7</sup> Rather, this article focuses on GATS commitments (of WTO Members) in financial services and its impact on national policy objectives. The central inquiry will be whether there exists any reason for Members to hold back on GATS commitments in order to retain the freedom to pursue certain macroeconomic and regulatory policy objectives of their internal economy.

Accordingly, the evaluation of the system below shows that commitments under GATS need not compromise the ability of governments to pursue sound regulatory and macroeconomic policies and hence still leaves them with considerable freedom to achieve other domestic policy targets. Based on the examination of the possible commitment scenarios which Ethiopia can possibly commit to, the author argues that there exists no reason why GATS commitments on financial services will have to compromise Ethiopia's ability to pursue sound regulatory and macro-economic policies.<sup>8</sup>

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<sup>6</sup> On all these issues generally see John Williamson and Zdenek Drabek (1999), *Whether and When to Liberalize Capital Account and Financial Services*, World Trade Organization Economic Research and Analysis Division, Staff Working Paper ERAD-99-03; Gerard Caprio (2001), *Financial Liberalization, How Far, How Fast?*, Cambridge University Press; Stiglitz, J. E. (2000), *Capital Market Liberalization, Economic Growth, and Instability*, World Development, Vol. 28, 1075-1086; World Trade Organization, WTO (1997), Newsletter , *Liberalizing Trade in Financial Services: Why It Matters?* Focus No. 22; Agénor, Pierre-Richard (2001), *Benefits and Costs of International Financial Integration: Theory and Facts*, Policy Research working paper, 2699, the World Bank; Jonse Bane (2002), *Merits and Demerits of Allowing Entry of Foreign Banks into the Ethiopian Banking Sector* Banking Sector: *Lessons From Selected Countries*, Paper Prepared for the First International Conference on the Ethiopian Economy organized by EEA (January 3-5, 2002 Addis Ababa, Ethiopia)

<sup>7</sup> See Kiyota, K., Peitsch, B., and M Stern, R. (2007), *The Case for Financial Sector Liberalization in Ethiopia*, Research Seminar in International Economics, Discussion Paper No. 565, University of Michigan and Yokohama National University; Robert M. Stern *et al.*, (2007), *Assessment of the Impact of the General Agreement on Trade in Services (GATS) on the Ethiopian Financial Services Sector*, Ministry of Trade and Industry, Addis Ababa; Gebrehiwot Ageba and Derk Bienen (2008), *Ethiopia's Accession to The WTO and the Financial Services Sector*, Munich; Also see, Solomon Abay Yimer (2011), *Financial Market Development, Policy and Regulation; The International Experience and Ethiopia's Need for Further Reform*, Academisch Proefschrift, ter verkrijging van de graad van doctor aan de Universiteit van Amsterdam.

<sup>8</sup> Financial services fall into two broad categories: insurance and banking, both of which cover a range of activities.

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To this end, the article evaluates the existing norms under the general WTO framework, and in particular GATS commitments and thereby examines to what extent the existing framework under the WTO allows regulatory freedom and policy space to achieve objectives such as prudential regulation and macro-economic policy. The article also evaluates to what extent Ethiopia's commitment scenario could be shaped-up to maintain the economic and regulatory space stated above and the tools needed in this regard. In particular, a detailed analyses of some of the main provisions of the GATS and the Annex on Financial Services will be made to determine its impact on domestic financial regulation and whether Ethiopia can achieve, under the WTO's GATS framework, an objective of liberalizing international trade in financial services while allowing itself maintain adequate domestic regulatory institutions.

The article is organized into three major sections. The first section provides an overview of the nature of GATS commitments and the modality of negotiations. This will be followed by the second section which briefly discusses Ethiopia's Accession to the WTO and Financial Services and the experience of recently acceded developing and least developed countries. The section also highlights the possible commitment scenarios with which Ethiopia could accede to the system. The last section consists of the major topics of discussion and evaluates *the Ethiopian Case* of financial market liberalization and economic policy space followed by a conclusion.

## 1. The Nature of GATS Commitments and Modality of Negotiations

Rather than representing itself as a liberalization agreement, GATS mainly provides a framework for liberalization of trade in services.<sup>9</sup> In so doing, it is based on three pillars. One, it includes a framework agreement, which contains a comprehensive general accord governing all possible sectors (i.e. financial services, telecommunications, and information technology).<sup>10</sup> Two, special sector annexes and other agreements, such as the *Understanding on Financial Services*, contain provisions focusing specifically on the sector concerned.<sup>11</sup> It finally, consists of scheduled commitments on market access, national treatment

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<sup>9</sup> Peter Van den Bossche (2005), *The Law and Policy of the World Trade Organization Text, Cases and Materials*, Cambridge University Press, p 480.

<sup>10</sup> See GATS Part II General Obligations and Disciplines.

<sup>11</sup> The list of annexes include; Annex on Article II Exemptions, Annex on Movement of Natural Persons Supplying Services under the Agreement, Annex on Air Transport Services, Annex on Financial Services, Second Annex on Financial Services, Annex on Negotiations on Maritime Transport Services, Annex on Telecommunications, Annex on Negotiations on Basic Telecommunications.

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and other commitments.<sup>12</sup> With regard to the last point, the GATS define trade in financial services, like in other services, in terms of *four modes of supply*, which are respectively referred to in this article as *Mode 1, Mode 2, Mode 3* and *Mode 4*:

For the purposes of this Agreement [i.e. GATS], trade in services is defined as the supply of a service: (a) from the territory of one Member into the territory of any other Member; (b) in the territory of one Member to the service consumer of any other Member; (c) by a service supplier of one Member, through commercial presence in the territory of any other Member; (d) by a service supplier of one Member, through presence of natural persons of a Member in the territory of any other Member.<sup>13</sup>

These modes are in short referred to as cross-border supply of services (*Mode 1*), consumption abroad (*Mode 2*), commercial presence (*Mode 3*), and temporary movement of natural persons (*Mode 4*).

In terms of market access, GATS does not provide positive and normative definition for market access but only provides six types of restrictions that a member cannot impose, unless identified in its schedule.<sup>14</sup> Conceptually this is similar to the principles of quantitative market access limitations under GATT Art XI.<sup>15</sup> Generally, GATS Art XVI:2 provides for rules that prohibit members from imposing market access limitations on: (i) the number of service suppliers whether in the form of numerical quotas, monopolies, exclusive service suppliers or the requirements of an economic needs test; (ii) the total value of service transactions or assets; (iii) number of operations or quantity of output; (iv) number of natural persons supplying a service; (v) type of legal entity or joint venture or, finally; (vi) limitations on the participation of foreign capital in terms of maximum percentage limit on foreign shareholding or the total value of individual or aggregate foreign investment, unless properly provided in their schedules. The existence of any limitations in these areas has to be indicated

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<sup>12</sup> See GATS Art XX, Schedules of Specific Commitments; 1. Each Member shall set out in a schedule the specific commitments it undertakes under Part III of this Agreement.

<sup>13</sup> General Agreement on Trade in Services (GATS), Art I.

<sup>14</sup> *Ibid*, Art XVI.

<sup>15</sup> General Elimination of Quantitative Restrictions: “1. No prohibitions or restrictions other than duties, taxes or other charges, whether made effective through quotas, import or export licences or other measures, shall be instituted or maintained by any contracting party on the importation of any product of the territory of any other contracting party or on the exportation or sale for export of any product destined for the territory of any other contracting party.”

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with respect to each of the four modes of supply in scheduled sectors.<sup>16</sup> The idea is that such market access limitations are prohibited even if they are not discriminatory.<sup>17</sup>

At the same time, GATS does not provide a comparable list in respect of national treatment restrictions, and it is up to members to ensure that all potentially relevant measures are listed in sectors where commitments are scheduled and, if they wish, members can inscribe various types of national treatment limitation (e.g., regarding taxation or regulations).<sup>18</sup> “If a member no longer wishes to conform to its specific commitments, it may modify its schedule by providing compensation in the form of alternative market access (even across sectors).”<sup>19</sup> “However, this undertaking may involve difficult negotiation and often creates confusions regarding the member’s commitments.”<sup>20</sup>

With respect to the final part of the GATS framework, the GATS schedules are key framework instruments providing the list of services with members’ commitments in terms of market access, national treatment and additional commitments. The lists of services correspond to GATT secretariat classification,<sup>21</sup> which is a standardized harmonized framework also following numerical references to the Central Product Classification system of the United Nations.<sup>22</sup>

It is important here to recall that, depending on how commitments are made, treaties liberalizing trade in services make use of either a ‘positive list’ or a

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<sup>16</sup> This done in accordance with United Nations CPC classification (Statistical Papers, Series M, No.77, 1991). Also see WTO, *Guidelines For The Scheduling Of Specific Commitments Under The General Agreement On Trade In Services (GATS)*, Adopted by the Council for Trade in Services (2001).

<sup>17</sup> Nicolas F. Diebold (2010), *Non Discrimination In International Trade In Services ‘Likeness’ In WTO/GATS*, Cambridge University Press, p 29.

<sup>18</sup> Art XVII lit 2 states; A Member may meet the requirement of paragraph 1 by according to services and service suppliers of any other Member, either formally identical treatment or formally different treatment to that it accords to its own like services and service suppliers.

<sup>19</sup> International Monetary Fund, *Reference Note on Trade in Financial Services*, Prepared by the Strategy, Policy, and Review and Legal Departments (September 3, 2010) p 5 <<http://www.imf.org/external/np/pp/eng/2010/090310.pdf>> General Agreement on Trade in Services (GATS), Art XXI: Modification of Schedules.

<sup>20</sup> *Ibid.*

<sup>21</sup> See Uruguay Round, *Services Sectoral Classification List, Note by the Secretariat*, MTN.GNS/W/120 (10 July 1991).

<sup>22</sup> Various versions available, see for instance, *Central Product Classification, CPC Version 1.1*, (Updated: 21.02.2002), *Version submitted to the United Nations Statistical Commission*, 5-8 March (2002).

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'negative list' approach.<sup>23</sup> Under a positive list approach, countries undertake national treatment and market access commitments specifying the type of access or treatment offered to services or service suppliers in scheduled sectors. The alternative top-down approach is based upon negative listing, whereby all sectors and measures are to be liberalized unless otherwise specified by reservations or non-conforming measures. This is the so-called "list-or-lose technique."<sup>24</sup> GATS follows a 'hybrid trend'; a positive list for sectoral coverage and a negative list for limiting market access and national treatment commitments "(with the qualification that even here, the GATS allows for entries that are 'unbound', that is where no commitment at all are made for a particular mode of supply under a given sector)."<sup>25</sup>

If a service sector is listed in the national schedule, it implies that the listing economy has liberalized its domestic market in that sector for trade and is ready to offer market access to foreign suppliers. It applies to all the members on a non-discriminatory basis in the selected services area. The GATS accord is fairly flexible, and members have complete freedom in choosing services as well as the degree to which foreign services suppliers can operate in their domestic markets. For instance, if a member country chooses financial services and commits to open its domestic banking sector for foreign suppliers, it is also free to limit market access by limiting the number of licenses it grants. Additionally, it may predetermine the number of foreign bank branches it is going to allow to operate in its territory. Thus, the services agreement, unlike the GATT, provides for both market access and national treatment limitation.<sup>26</sup>

Consequently, despite the almost unanimous agreement that GATS is a technically difficult agreement to comprehend, there is also outstanding evidence that trade negotiations over GATS is comparatively less rigid for

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<sup>23</sup> James Gillespie (2000), *Financial Services Liberalization in the World Trade Organization*, Harvard Law School, p 11.

<sup>24</sup> Sherry M. Stephenson (2001), *Multilateral and Regional Services Liberalization by Latin America and the Caribbean*, A Publication of the Organization of American States Trade Unit (March 2001) p 30.

<sup>25</sup> Sherry Stephenson and Patricio Contreras, *An Asymmetric Approach to Services Liberalization: the European Union-Mercosur Case*, <[http://www.sedi.oas.org/DTTC/TRADE/PUB/STAFF\\_ARTICLE/steph01\\_asym.as](http://www.sedi.oas.org/DTTC/TRADE/PUB/STAFF_ARTICLE/steph01_asym.as) p> (accessed Jan 2013) Also See Sherry M. Stephenson, *Approaches to Liberalizing Services*, Development Research Group of the World Bank (DECRG). The positive list approach was adopted specifically at the request of developing countries which felt they did not have the administrative resources required to determine all the measures that apply to each sector and to decide which they want to exempt. See Paul Kruger, *GATS Commitments of the SADC EPA Configuration*, Tralac (2009).

<sup>26</sup> Dilip K. Das (2005), *The Doha Round of Multilateral Trade Negotiations: Arduous Issues and Strategic Responses*, Palgrave Macmillan, p 131.

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negotiating members inside the system which is equally relevant to those in the process of accession because of the following major peculiarities of GATS. First, member/acceding countries identify the sectors and sub-sectors for making commitments to foreign services suppliers. Although members have a schedule of commitments, there is no minimum requirement in this regard. Members have liberty to identify as small part of one sector for guaranteeing the rights of foreign suppliers to provide services as they please.<sup>27</sup> Second, having identified the sector(s), member/acceding governments have a right to set limitations on market access and the degree of national treatment they are willing to guarantee. Third, developing country governments frequently limit their commitments to one or two modes of supply through which services can be traded. Furthermore, if they see it is reasonable and appropriate, they may withdraw or renegotiate commitments.<sup>28</sup> This *modus operandi* has thus rendered the GATS accord essentially and relatively adaptable and accommodating.<sup>29</sup>

## 2. Ethiopia's Accession to the WTO and Financial Services: Setting the Stage

Accession to the WTO is a protracted, multi-stage and complex process.<sup>30</sup> Essentially, the way to become a WTO member is through accession "on terms to be agreed" between the acceding country or customs territory and other WTO members.<sup>31</sup> The WTO Agreement does not contain any further guidelines on

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<sup>27</sup> Generally see, Council for Trade in Services, *Guidelines for the Scheduling of Specific Commitments Under The General Agreement On Trade In Services (GATS)*, S/L/92 (2001).

<sup>28</sup> GATS Article X Sub 2: In the period before the entry into effect of the results of the negotiations referred to in paragraph 1, any Member may, notwithstanding the provisions of paragraph 1 of Article XXI, notify the Council on Trade in Services of its intention to modify or withdraw a specific commitment after a period of one year from the date on which the commitment enters into force; provided that the Member shows cause to the Council that the modification or withdrawal cannot await the lapse of the three-year period provided for in paragraph 1 of Article XXI.

<sup>29</sup> Dilip K. Das, *supra* note 26 above. This however does not mean that there is a 'level playing field' in the WTO accession process. Unfortunately, acceding members have, more often than note, less bargaining chip than incumbent members.

<sup>30</sup> ICTSD, *An Analysis of the WTO Accession Guidelines for Least Developed Countries*; ICTSD Programme on Competitiveness and Development; Information Note; International Centre for Trade and Sustainable Development, Geneva, Switzerland, <[www.ictsd.org](http://www.ictsd.org)>, (2012), p 2.

<sup>31</sup> Art Article XII:1 of the Marrakesh Agreement Establishing the WTO states, "Any State or separate customs territory possessing full autonomy in the conduct of its external commercial relations and of the other matters provided for in this Agreement and the Multilateral Trade Agreements may accede to this Agreement, on terms to be



what the “terms to be agreed” are or how the accession process is going to follow from here except that it leaves the discretion to the incumbent WTO members and the results of the negotiations.<sup>32</sup>

Within the above context, the accession process can be categorized into a four stage process of multilateral and bilateral negotiation. The first stage starts when the acceding country (or customs territory as the case may be) submits its formal request of membership and its Memorandum of Foreign Trade Regime (MFTR). This is a document that provides detailed sets of information on the country’s economic, political and legal infrastructure that mostly has to do with international trade. The second stage in the accession process establishes a designated working party which is a multilateral negotiation medium open for all interested WTO members and it essentially involves a fact finding process. At this stage members would send various sets of questions based on the MFTR submitted. It is an important stage which makes sure that the internal policies and laws of the acceding country are in compliance with the WTO Agreement. This stage is followed by,<sup>33</sup> the third stage of bilateral negotiation between the acceding country and individual WTO members. It is perhaps the most important stage of the negotiation process as it determines the shape of commitments to be taken by the acceding country. The final stage deals with more administrative issues such as drafting the terms of accession protocol, schedules of commitments and of course involves final decision making by the WTO Ministerial Conference.<sup>34</sup>

Ethiopia applied for the accession to the WTO in January 2003 and the WTO’s General Council has established a Working Party to which the Government of Ethiopia submitted a Memorandum of Foreign Trade Regime of the country for the consideration of WTO members. Until December 2012 the working party has met three times and Ethiopia is in the process of responding to its fourth set of questions from WTO members about the workings of its economy and trade regime.

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agreed between it and the WTO. Such accession shall apply to this Agreement and the Multilateral Trade Agreements annexed thereto.” It is to be noted that this provision follows similar language contained in the accession provision of GATT Art. XXXIII.

<sup>32</sup> Ivan Marković (2009), *How To Join The World Trade Organization: Some Aspects Of The Accession Process*, Economic Annals, Volume LIV, No. 180, (January – March 2009) p 121.

<sup>33</sup> Often overlaps are also common between the multilateral negotiations under the working party meetings and bilateral trade negotiations.

<sup>34</sup> According to Art XII:2, “[d]ecisions on accession shall be taken by the Ministerial Conference. The Ministerial Conference shall approve the agreement on the terms of accession by a two-thirds majority of the Members of the WTO.”

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As part of achieving membership in the WTO, Ethiopia will enter into bilateral negotiations with various members of the WTO and perhaps will be required to make commitments to market access for a number of sectors and modes of supply in the services sector. As an LDC, Ethiopia is likely to be given some flexibility in assuming liberalization commitments in services.<sup>35</sup> However, it should be expected that Ethiopia will be asked to agree to some threshold of liberalization in the financial sector, and it is important for Ethiopia to develop a negotiating strategy that protects its macroeconomic and regulatory interests but also be prepared to undertake some commitments in these sectors. Ethiopia will also be required to have a system of transparency in regulation that meets the general obligations of the GATS.

### 2.1. Experience of Recently Acceded Countries

The vast number of agreements for the liberalization of trade in services that has been implemented both at the multilateral and bilateral levels has shed light on the negotiating strategies that might be considered by governments in order to obtain the full benefits of liberalization. "The main conclusion arising from these experiences is that no specific recipe can be prescribed for negotiating the liberalization of trade in services,"<sup>36</sup> but that, whatever negotiating modality is chosen, it should take into account the speed with which the economies of participating countries are able to open their markets to international trade and the degree to which the agreement is capable of conveying credibility.<sup>37</sup> "The legitimacy of an agreement will depend upon how it is structured, while the

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<sup>35</sup> Although it is not as effective as it ought to be, the WTO Guideline on LDCs accession is a notable indicator to these flexibilities. See WTO, *Guidelines for Accession of Least-Developed Countries*, WTO document WT/L/508 of 20 January 2003, Decision of 10 December 2002. Paragraph 1 states for example "1. Market Access -WTO Members shall exercise restraint in seeking concessions and commitments on trade in goods and services from acceding LDCs, taking into account the levels of concessions and commitments undertaken by existing WTO LDCs' Members." Also see recent efforts to "further strengthen, streamline, and operationalize the 2002 LDC accession guidelines," under the Eighth WTO Ministerial Conference in December 2011. Accession of Least-Developed Countries Decision of 17 December 2011 WT/L/846, (19 December 2011).

<sup>36</sup> Sherry Stephenson and Patricio Contreras, *supra* note 25.

<sup>37</sup> In exploring the current account implications of alternative speeds of liberalization, studies have shown that in a framework where a country faces a borrowing constraint, a gradual liberalization of trade is to be preferred to an immediate approach. However, this question is one that has often been debated in the economic literature and no universally agreed conclusion exists with respect to the optimum speed of undertaking trade liberalization, whether for goods or services. Generally see World Bank, *Finance for growth: Policy choices in a volatile world*, Policy Research Report (2001).

ability of members to implement the commitments to be undertaken will depend to a considerable extent on their level of development and particularly on the sophistication of their regulatory instruments”.<sup>38</sup> The commitment scenarios of four recently acceded developing and least developed countries are highlighted below.

### 2.1.1. Kingdom of Cambodia

“Cambodia has undertaken market access commitments in at least one sub-sector under each of 11 different services headings under the WTO classification”.<sup>39</sup> The Cambodian Law on Banking and Financial Institutions and subsequent regulations guaranteed foreign banks rights and obligations equal to local banks and there was no restriction regarding foreign ownership of banks.<sup>40</sup> Accordingly, Cambodia made commitments on: acceptance of deposits and other repayable funds from the public, lending of all types, including, among others, consumer credit, mortgage credit, factoring and financing of commercial transaction, and all payment and money transmission service, including credit, charge and debit cards, travellers’ cheques and bankers drafts.<sup>41</sup> Thus Cambodia did not commit to financial services under sub-sectors B(c), (e), (f)–(l).<sup>42</sup> Cambodia maintained that it will unbound these sectors until the Government determines what types of entities can conduct these services, the related laws and regulation are established, and such business is authorized by the government or other relevant designated authority. Thus, the commitments for subsectors (a), (b) and (d) only refer to commercial banking.

### 2.1.2. Cape Verde

The accession schedule of Cape Verde shows that, Cape Verde made market access commitments on *Mode 2* and *3* on sectors such as (v) acceptance of deposits and other repayable funds from the public; (vi) lending of all types, including consumer credit, mortgage credit, factoring and financing of commercial transaction; (vii) financial leasing; (viii) all payment and money

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<sup>38</sup> Sherry Stephenson and Patricio Contreras, *supra* note 25.

<sup>39</sup> Sok Siphana (2005), *Lessons from Cambodia’s Entry into the World Trade Organization*, Asian Development Bank Institute, ADBi Publishing -11/05, p 51.

<sup>40</sup> Samnang Chea, et al., *Trade in Services in Cambodia*, ASEAN Economic Forum, <[http://siteresources.worldbank.org/INTRANETTRADE/Resources/Topics/Services/Cambodia-Asean\\_services.pdf](http://siteresources.worldbank.org/INTRANETTRADE/Resources/Topics/Services/Cambodia-Asean_services.pdf)> (last accessed April 2012).

<sup>41</sup> World Trade Organization, *Report Of The Working Party on The Accession Of Cambodia, Addendum Part II- Schedule of Specific Commitments in Services List of Article II MFN Exemptions*, T/ACC/KHM/21/Add.2 (2003).

<sup>42</sup> These sectors are (c) Financial leasing, (e) Guarantees and commitments, (f) Trading for own account or for account of customers, (g) Participation in issues of all kinds of securities, (h) Money broking and finally (i) Asset management.

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transmission services, including credit, charge and debit cards, travellers' cheques and bankers drafts; (ix) guarantees and commitments; (x) trading for own account or for account of customers, whether on an exchange, in an over-the-counter market or otherwise, the following: (A) money market instruments (including cheques, bills, certificates of deposits); (B) foreign exchange; (C) derivative products including, but not limited to, futures and options; (D) exchange rate and interest rate instruments, including products such as swaps, forward rate, etc.<sup>43</sup> Cape Verde also made commitments on areas of (xi) participation in issues of all kinds of securities, including underwriting and placement as agent (whether publicly or privately) and provision of services related to such issues (xii) money broking (xiii) asset management, such as cash or portfolio management, all forms of collective investment management, pension fund management, custodial, depository and trust services (xiv) settlement and clearing services for financial assets, including securities, derivative products, and other negotiable instruments, while at the same time Cape Verde forfeited the privilege to discriminate against foreigners except on *Mode 4*, in accordance with limitations under horizontal commitments. In the meantime Cape Verde, in its financial services head note, maintained that it will permit the establishment of branches for committed sub-sectors in insurance, banking and securities within 10 years from the date of Cape Verde's accession to the WTO.<sup>44</sup>

### 2.1.3. Kingdom of Nepal

The schedules of services commitments of the Kingdom of Nepal shows that Nepal made full market access and national treatment commitments (except on *Mode 4*) on all Banking and other Financial Services,<sup>45</sup> which includes; (a) acceptance of deposits and other repayable funds from the public, (b) lending of all types, including, *inter alia*, consumer credit, mortgage credit, factoring and financing of commercial transactions, (c) financial leasing (d) all payment and money transmission services (e) guarantees and commitments (f) trading for own account or for account of customers, whether on an exchange, an over-the-counter market, participation in issues of all kinds of securities, including underwriting and placement as agent (whether publicly or privately) and provision of service – related to such issues. It further includes (h) money broking, (i) asset

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<sup>43</sup> Cape Verde, *Report of The Working Party on The Accession of Cape Verde: Addendum, Part II Schedule of Specific Commitments in Services List of Article II MFN Exemptions*, WT/ACC/CPV/30/Add.2.

<sup>44</sup> *Ibid.*

<sup>45</sup> For a detailed review of the financial services reform in Nepal see, Project Research & Management Associates P. Ltd (2007), *Study on Financial Sector Reform in Nepal; Overall Impact and Public Ownership of Financial Institution*, South Asian Network of Economic Institutes –SANEI.

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management, such as cash or portfolio management, all forms of collective investment management, pension fund management, custodial depository and trust services, (j) settlement of and clearing services for financial assets, including securities, derivative products, and other negotiable instruments, (k) provision and transfer of financial information, and financial data processing and related software by providers of other financial services, and (l) advisory services on all the activities listed above.<sup>46</sup>

In the meantime, Nepal maintained under the services schedule head notes that financial services in the form of operations identified in the Schedule can be carried out in Nepal only through a locally incorporated company. Importantly, branches for insurance services and wholesale banking were scheduled to be allowed only as of 1 January 2010.<sup>47</sup> In addition, only a licensed commercial bank, a licensed specialized bank or a registered finance company may accept deposits. Only financial institutions with rating of at least 'B' by 'Credit Rating Agency' e.g. MOODI, Standard & Poor can have commercial presence in Nepal. Another important limitation is the total foreign shareholding in any institution providing financial services which is limited to 67 per cent of the issued share capital. It has, nevertheless, been bound for the existing foreign financial service providers as to their scope of operation and equity structure. Nepal also maintained that the shares held by foreign nationals and foreign financial institutions in their locally incorporated companies are not transferable without the prior written approval of the Nepal Rastra Bank (the central bank) or any other competent authority as the case may be. Moreover, representative offices in Nepal may not be engaged in commercial business.<sup>48</sup>

#### 2.1.4. Jordan

Jordan's GATS commitments in financial services are not different from the other recently acceded states. Essentially, Jordan made full market access and national treatment commitments on banking services such as; acceptance of deposits and other repayable funds from the public, guarantees and commitments and money broking.<sup>49</sup> The only exceptions were that Jordan bound a national treatment exception on mode one that real property in Jordan may not be mortgaged to banks outside Jordan and that national treatment on *Mode 4* is unbound, except as indicated in the horizontal section while, branches of foreign banks are required to have a resident regional manager. Jordan also made

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<sup>46</sup> World Trade Organization (2004), *Trade in Services, The Kingdom of Nepal, Schedule of Specific Commitments*, GATS/SC/139.

<sup>47</sup> *Ibid.*

<sup>48</sup> *Ibid.*

<sup>49</sup> World Trade Organization (1999), *Report of the Working Party on the Accession of Jordan*, Schedule CXLVIII-Jordan, WT/ACC/JOR/33/Add.2, WT/MIN(99)/9/Add.2.

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market access and national treatment commitments with respect to, lending of all types including consumer credit, factoring, mortgage credit, and financing of commercial transaction, financial leasing and all payment and money transmission services, except that under mode three market access is limited to services provided through banks and specialized financial companies and like the above commitments branches of foreign banks are required to have a resident regional manager.<sup>50</sup>

Jordan made full national treatment commitments on the first three modes with the usual limitations on *Mode 4* and at the same time made market access commitments on *Mode 1* and *Mode 2* with an exception to derivative products which are unbound. On *Mode 3*, access is restricted to: banks and financial services companies constituted in Jordan, in the form of public shareholding company, Limited Liability Company or a limited partnership in Shares Company.<sup>51</sup> Finally, with respect to advisory and other auxiliary financial services on all the activities including credit reference and analysis, investment and portfolio research and advice, advice on acquisitions and on corporate restructuring and strategy and provision and transfer of financial information as related to financial data processing and related software by providers of other financial services, Jordan made market access and national treatment commitments except with respect to the former access which is restricted to financial services companies constituted in Jordan.<sup>52</sup>

## 2.2. The Financial Services Market, Policy and Ethiopia's Possible Commitment Scenarios

The current picture of financial services in Ethiopia is dominated by banks. "Banks are the dominant financial institutions in the country" and they "account, on average, for 96% of total gross financial assets. Non-banks account only for about 4%".<sup>53</sup> Unfortunately, the current state of performance of the banking services in the country is one of the lowest in sub-Saharan Africa. "Ethiopia has a very low rural banking density and consequently one of the lowest financial inclusion ratios of Sub-Saharan Africa, with only 14 percent of adults having access to credit. Most of the bank branches are in urban areas. The ratio of the rural population to a commercial bank or a Micro Finance Institution (MFI) branch is one branch to 125,158 people. Thus it is not surprising that only one

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<sup>50</sup> *Ibid.*

<sup>51</sup> *Ibid.*

<sup>52</sup> *Ibid.*

<sup>53</sup> Ebisa Deribie (2012), *The Effects of Post 1991 Era financial sector deregulations in Ethiopia: An Inspirational guide for agribusiness*, Research Journal of Agricultural Science and Review ISSN 2315-6880 Vol. 1(4) pp. 81-87 (October 2012) p 82.

percent of the rural population have bank accounts”.<sup>54</sup> In the meantime, Ethiopia is the host of one of the fastest growing microfinance institutions in the World. By the end of 2005, “26 MFIs had 1,277,939 borrowing clients with an aggregated portfolio of 1.622 billion Birr”.<sup>55</sup> “Ethiopia’s insurance industry is relatively undeveloped which is exemplified by the sector’s low penetration levels – there are an estimated 0.3 million formal insurance clients in Ethiopia”.<sup>56</sup> According to the Centre for Financial Regulation and Inclusion report; “insurance premiums, including life and general insurance, totaled US \$105 million in the 2006/07 financial year represented merely 0.2% of GDP in 2007 - while in Kenya and Namibia premiums represent 2.5% and 8.1% of GDP respectively”.<sup>57</sup>

From the public governance side of the market, major economic policy and regulatory interests revolve around areas of financial stability and banking regulation. The Ethiopian legal regime in banking services regulation takes the form of nationality and investment limitations in the banking sector.

The typical forms of limitations in relation to investment in banks are: the nationality requirement restriction, the restriction on maximum amount of investment (shares) to be held by a single investor/related investors, and the prohibition of an investor having allegedly substantial investment in one bank (influential shareholder) from investing in any other bank. On the other hand, Ethiopian law has delineated the scope of banking activities and it has also limited the scope of equity participation of banks in other firms.<sup>58</sup>

Financial stability issues in Ethiopia are centred towards the closed nature of international capital account and restrictions on the free convertibility of foreign exchange. Concerns in this regard are highly tied with the aim to maintain price

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<sup>54</sup>World Bank, *Enabling Environment: Access to Financial Services and Transportation*, technical brief (2012) <<http://www.agrifinfacility.org/enabling-environment-access-financial-services-ethiopia>> (last accessed Jan 2012).

<sup>55</sup> Alemayehu Yirsaw (2008), *The Performance of Micro Finance Institutions in Ethiopia: A case of six microfinance institutions*, Addis Ababa University Master Thesis, p 6.

<sup>56</sup> AEMFI, Association of Ethiopian Microfinance institutions, *Overview of Ethiopia’s Insurance Industry*, <<http://www.aemfi-ethiopia.org/.../6-articles.html?...14%3Ainsurance-overvi>> ... (Last accessed Jan 2012) Generally see Hailu Zeleke (2007), *Insurance in Ethiopia: Historical Development, Present Status and Future Challenges*. Addis Ababa: Master Printing Press.

<sup>57</sup> *Ibid.*

<sup>58</sup> Getnet Temechew (2010), *Investment Limitations in and by Banks in Ethiopia*, Addis Ababa University The School Of Graduate Studies Faculty of Law, Master’s thesis, p 51.

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and exchange rate stability, and achieving balance of payments equilibrium since these are ongoing problems in the country.

Currently, Ethiopia does not have limits on the number of banks, insurers and microfinance institutions that have to be licensed. It, however, prohibits the ownership of these institutions by foreign nationals and foreign owned juridical persons.<sup>59</sup> This aspect of financial sector development was also common in most developed, developing and transition economies of Eastern Europe, Asia and Latin America.<sup>60</sup> But in due time, most of these countries, including African states have removed these types of restrictions and opened up their financial markets for foreign investment after the reforms of the late 1980s and the 1990s.<sup>61</sup> The works of international and regional institutions, primarily the IMF, World Bank and WTO, were instrumental in this regard.<sup>62</sup>

The first among the four modes of supply, in GATS Part I terms, relates to cross border supply of financial services. In this particular mode, the experience of WTO Members and recently acceded countries shows that Ethiopia can possibly maintain the status quo of whatever practically exists now. It may also seem viable to achieve this in the accession negotiations as this is one of the most important modes which is highly dependent on international capital transfers and hence possibly entails capital movement volatility. Such strategy also seems wise considering other objectives of financial market liberalizations such as technology transfer and transfer of managerial skills or any other expectations of positive spillover from openness. Compared to *Mode 3* trade for instance, liberalization of cross-border trade in financial services carries more

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<sup>59</sup> See Investment Proclamation, (Proclamation No 769/2012). And the regulation, Investment Incentives and Investment Areas Reserved for Domestic Investors Council of Ministers Regulation, Regulation No 270/2012 Art 3. For former legal instruments see Re-Enactment of the Investment Proclamation, Proclamation No. 280/2002, According to the Investment Proclamation, The banking, insurance, and micro-credit sectors, are restricted to domestic investors; Also see Transitional Government of Ethiopia, *Licensing and Supervision of Banking Business Proclamation* No. 84/1994, Art 4(2); Also see Federal Democratic Republic of Ethiopia, *Banking Business Proclamation* No. 592/2008, Arts 4(1)(d), 2(5) & 9.

<sup>60</sup> Earl H. Fry, *The Politics of International Investment* (McGraw-Hill Book Company, 1983) p.133, Also see Ha-Joon Chang, *Foreign Investment Regulation in Historical Perspective: Lessons for the Proposed WTO Agreement on Investment*, University of Cambridge, Faculty of Economics and Politics, (2003) p 1; Jeswald.W.Salacuse, *Direct foreign investment and the law in Developing Countries*, *Foreign Investment Journal*, Vol.15,No. 2, (2000) p. 389-390.

<sup>61</sup> See Solomon Abay Yimer, *supra* note 7, p 26.

<sup>62</sup> Generally see Ahn, Dukgeun, *Linkages between International Financial and Trade Institutions: IMF, World Bank and WTO*, *Journal of World Trade* 34(4).

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risks and fewer benefits.<sup>63</sup> The experiences of recently acceded countries also seem to allow this scenario. But, of course, new precedents can always be set any time and hence pressure to commit to this mode is expected.

On the other hand, compared to other service sectors, Ethiopia is less likely to bear pressure to commit in *Mode 2* financial services. Considering the virtual impossibility of regulation against individuals and firms consuming services abroad, this mode also seems the less difficult for Ethiopia to swallow. The experience of recently acceded countries also shows that with the exception of Nepal, this mode has been fully liberalized by all acceded countries. Indeed, the consumption of financial services abroad is almost impossible to monitor or distinguish from other modes of trade.<sup>64</sup> Therefore, offering full liberalization of this mode might be a wise tactical move by any acceding country as it constitutes a liberalization proposal without incurring any cost.<sup>65</sup>

With respect to the third mode of supply, i.e., commercial presence, Ethiopia currently has one of the few overtly protected financial markets in the world.<sup>66</sup> Primarily, the current system does not allow commercial presence of foreigners in the financial sector. This perhaps will be the most important subject of negotiations in Ethiopia's accession bid and possibly the entire accession negotiations can become contingent upon the commitment result of this particular service sector and mode of supply. Thus, potentially, there exists a very small chance that Ethiopia will be able to join the system without committing anything in this particular sector. But still there can be different scenarios of commitment levels.

For starters, one option is entry through equity ownership, with significant, but less than 100% share. This still would allow the various macro and efficiency benefits expected out of foreign partaking. Basically, the increased capital base would increase availability, accessibility and affordability of finance to the economy in general.<sup>67</sup> The other scenario is full commercial

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<sup>63</sup> Gebrehiwot Ageba and Derk Bienen, *supra* note 7, p 13.

<sup>64</sup> Marion Panizzon, Nicole Pohl And Pierre Sauvé (2003), *GATS and The Regulation of International Trade In Services*, Cambridge University Press (2008) pp. 183-187, Also see Sydney J. Key (2003), *The Doha Round and Financial Services Negotiations*, The AEI Press, Washington DC, p 8.

<sup>65</sup> Gebrehiwot Ageba and Derk Bienen, *supra* note 7.

<sup>66</sup> Kozo Kiyota *et al.* (2007), *The Case for Financial Sector Liberalization in Ethiopia*, Research Seminar In International Economics, Gerald R. Ford School of Public Policy, Discussion Paper No. 565, p 4.

<sup>67</sup> Generally see Kevin Davis, *Competition Policy in Banking and Financial Services*, <<http://kevindavis.com.au/secondpages/workinprogress/Competition%20Policy%20in%20Banking%20and%20Financial%20Services-Mar08.pdf>> (last accessed May 2012).

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presence. This is both economically useful and will also address other regulators' concerns that Ethiopia faces. Basically under this scenario, the subsidiary's solvency is determined by its own financial performance, and in accordance with the laws and regulations set by the Ethiopian government. This strategy could also be accompanied by the type of market access limitations enumerated under Art XVI.<sup>68</sup> The experience of recently acceded countries shows that market access limitations in this mode are less limited compared to limitations on national treatment, whereas in this latter case as well most of recently acceded countries have eliminated all or virtually all limitations on national treatment.<sup>69</sup>

With regard to the last mode of supply, *Mode 4*, the issues will be highly entrenched with the commitment scenarios undertaken under the 3rd mode. Moreover, there is less pressure from the accession negotiations and perhaps less concern from domestic economic considerations towards committing to this mode. In this respect almost none of the recently acceded countries made commitments in this mode. This reinforces any strategy Ethiopia could have in this regard.

### **3. Financial Market Liberalization and Domestic Policy Space**

The financial services sector is a key to any properly functioning economy.<sup>70</sup> Essentially, the sector facilitates financial intermediation in the economy (i.e. mobilization and allocation of funds). Financial services are also important for the economy as a whole since it allows financial transfers and payments. Hence, a healthy and stable financial service is essential for sustainable economic

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<sup>68</sup> These include limitations on the number of service suppliers ( e.g. such as ceilings on the total number of banks); limitations on the total value of transactions on assets (e.g. foreign bank subsidiaries limited to X per cent of total domestic assets of all banks); limitations on the total number of service operations or on the total quantity of service output (e.g. restrictions on amount of lending capital for foreign firms); limitations on the total number of natural persons (in particular non-nationals) that may be employed in the sector (or the share of wages paid to foreign labour); restrictions on, or requirements of, specific types of legal entity through which that service may be supplied (e.g. commercial presence exclude representative offices, foreign companies required to establish subsidiaries, commercial presence must take the form of a partnership, commercial presence must take some form of incorporation); and limitations on the participation of foreign capital.

<sup>69</sup> See section 2.1 above in this article.

<sup>70</sup> Gary Gorton and Andrew Winton (2002), *Financial Intermediation*, Wharton Financial Institutions Center, p 1.

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growth.<sup>71</sup> Conversely, instability in financial service can potentially have economy-wide effects (local or global) and can be seen most dramatically in the crisis in Latin America, East Asia and the US financial crisis where fragility in the financial system spilt over to other countries in the region and the World at large.<sup>72</sup>

The process of review of domestic regulation and the accompanying regulatory reform go hand-in-hand with services liberalization under any given approach. It is a common understanding that services liberalization involves essentially the removal of discriminatory regulation, whether in quantitative or qualitative form, while nondiscriminatory restraints are a matter of domestic regulation. This distinction allows countries to tackle the reduction of barriers to services trade, on the one hand, and the reform of domestic regulation, on the other.<sup>73</sup> In the WTO accession context, the challenge today is on how to fine tune financial sector liberalization with the necessary legislative and institutional reforms which will enable it to easily accomplish the objectives of financial liberalization without at the same time tearing down legitimate regulatory instruments and risk financial collapse.

Accordingly, it is important to keep in mind that services liberalization and domestic regulatory reform must go forward in a parallel and unified path so that liberalization does not occur faster than the necessary regulatory reform in service sectors that are susceptible to specific types of market failure. Thus the Ethiopian government is expected to set appropriate sequencing and moderating infrastructure parallel to market liberalization efforts. In the mean time, it should

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<sup>71</sup> John Bonin and Paul Wachtel, *Financial Sector Development in Transition, Economies: Lessons from the First Decade*, Financial Markets, Institutions & Instruments, V. 12, No. 1, New York University Salomon Center (February 2003) p 1

<sup>72</sup> International Finance Division Research Department Nepal Rastra Bank, *A Comparative Review of Financial Services Sector Commitments in The Selected SAARC Member Countries: Relevant Experiences For Nepal's Accession to WTO*, p 4.

<sup>73</sup> This issue has been extensively discussed in the context of the classification of market access and national treatment commitments under GATS. See Feketekuty, Geza (2000), *Improving the Architecture of the General Agreement on Trade in Services*, in Sherry Stephenson (eds.), *Services Trade in the Western Hemisphere: Liberalization, Integration, and Reform*, Brookings Institution Press, Chapter 1; Low, Patrick and Aaditya Mattoo, *Is There a Better Way? Alternative Approaches to Liberalization under GATS*, (in) Pierre Sauvé and Robert M. Stern, *GATS 2000: New Directions in Services Trade Liberalization*, Brookings Institution Press, Chapter 15 Also see, Stephenson Sherry, *GATS and Regional Integration*, in Pierre Sauve and Robert Stern (eds.), *GATS 2000: New Directions in Services Trade Liberalization*, Brookings Institution Press, 2000, Chapter 18.

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be noted that efforts towards multilateral trade negotiations, typically the WTO, do not obstruct the government's policy options to achieve these objectives.

Four types of government intervention or involvement are believed to have impact on the financial services sector, namely: (i) macroeconomic policy management, (ii) prudential regulations, (iii) non-prudential regulation to pursue various public policy objectives other than that falling under, and (iv) trade restrictions concerning market access or national treatment.<sup>74</sup> A brief discussion is made on three of these issues in the context of Ethiopia's accession to the WTO. Under the GATS, item (ii) is dealt with by paragraph 2 of the Annex on Financial Services, and (iii) by Article VI. Item (iv) is dealt with by Articles XVI and XVII.

### **3.1. Financial Sector Liberalization and Capital Account Liberalization**

#### **3.1.1. GATS on Capital Movements**

Global experience with financial deregulation and liberalization has been a mix of bewildering array of experiences. "Several countries have suffered serious banking crises following the opening of their financial markets, and, as formal econometric work shows, banking crises have generally been good predictors of currency crises."<sup>75</sup> GATS does not, in principle, oblige a Member to allow international capital mobility.<sup>76</sup> It is to be noted that liberalization of capital movements is distinct from – but closely related to – liberalization of trade in financial services.<sup>77</sup> For example, provision of financial information by foreign financial organizations is entirely unrelated to capital account liberalization.<sup>78</sup> In the meantime, if a Member undertakes a market-access commitment in relation to the cross-border supply of a service and if the cross-border movement of capital is an essential part of the service itself, the Member is consequently

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<sup>74</sup> See WTO (1997), *Opening Markets in Financial Services and the Role of the GATS*, WTO Special Studies, Geneva.

<sup>75</sup> Peter K. Cornelius (2000), *Trade in Financial Services, Capital Flows, and the Value-at-Risk of Countries*, Harvard Institute for International Development, Research Note RN-00-2, p 3.

<sup>76</sup> Victor Murinde and Cillian Ryan (2003), *The Implication of WTO and GATS for the Banking Sector in Africa*, Blackwell Publishing Ltd ; See footnote text 9, p 185.

<sup>77</sup> A. Kireyev (2002), *Liberalization of Trade in Financial Services and Financial Sector (analytical approach)*, IMF Working Paper WP/02/138, pp 10-14. Also see Tamirisa, N. *et al* (2000), *Trade Policy in Financial Services*, IMF Working Paper WP/00/31.

<sup>78</sup> See A.Kireyev, *Ibid*, pp. 10-14.

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committed to allow such movement of capital.<sup>79</sup> Further, if a Member undertakes a market access commitment in relation to the supply of a service through commercial presence, that Member is committed to allow related inflows of capital.<sup>80</sup>

Thus, the establishment of a commercial presence in a host country by a foreign service supplier involves both trade in services under the GATS and international capital transactions.<sup>81</sup> In theory, it is still possible that once established, a subsidiary of a foreign financial firm could conduct its on-going activities without engaging in additional international capital transactions.<sup>82</sup> However, its activities would need to be limited to transactions with host-country residents involving domestic financial assets.<sup>83</sup> This may happen in very rare circumstances – and certainly not in a small developing economy.

WTO Members do not seem to have any obligation with respect to capital flows related to consumption abroad and capital outflows related to commercial presence.<sup>84</sup> Hence, GATS primarily mandates Members to liberalize inward

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<sup>79</sup> See A. Cornford (2003), *The Multilateral Negotiations on Financial Services : current issues and future directions*.

<sup>80</sup> This is particularly provided under footnote 8 of Art XVI GATS which states: “[I]f a Member undertakes a market-access commitment in relation to the supply of a service through the mode of supply referred to in subparagraph 2(a) of Article I 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. If a Member undertakes a market-access commitment in relation to the supply of a service through the mode of supply referred to in subparagraph 2(c) of Article I, it is thereby committed to allow related transfers of capital into its territory.”

<sup>81</sup> As we all know, the capital account covers capital movements for investments while the current account covers (the payment of) imports and exports of goods and services.

<sup>82</sup> This could for instance be a situation where the foreign subsidiary wishes to raise its capital from equity or debt capital from the host economy itself. Thus only later, for example, when the bank wishes to repatriate profits from its foreign operations, may a capital flow occur, but out of the host country. See for instance Sydney J. Key, *Financial Services* (in) Patrick F. J. Macrory et al, (eds.) *The World Trade Organization: Legal, Economic and Political Analysis*, Volume 1, Springer, 2005, p 962.

<sup>83</sup> Under standard balance-of-payments accounting, however, even if the earnings of the subsidiary were reinvested, they would be regarded as additional foreign direct investment by the parent in the subsidiary.

<sup>84</sup> This can be inferred by reading Article XI, the provision on international payments and transfers together with footnote 8 to Article XVI, the market-access provision. See Wendy Dobson, *Financial Services and International Trade Agreements: The Development Dimension* (in) Aaditya Mattoo et al, (eds.), *A Handbook of International Trade in Services*, Oxford (2008) p 294; For Mode 2 transactions, not

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transfers of international payments in connection with services that are provided pursuant to a specific commitment made under the GATS.<sup>85</sup> “The bottom-line is that if a country makes a commitment to liberalize trade with respect to a particular financial service in the GATS, it is also making a commitment to liberalize most capital movements associated with the trade liberalization commitment”.<sup>86</sup> The country is not, however, making an across-the-board commitment to freedom of capital movements.<sup>87</sup>

While GATS Article XI, as a general rule, prohibits any restrictions on international transfers and payments on sectors subject to commitments, it permits exceptions in five sets of circumstances. These are: (1), restrictions which are applied to safeguard the balance of payments in accordance with Article XII GATS; (2), in case a general exception applies in accordance with Art XIV and XIV***bis*** GATS; (3), in case an exception applies in accordance with Para 2 lit. a, of the Annex on Financial Services; (4), in the case of current transactions, if consistent with the rights and obligations of the members of the IMF under the IMF Agreement; or (5), in the case of capital transactions, at the request of the IMF. The types of restrictions that can possibly lie under GATS Article XII and Para 2 (lit a) of the Annex on Financial Services will be discussed in the subsections below.

The first of the other three exceptions relates to the case of current transactions, which are consistent with the rights and obligations of the members

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even this obligation exists. Rather, under Mode 2 countries seem to be free to set restrictions on capital transfers related to services supplied under the market access commitments made. As Kono et al. (1997, p. 23) emphasize, “(t)he GATS focuses upon seeking improvements in the terms and conditions of market access and non-discriminatory treatment for foreign suppliers of financial services, and not on the question of how far and how fast a government liberalizes capital account restrictions.” See Peter K. Cornelius, *supra* note 75 above.

<sup>85</sup> Christian Tietje *et al.* (2010), *Liberalization and Rules on Regulation in the Field of Financial Services in Bilateral Trade and Regional Integration Agreements; A Scientific Study*, Halle, September, p 7.

<sup>86</sup> Sydney J. Key, *Financial Services* (in) Patrick F. J. Macrory *et al.*, (eds.) *supra* note 82; See GATS Article XI: Payments and Transfers.

<sup>87</sup> Sydney J. Key (2003), *supra* note 64. Also see Diemo Dietrich *et al.* (2010), *Liberalization and Rules on Regulation in the field of Financial Services in Bilateral Trade and Regional Integration Agreements*, Institute of Economic Law (TELC), Martin Luther University Halle-Wittenberg, p 12. In the words of Dietrich *et al.* “GATS does not aim at the overall liberalization of international payments and transfers. However, it provides for a ‘conditional obligation’ according to which WTO members must not restrict current transactions and capital transactions that have been made in relation to service for which a member has undertaken specific commitments.”

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of the IMF under the IMF Agreement. This exception permits certain transitional or, with the IMF's prior approval, temporary restrictions in accordance with Article XIV and VIII of the IMF Agreement.<sup>88</sup> The second exception refers to situations where the IMF Agreement permits any of these practices and, to the extent that they relate to current transactions, the IMF Agreement will take precedence over the GATS to avoid any inconsistencies between IMF and GATS rights and obligations.<sup>89</sup> The reference made to 'the request of the Fund' "relates to Art VI Section 1 [of the] IMF Agreement under which the IMF may request a Member to impose capital controls",<sup>90</sup> to prevent "the use of the IMF's resources to meet a large or sustained outflow of capital".<sup>91</sup> Therefore, as with current transactions, the IMF Agreement takes precedence regarding capital transactions, but only if (direct or indirect) capital controls actually have been requested by the IMF.<sup>92</sup>

The last exception refers to the General Exceptions under Arts XIV and XIV*bis*. These exceptions to Article XI provide for exceptions to a Member's obligations under the GATS in a number of circumstances. These articles refer to concerns such as measures maintained to protect public morals or to maintain public order, measures necessary to secure compliance with laws or regulations, essential security interests etc. This essentially means that a member can maintain measures such as seizure or blocking of assets in connection with bankruptcy or to enforce criminal procedures. Thus, even though such measures can, strictly speaking, amount to restrictions of international transfers and payments, they prevail over other GATS rules for public policy reasons by operation of Articles XIV and XIV*bis* over the rules of Article XI.

Thus, we can see that GATS does not oblige WTO members to fully liberalize capital flows related to the activities of such local establishments. This means that the opening up of financial services is consistent with an option to maintain certain capital account restrictions. "This is particularly important to

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<sup>88</sup> Rüdiger Wolfrum, *et al* (2008), *WTO – Trade in Services*, Max Planck Commentaries on World Trade Law, Martinus Nijhoff Publishers, p 255; Generally see Deborah E. Siegel (2002), *Legal Aspects Of The IMF/WTO Relationship: The Fund's Articles Of Agreement And The WTO Agreements*, 562 *The American Journal Of International Law*, Vol. 96:561.

<sup>89</sup> *Ibid.*

<sup>90</sup> Rüdiger Wolfrum, *et al*, *supra* note 88, p 256, *Articles of Agreement of the International Monetary Fund*, IMF, Article VI Capital Transfers, Section 1.

<sup>91</sup> Joshep Gold (1991), *Borrowing by the IMF, ultra vires and other problems*, (in) Jacob A. Frenkel and Morris Goldstein, (eds.) *International Financial Policy: Essays in honour of Jacques J. Polak*, p 215.

<sup>92</sup> *Ibid.*

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most of developing countries, where domestic financial markets remain underdeveloped and small, and balance of payments positions are weak".<sup>93</sup>

### 3.1.2. The Ethiopian Case

Ethiopia authorizes the National Bank of Ethiopia (NBE) – the central bank – to regulate the supply of money and interest rates of financial institutions, the use of foreign currency, exercise of foreign exchange transactions and exchange rates of the financial institutions, and the conditions, limitations and circumstances under which residents of the country and the financial institutions can hold foreign currency and instruments of payment in foreign currency.<sup>94</sup> Thus, for the moment (considering the closed status of the financial services sector now), there does not seem to be any case where the practice of the National Bank would essentially violate the main principles and the important exceptions of the GATS provisions.

The Ethiopian government is expected to negotiate demands by considering what should be done in the accession negotiations to achieve legitimate economic goals under this issue. In principle, "domestic reform and trade policy reform can be seen as precursors of capital account liberalization".<sup>95</sup> A sound and diverse financial system will better intermediate volatile international capital flows. However, a variety of sequences seen in various countries will demonstrate that there is no one-size-fits-all approach to sequencing. For example, Taiwan has not fully deregulated its domestic financial markets and still imposes some restrictions on the capital account, but it permits market access by foreign financial service providers.<sup>96</sup> South Korea restricted both market access and capital flows, yet in 1997 it experienced a severe balance of payments crisis related in part to a weak record of domestic reform.<sup>97</sup> Thus,

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<sup>93</sup>Yun-Hwan Kim (2002), *Financial Opening Under The WTO Agreement In Selected Asian Countries: Progress And Issues*, Asian Development Bank, ERD Working Paper No. 24 (September 2002), p 2.

<sup>94</sup>*The National Bank of Ethiopia Establishment (as Amended) Proclamation* No 591/2008, Articles 5 (4), 5 (5-6 and 9-10) and 19-21; *Micro-Financing Business Proclamation* No. 626/2009, Article 28 (1).

<sup>95</sup>Wendy Dobson, *supra* note 84.

<sup>96</sup>*Ibid*, p 294.

<sup>97</sup>*Ibid*, Also according to Yoon Je Cho "The immediate cause of the crisis was the run of foreign creditors." "The accelerated opening up to international capital flows from 1994 without adequate supervision also contributed to the currency crisis. See Yoon Je Cho, *The Role of Poorly Phased Liberalization in Korea's Financial Crisis* (in Gerard Caprio (eds.) (2001), *Financial Liberalization, How Far, How Fast?*, Cambridge University Press, p 159.



there is no clear-cut evidence which correctly shows the relevant relationship between financial market liberalization and financial crisis.<sup>98</sup>

Moreover, it is to be noted that financial services liberalization does not necessarily imply complete capital account liberalization. Yet, it is important to find strategic ways to limit the country's exposure to potential financial crises. For instance, it appears that the relationship between trade in financial services and capital flows is particularly close under *Mode 1* (cross-border supply) than the other modes. The experience of WTO members also shows that at present, relatively few countries have made commitments under *Mode 1*, reflecting fears that a more liberal trade policy in this mode could seriously undermine financial stability while its potential gains are in contrast limited. Studies have shown the various contrasting effects of commitments under the various modes of GATS commitments. The table below shows a simple representation of the effects of financial services commitments on capital flows and the financial system as affected by the mode of supply and range of instruments.

**Table 1: Effects of Financial Services Commitments on Capital Flows and the Financial System, As Affected by the Mode of Supply and Range of Instruments**<sup>99</sup>

	By Mode of Supply		By Range of Instruments which can be supplied	
	Mode 1	Mode 3	Narrow *	Broad
<b>Capacity Building</b>				
Improved transparency/information	Weak	Strong	Weak	Strong
Incentive to improve regulation/ supervision	Weak	Strong	Weak	Strong
Infrastructure/ market development	Weak	Strong	Weak	Strong
Risk management	Weak	Strong	Weak	Strong
<b>Capital Flows</b>				
More capital flows	Yes	Limited	**	**
Bias toward short-term lending	Strong	Weak	Possibly strong	Weak
Increased volatility	Strong	Weak	Possibly strong	Weak
<b>Efficiency/local benefits</b>				
More competition/efficiency	Strong	Strong	Weak	Strong
Skills/technology transfer	Weak	Strong	Weak	Strong
Local employment creation	Weak	Strong	weak	Strong
* Commitments exclude or limit provision of important instruments/allow only lending and deposit-taking.				
** Depends on the instrument and mode of supply permitted, and market conditions				

<sup>98</sup> Eswar S. Prasad, *Effects of Financial Globalization on Developing Countries, Some Empirical Evidence*, IMF (2003), p. 1. Also see Arturo Galindo (2002), "Financial Liberalization: Does It Pay to Join the Party? [with Comments]", *Economía*, Vol. 3, No. 1.

<sup>99</sup> Adopted from Masamichi Kono and Ludger Schuknecht (1998), *Financial Services Trade, Capital Flows, and Financial Stability*, World Trade Organization Economic Research and Analysis Division, Staff Working Paper ERAD-98-12.

In light of the severe financial turmoil over the last few years, some countries could have pursued a more cautious approach to capital account convertibility and financial services trade.<sup>100</sup> Rather than dismantling barriers to trade in financial services across-the-board, it might have been preferable for them to at least maintain restrictions under *Mode 1*. This applies primarily to countries with weak financial systems. For these countries, they caution against modal neutrality, i.e., equal liberalization commitments between, for example, cross-border supply and supply through commercial presence.

While in their view, "...countries with stable financial systems and a sound macroeconomic and regulatory framework have every reason to apply a very broad liberalization strategy and commit to far-reaching trade liberalization across all modes of supply," they recognize that in countries with weak financial systems potentially volatile capital flows can be highly destabilizing, resulting in banking and currency crises.<sup>101</sup> "Thus, with respect to these countries they counsel to confine commitments to the commercial presence of foreign institutions, requiring only limited liberalization of capital flows in the GATS context".<sup>102</sup> Hence, for Ethiopia it seems preferable to save this policy space against GATS *Mode 1* commitments in financial services until the necessary domestic capacity in regulatory capacity and a sound economic setting are created.

## 3.2. Problems in Balance of Payments

### 3.2.1. General features of BOP and policy options

An unsustainable Balance of Payments (BOP) situation in a given country may arise for a number of reasons and the risk of its aggravation onto a BOP crisis is always a possibility.<sup>103</sup> One example of an unsustainable current account position is when the current account is in deficit, and the net imports of goods and services cannot be financed with a sufficient inflow of foreign capital or a reduction in foreign reserves. This may lead to an unsustainable BOP situation.<sup>104</sup> The policy options available include improving the current account,

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<sup>100</sup> Peter K. Cornelius, *supra* note 75.

<sup>101</sup> *Ibid.*

<sup>102</sup> *Ibid.*

<sup>103</sup> C. Thomas (2000), "Balance-of- Payments Crises in the Developing World: Balancing Trade, Finance and Development in the New Economic Order", *Am. U. Int'l L. Rev.* IV.

<sup>104</sup> World Trade Organization, *Concept Paper On Balance-Of-Payments Safeguards*, Working Group on The Relationship Between Trade And Investment, Communication From The European Community and its Member States, WT/WGTI/W/153, (2002) p 2.

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for instance by expanding exports or restricting imports (provided these restrictions are compatible with its international obligations and preferably not counterproductive in terms of future developmental objectives) etc. “In seeking to avoid serious BOP difficulties, governments have sometimes taken restrictive measures on current transfers as well as on capital movements”.<sup>105</sup>

As discussed above, GATS Art XI mandates WTO members to allow movement of capital in line with the commitment obligations of the Member state. In principle, a member’s market access commitments oblige it to allow a certain degree of capital mobility – specifically, when the cross-border movement of capital is an essential part of the service itself and inflows of capital are related to commercial presence. Nevertheless, the agreement allows a member to impose restrictions on current or capital transactions in the event of serious balance of payments or external financial difficulties or the threat thereof.<sup>106</sup> This is what is stated under Art XII of the GATS Agreement, (*Restrictions to Safeguard the Balance of Payments*).<sup>107</sup>

To a very large extent, this article applies the same terms, conditions and procedures defined by the GATT for the invocation of Balance-of-payments Safeguards Provisions.<sup>108</sup> As in GATT Article XVIII,<sup>109</sup> there is recognition in

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<sup>105</sup> *Ibid.*

<sup>106</sup> The GATT also contains similar provisions that address financial stability concerns regarding a member’s right to derogate from liberalization commitments when it is suffering a severe balance of payments imbalances. See General Agreement on Tariffs and Trade (GATT) Articles XII and XVIII:B.; Also see Annex 1A of the Marrakech Agreement, Multilateral Agreements On Trade In Goods, Understanding on the Balance-of-Payments Provisions of the General Agreement on Tariffs and Trade (1994).

<sup>107</sup> Article XII *Restrictions to Safeguard the Balance of Payment*; (1) states - “In the event of serious balance-of-payments and external financial difficulties or threat thereof, a Member may adopt or maintain restrictions on trade in services on which it has undertaken specific commitments, including on payments or transfers for transactions related to such commitments...” Importantly, sub-article 3 provides, - “In determining the incidence of such restrictions, Members may give priority to the supply of services which are more essential to their economic or development programmes. However, such restrictions shall not be adopted or maintained for the purpose of protecting a particular service sector.”

<sup>108</sup> See GATT Art XII.

<sup>109</sup> See Article XV paragraphs 4 and 9. Paragraph 4 specifically provides: “Contracting parties shall not, by exchange action, frustrate the intent of the provisions of this agreement...” Article XV, Paragraph 9(a) provides Nothing in this Agreement shall preclude: (a) the use by a contracting party of exchange controls or exchange restrictions in accordance with the Articles of Agreement of the International Monetary Fund ...

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the GATS that a developing country Member may need to use trade restrictions in order to ensure the maintenance of a level of financial reserves adequate for the implementation of its programme of economic development, and in the GATS this provision extends also to economies in transition.<sup>110</sup> Generally, in the event of serious balance-of-payments and external financial difficulties or threat thereof, a Member may restrict trade in services on which it has undertaken specific commitments, including on payments or transfers for transactions related to such commitments.<sup>111</sup> The restrictions should be non-discriminatory, consistent with the IMF Articles of Agreement, temporary and phased-out progressively. Such restrictions should also avoid unnecessary damage to the commercial, economic and financial interests of other Members, should not exceed what is necessary to address the balance-of-payments problem, and should not be used to protect specific industries or sectors.<sup>112</sup>

A number of important features of Article XII are worth noting. First of all, Article XII:1 clearly gives WTO Members with developing or transitional economies an autonomy to take measures that provide a level of financial reserves “adequate” for that particular Member’s programme of economic transition or development. Thus, Art XII:1 affirms that development goals are the legitimate basis for a WTO Member in determining the kinds of balance of payments measures it needs. Whereas the measures must “not exceed those necessary” to deal with “serious balance-of-payments and external financial difficulties or threat thereof,” Art XII: 3 affirms that a Member “may give priority to the supply of services which are more essential to their economic or development programmes.” The concept of “necessity” ought to be interpreted in the context of Art XII as a whole, which gives considerable emphasis to an individual Member’s approach to development. There is also ample room to

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<sup>110</sup> WTO, *Concept Paper On Balance-Of-Payments Safeguards*, Communication From The European Community And Its Member States, WT/WGTI/W/153 (28 November 2002) p 4.

GATS Art XII (1) second sentences which states “It is recognized that particular pressures on the balance of payments of a Member in the process of economic development or economic transition may necessitate the use of restrictions to ensure, *inter alia*, the maintenance of a level of financial reserves adequate for the implementation of its programme of economic development or economic transition.”

<sup>111</sup> For instance the GATT interpretive notes make clear that the intent of paragraph 4 is not to limit the ability of countries to impose exchange controls when they are considered warranted by the IMF, but rather to ensure that countries do not use exchange actions as a way to get around the intent of the substantive GATT provisions such as those in Article XI.

<sup>112</sup> World Trade Organization (2002), *Exceptions and Balance-Of-Payments Safeguards*, Note by the Secretariat, Working Group on the Relationship between Trade and Investment, WT/WGTI/W/137, p 8.

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read Art XII so as not to require a Member to use alternative policy measures, even if less restrictive of services trade, where those measures undermine the objectives set by the Member's development program.<sup>113</sup>

At this juncture, reading GATS Art XII together with the language of XI: 2, indicates an extremely important difference between GATT and GATS. That is, no matter how narrowly or restrictively interpreted, the relevant provisions of the GATT contain only disciplines on 'current account' measures. However, under GATS, a Member's specific commitments may not prevent it from instituting 'capital account' controls. This nature of GATS Art XI & XII exceptions makes it one of the most important provisions that install policy space and flexibility into the system.<sup>114</sup>

The imposition of restrictions on current or capital transactions in the event of serious balance-of payments and external financial difficulties or the threat thereof is thus generally permitted. This would allow members in serious balance of payments difficulties – or threatened by such difficulties – to restrict trade in services for which they have undertaken market access commitments. Hence, such restrictions may be utilized by developing countries, or countries in transition, if such measures are necessary to maintain a level of reserves adequate for the prudent management of their economies.<sup>115</sup> These restrictions, however, must not discriminate among members, cause unnecessary damage to the trading interests of other members, or be unnecessarily restrictive, and should be temporarily phased out as the situation improves.<sup>116</sup> Although the restrictions may possibly focus on a particular sector, they must not be used or maintained as a protectionist trade barrier.<sup>117</sup> It is also important to notice the

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<sup>113</sup> Robert Howse (2008), *Pursuing Sustainable Development Strategies: The case of the balance of payment rules in the WTO*, NYU Law School, pp 26 -27.

<sup>114</sup> *Ibid.*

<sup>115</sup> Kern Alexander (2003), *The World Trade Organization and Financial Stability: The Balance between Liberalization and Regulation in the GATS*, Cambridge Endowment for Research in Finance, p 20.

<sup>116</sup> General Agreement on Trade in Services (GATS) Art XII sub 2 primarily mentions - (c) shall avoid unnecessary damage to the commercial, economic and financial interests of any other Member; (d) shall not exceed those necessary to deal with the circumstances described in paragraph 1.

<sup>117</sup> Generally, the burden of proof while invoking the prudential carve out - like any exception - rests with the country taking the prudential measure. Accordingly, the prudential exception is limited by certain good faith requirements including the requirement that 'such measures shall not be used as a means of avoiding the Member's commitments or obligations under the Agreement'. See Anne van Aaken and Jurgen Kurtz, *Prudence or Discrimination? Emergency Measures, The Global Financial Crisis and International Economic Law*, *Journal of International Economic Law* 12(4), 859-894, p 876 Also see Bart De Meester, *The Global*

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institutional accountability framework as restrictions adopted pursuant to Article XII must be reviewed periodically by the WTO Balance of Payments Committee.<sup>118</sup>

### 3.2.2. The Ethiopian Case

Ethiopia has experienced chronic balance of payments difficulties since the Imperial era, with the exception of a few periods.<sup>119</sup> The major factor in the deteriorating balance of payments was and still is the worsening situation of merchandise trade. This situation persisted for decades and the trade deficit that existed during the imperial years continued to grow after two revolutions, despite the introduction of various adjustment measures including import controls or export promotion.<sup>120</sup>

A typical means by which foreign financial institutions can exacerbate the above situation and hence cause greater financial instability is by lending in foreign currencies. This leads to the payment and repayment of loans in foreign exchange which increases the rate of inflow and outflow of international capital. When this results in an imbalanced exchange between local and foreign currencies, it puts the exchange rate and foreign exchange reserves under pressure, particularly if the loans are short-term. Thus, "too much demand for foreign exchange increases the balance of payments deficit and with it the risk of exchange rate and financial instability".<sup>121</sup>

What is said to be difficult to predict after liberalization efforts have been undertaken is "how branches or subsidiaries of foreign financial firms and their headquarters will behave in times of financial crises"<sup>122</sup> – especially in developing countries.<sup>123</sup> Various studies have been undertaken to evaluate

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*Financial Crisis and Government Support For Banks: What Role For the GATS?*,  
Journal of International Economic Law 13(1), 27–63

<sup>118</sup> Article XII sub 5.

<sup>119</sup> National Bank of Ethiopia, *Annual Report - 2008/9*, Economic Research and Monetary Policy Directorate, 2009, pp. 3, 62.

<sup>120</sup> <[http://www.mongabay.com/history/ethiopia/ethiopia-balance\\_of\\_payments\\_and\\_foreign\\_assistance.html](http://www.mongabay.com/history/ethiopia/ethiopia-balance_of_payments_and_foreign_assistance.html)>

<sup>121</sup> M. Vander Stichele (2004), *Critical Issues In The Financial Sector*, SOMO sector report (full report at [www.somo.nl: publications](http://www.somo.nl/publications)), (2004) p. 19; Also see A. Cornford, *The WTO negotiations on financial services : current issues and future directions*, Paper for the Financial Markets Center.

<sup>122</sup> Halfan Mkiwa (2007), *The Anticipated Impact of GATS on The Financial Service Industry In Africa*, University Of The Western Cape-Cape Town, South Africa, p. 59.

<sup>123</sup> Generally see Thomas, Chantal (2000). *Balance-of-Payments Crises in the Developing World: Balancing Trade, Finance and Development in the New*

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whether foreign source capital and its holders would panic and abruptly move out upon the first signs of crisis as they did in East Asia in 1997? “Or will they be able to resist the crisis with capital flowing in from the headquarters?”<sup>124</sup>

In the late Argentinean crisis, studies have shown that “foreign banks refused to recapitalize their branches and subsidiaries”.<sup>125</sup> Most East Asian countries have not been able to borrow in their own currency, which means “that they are continuously exposed to problems that triggered the crisis in 1997”.<sup>126</sup> Generally, current empirical studies in relation to banking crises have been able to identify “channels of transmission through which financial liberalization may exert an influence on banking stability”.<sup>127</sup>

Considering the above, it might be wise to expect that smaller economies such as Ethiopia can be more vulnerable to capital movements that result in financial volatility and destabilization of domestic bank credit.<sup>128</sup> In the GATS accession offers and negotiations, it is important to consider that cross-border e-banking and buying foreign products – or even securities – through internet,<sup>129</sup>

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*Economic Order*. American University International Law Review 15, no. 6, p 1249-1277.

<sup>124</sup> See Myriam Vander Stichele, *The Risks of Financial Service Liberalization For Financial Stability*, <[www.somo.nl](http://www.somo.nl)>

<sup>125</sup> Generally however empirical evidence for developing countries is in favor of a “stability-enhancing” role for international banks in periods of local financial crises. See Christian Tietje *et al*, *supra* note 85, p 12.

<sup>126</sup> Halfan Mkiwa, *supra* note 122 above. Or on the other hand, other studies in relation to the recent financial crisis has shown the reverse of the above situation. According to Ibrahim Zeidy, “The financial meltdown suffered by the parent banks following market capitalisation losses was not passed down to their African subsidiaries. In fact, some subsidiaries of foreign banks saw considerable increases in their market capitalisation. For example, Swaziland Ned bank, Bank of Africa Benin and Standard Bank of Ghana saw their market capitalisation increase between July 2007 and January 2009. Therefore, the contagious effect of the financial meltdown is weak compared to the effect on parent banks”

<[http://www.afdb.org/fileadmin/uploads/afdb/Documents/Knowledge/Financial%20crisis\\_Impacts%20on%20Africa.pdf](http://www.afdb.org/fileadmin/uploads/afdb/Documents/Knowledge/Financial%20crisis_Impacts%20on%20Africa.pdf)> (last accessed: May 2012) Also see AfDB, *The Current Financial Crisis: Impact on African Economies*, Briefing note prepared for Ministerial Conference on the Financial Crisis, Nov, 12, 2008.

<sup>127</sup> J.-P. Allegret, B. Courbis, Ph. Dulbecco (2003), *Financial Liberalization and Stability of the Financial System in Emerging Markets: The Institutional Dimension of Financial Crises*, Review of International Political Economy, Vol. 10, No. 1 (Feb., 2003), p 75.

<sup>128</sup> Normally, foreign banks may repatriate all the profits to the parent country. Moreover, if lending rates rise in the parent country and/or profit rates decline in the host country, foreign banks may withdraw their investment.

<sup>129</sup> This would be ‘*Mode I*’ under GATS.

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typically involve cross-border capital movements and foreign currencies which puts the country at potentially risky situations. Ethiopia is thus expected to negotiate the appropriate undertaking considering the existing overall situation by prudently avoiding risks and distinguishing between what limitations should be sought after and which ones should not. This is because some kinds of (outbound) capital controls might be viewed as conditions which should be bound under GATS schedules of commitments.

Typical instances are, conditions on who can supply services (number of service suppliers) in violation of XVI: 2(a), or as "limitations on the total value of service transactions or assets" in violation of XVI: 2 (b) or "total number of service operations or the total quantity of service output" in violation of XVI:2(c). This possibility arises from the extremely broad interpretation of XVI:2(a) and (c) by the Appellate Body in the *US-Gambling* case.<sup>130</sup> The Appellate Body suggested that to violate either provision, measures need not take the explicit forms described in those provisions provided they have comparable *effects* on restricting market access and are quantitative in nature.<sup>131</sup> Since capital account controls are clearly measures that are quantitative in nature they may well have effects on the number of service suppliers, the total value of services transactions or assets under Art. XVI.<sup>132</sup> However, speaking of GATS rules, we can say that GATS provisions provide the Ethiopian Government with sufficient domestic policy space to implement its financial stability objectives.

### 3.3. Macroeconomic Policy

Despite an overwhelmingly broad understanding of services in the WTO and hence GATS, the services supplied in the exercise of governmental authority, including activities conducted by a central bank or monetary authority or by any other public entity in pursuit of monetary or exchange rate policies are entirely excluded from the scope of the GATS.

One of its principal provisions in the discussion of financial services is GATS Article I. This provision excludes services supplied in the exercise of governmental authority, the activities of central banks or other authorities carrying out monetary or exchange rate policies. GATS Art I:3 (b) provides that, 'services' includes any service in any sector except services supplied in the exercise of governmental authority. According to Art I:3 (c); 'a service supplied in the exercise of governmental authority' means any service which is supplied

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<sup>130</sup> Appellate Body Report, *United States - Measures Affecting the Cross-Border Supply of Gambling and Betting Services*, (WT/DS285/AB/R), Report of the Appellate Body, paragraphs 232, 247.

<sup>131</sup> *Ibid.*

<sup>132</sup> Robert Howse, *supra* note 113, pp 6-7.

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neither on a commercial basis, nor in competition with one or more service suppliers. In the words of, Patrick Low and Aaditya Mattoo, *et al*, “when a central bank conducts open market operations, for example, conditions in the financial sector could be affected through the impact of such interventions on the money supply, interest rates or exchange rates. These types of interaction fall entirely outside the ambit of the GATS.”<sup>133</sup>

The exclusion of foreign service suppliers also extends to activities which form part of statutory social security or public retirement plans, or other activities that are carried out by a public entity on behalf of the government, or using government financial resources, provided that domestic non-governmental financial suppliers are also not allowed to take part in these activities.<sup>134</sup> The agreement also allows a member to pursue other domestic policy objectives through, for instance, directed lending programs, provided that the measures are neither discriminatory nor intended to restrict the access of suppliers to a market.<sup>135</sup>

In the Ethiopian context, the National Bank of Ethiopia regulates the money supply, interest rates, exchange rates or various other macroeconomic functions.<sup>136</sup> Considering the central place that these measures have in the ongoing economic policy in the country, the National Bank of Ethiopia and other relevant government agencies will still be able to maintain such kind of macroeconomic activities after accession irrespective of the form of accession commitments the country has granted. This is mainly because, services supplied in the exercise of governmental authority, including activities conducted by a national bank, central bank or monetary authority or by any other public entity in pursuit of monetary or exchange rate policies are excluded from the scope of the GATS.<sup>137</sup>

Another instance is where the Ethiopian government may wish to maintain other rules and regulations that influence the operations of markets and competition in market, such as for example, a requirement to lend to certain

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<sup>133</sup> Patrick Low *et al* (1997), “Opening Markets in Financial Services and the Role of The GATS”, *WTO Special Studies*, p 3.

<sup>134</sup> General Agreement on Trade in Services, Annex on Financial Services Art 1 (b), Scope and Definition.

<sup>135</sup> Rudolf Adlung *et al* (2002), *The GATS: Key Features and Sectors* (in) Bernard Hoekman *et al* (eds.), *Development, Trade, And The WTO: A Handbook*, The World Bank, Washington, D.C. pp 259-279.

<sup>136</sup> Proclamation No. 591/2008, Articles 5 (4), 5 (5-6 and 9-10) and 19-21; and See National Bank of Ethiopia (2007), *Interest Rates Directive* No. NBE/INT/10/2007.

<sup>137</sup> General Agreement on Trade in Services, Art I: 3, General Agreement on Trade in Services, Annex on Financial Services Art 1 (b), Scope and Definition. Also see, Wendy Dobson, *supra* note 84 above.

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sectors or individuals, or lending mandated on the basis of preferential interest rates for certain types of lending. Even though such measures sometimes have been argued against for not being the most efficient means of achieving particular objectives, these policies are not necessarily subject to GATS commitments. "If they are neither discriminatory nor intended to restrict the access of foreign suppliers to a market, then such domestic regulatory measures would be permitted provided they met certain basic criteria, such as impartiality and objectivity".<sup>138</sup>

### **3.4. Financial Market Liberalization and Prudential Regulation**

The aims of GATS can potentially provoke concern that its rules might compromise the ability of governments to pursue legitimate regulatory and prudent measures or might limit their freedom to achieve other domestic policy objectives. Most of these concerns seem to have been already addressed under GATS rules.<sup>139</sup>

None of the GATS provisions prevent a member from taking measures for prudential reasons, for example, to protect investors or depositors or to ensure the integrity and stability of the financial system.<sup>140</sup> In particular, the prudential 'carve-out' for domestic regulation of financial services, under Art 2 of Financial Services Annex, allows a country to take prudential measures for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed or to ensure the integrity and stability of the financial system regardless of any other provisions of the GATS. Thus prudential measures could, in principle, be inconsistent with a country's national treatment or market access commitments or its Most Favoured Nation obligation.

While these sorts of exceptions are common in the WTO Agreements,<sup>141</sup> the prudential carve-out here differs from other exceptions for domestic policy contained in the GATT and GATS in one very significant respect. In contrast to health and safety, for example, where only 'necessary' measures can be raised

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<sup>138</sup> Wendy Dobson, *Ibid*, p 293; General Agreement on Trade in Services (GATS), Art VI.

<sup>139</sup> But see Lazaros E Panourgias, *Banking Regulation and World Trade Law, GATS, EU and 'Prudential' Institution Building*, Oxford (2006) Chapter III.

<sup>140</sup> There is no definition of what it means by 'prudential' objectives under GATS or any of the other agreements under the WTO. For the moment this is left for the GATS adjudicatory body (dispute settlement body) to interpret what sort of measures fall under this notion.

<sup>141</sup> See Art XX of General Agreement on Tariffs and Trade, General Exceptions, Art XXIV of GATS General Exceptions, Agreement on Trade-Related Aspects of Intellectual Property Rights, Art 73, and Security Exceptions etc.

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as an exception under Article XXIV of GATS,<sup>142</sup> here all prudential measures are exceptions to the rule under GATS Art XI and hence can be claimed without the need to prove necessity.<sup>143</sup> As a result, a prudential measure may not be challenged on the ground that it is not ‘necessary’ or ‘least trade restrictive.’ Moreover, “the prudential carve-out overrides the requirements for domestic regulations in GATS Article VI (Domestic Regulation)”.<sup>144</sup>

### 3.4.1 The Ethiopian case

As discussed above, GATS recognizes that governments may find it necessary to exercise considerable regulatory control over the activities of banks, insurance companies and other financial institutions. Its Annex on Financial Services therefore provides that the liberalization commitments undertaken should not prevent them from taking measures for prudential reasons, including the protection of investors, depositors, policy holders or to ensure the integrity and stability of the financial system. Although the Annex does not give details as to what constitutes prudential measures, licensing requirements intended to ensure business competence and financial integrity, minimum capital requirements and regular accounting requirements would ordinarily be considered prudential measures. Accordingly the National Bank of Ethiopia

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<sup>142</sup> See for instance Art XXIV of GATS General Exceptions states; Subject to the requirement that such measures are not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where like conditions prevail, or a disguised restriction on trade in services, nothing in this Agreement shall be construed to prevent the adoption or enforcement by any Member of measures: (a) necessary to protect public morals or to maintain public order; (b) necessary to protect human, animal or plant life or health; (c) necessary to secure compliance with laws or regulations which are not inconsistent with the provisions of this Agreement.

<sup>143</sup> Meester, B.de, *Testing European Prudential Conditions for Banking Mergers in Light of Most Favoured in the GATS*, Journal of International Economic Law II (2008) pp 609-647.

<sup>144</sup> Sydney J. Key (2003), *supra* note 63 above. She reiterates, “The absence of a necessity test does not, however, resolve the issue of whether a measure is prudential or is being used to avoid the obligations of the agreement. An allegedly prudential measure that violates a country’s obligations or commitments under the GATS might be challenged on the grounds that its purpose is really trade restrictive rather than prudential and therefore it does not fall within the scope of the prudential carve-out.” Also See Diemo Dietrich *et al* (2010), *Liberalization and Rules on Regulation in the field of Financial Services in Bilateral Trade and Regional Integration Agreements*, Institute of Economic Law (TELC), Martin Luther University Halle-Wittenberg, p. 12.

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(NBE) can keep regulating financial institutions in the above terms after accession irrespective of any commitment scenario upon accession.

Below is a brief review of some of the major prudential regulatory measures that are currently being practised under the supervision of the National Bank of Ethiopia.<sup>145</sup> A brief evaluation is made whether these measures can be accommodated within the bounds of GATS prudential carve-out thereby allowing policy space for the government upon accession.

### **a) Establishment and structural requirements**

Ethiopian law mandates private banks, insurers and Micro Financial Institutions (MFIs) to be incorporated as share companies.<sup>146</sup> It, among others, mandates all banks to get a banking business license, including branch permits, from the National Bank of Ethiopia (NBE) and to notify the latter on their new branching decisions to the latter.<sup>147</sup> A bank to which a license is granted is required to “fulfill, before commencing operation, sound information management and internal control systems, risk management policies and procedures, and human resource organization and such other essential obligations to carry out banking business as determined by the directive to be issued by the National Bank”.<sup>148</sup> The NBE is also authorized to impose qualification, fitness and propriety criteria on influential shareholders of the banks and directors and on chief (and senior) executives of the banks.

These establishment and structural requirements are compatible with the GATS rules as long as they are based on objective and transparent criteria, not

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<sup>145</sup> It is beyond the purpose of this note to discuss the appropriate content of prudential regulation or the means of adequate supervision of financial institutions. For a detailed synthesis on the subject please see IMF, *International Capital Markets*, IMF, Washington, D.C, (1998) This study describes the overall developments in prudential regulation and banking supervision in the world. Major international achievements have also been made by the various international institutions to improve regulatory and supervisory standards across countries. In this regard the activities of the Basle Committee on Banking Supervision in developing prudential standards for banking are extensive and well-documented. See BIS, *Core Principles for Effective Banking Supervision*, Basle Committee on Banking Supervision, Bank for International Settlements, Basle (1997).

<sup>146</sup> Primarily see *Commercial Code of the Empire of Ethiopia*, 1960, Title VI. Also see Article 513; Proclamation No 592/2008, Article 4.

<sup>147</sup> Proclamation No 626/2009, Article 6 (5); Proclamation No 592/2008, Article 3 (3) 1/ It is prohibited to transact banking business in Ethiopia without obtaining a banking business license from the National Bank. 2/ No person shall use the word ‘bank’ or its derivatives as part of the name of any financial institution unless it has obtained a license from the National Bank.

<sup>148</sup> Proclamation No 592/2008, Article 6.

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more burdensome than necessary to ensure the quality of service, and less trade restrictive, as the GATS requires. But, with respect to the form and type of organizations allowed to operate banking business, it seems wise to include the rules under the Ethiopian Commercial Code and the Banking Proclamation in the commitment schedules. For instance, Cape Verde maintained a market access exception that commercial presence must take the form of a limited liability company, or as provided for in the financial services head note of the respective schedule.<sup>149</sup> This aspect of the regulatory system is out of the exception given to measures falling under the prudential carve-out. This objective can also be achieved by enlisting a general condition under the financial services schedule whereby the concerned regulatory tools and the institutions can easily be enlisted. For instance, the services schedule of Nepal maintains the following:

“[T]he commitments in financial services are made in accordance with the General Agreement on Trade in Services and the Annex on Financial Services. All the commitments are subject to entry requirements, domestic laws, rules and regulations and the terms and conditions of the Nepal Rastra Bank (the central bank of Nepal) and any other competent authority in Nepal, as the case may be, which are consistent with Article VI of the GATS and paragraph 2 of the Annex on Financial Services.”<sup>150</sup>

#### **b) Operational and disclosure requirements**

Financial services providers in Ethiopia are generally obliged to comply with directives issued by the National Bank on “minimum amounts of capital and reserves to be maintained by banks and the rules for their computation” shall be determined by the latter.<sup>151</sup> Article 29 of the Banking Proclamation also empowers the National Bank to periodically or at any time, without prior notice, make, or cause to be made, an on-site inspection of any bank. With respect to disclosure rules, it is notable that transparency in the banking sector is, compared to other sectors or the general commerce, better regulated and monitored in the country. The National Bank of Ethiopia is given a mandate to

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<sup>149</sup> As discussed above in Section (3), the financial services head note maintains that Cape Verde will permit the establishment of branches for committed sub-sectors in insurance, banking and securities within 10 years from the date of Cape Verde's Accession. See Cape Verde, *Report of The Working Party on The Accession of Cape Verde: Addendum, Part II - Schedule of Specific Commitments in Services List of Article II MFN Exemptions*, WT/ACC/CPV/30/Add.2.

<sup>150</sup> World Trade Organizations, *Trade in Services, The Kingdom of Nepal, Schedule of Specific Commitments*, GATS/SC/139 (2004).

<sup>151</sup> Proclamation No 592/2008, Article 18.

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see into the compliance of these sectors with their disclosure and transparency obligations.<sup>152</sup> Among many, the working regulation empowers the NBE to see that banks keep records and accounts following international financial statements standards,<sup>153</sup> to have their assets valued by government approved experts, to have their accounts audited by independent auditors appointed upon approval of the NBE or the government,<sup>154</sup> and to report the state of their financial activities and affairs to the NBE, their customers and the general public annually and as may be required by the NBE. The NBE is also authorized to lay down auditing standards,<sup>155</sup> and impose an obligation on banking services providers to provide their audited annual balance sheets and profit and loss accounts in accessible places of businesses, etc.<sup>156</sup> Understandably, all these measures are not incompatible with the GATS since they are meant to protect the financial institutions, investors, consumers and the general public against fraud.

### c) Prudence and performance requirements

Article 18 of the Banking Proclamation empowers NBE to set the minimum amounts of capital and reserves that should be maintained by banks and the rules for their computation.<sup>157</sup> The same Proclamation provides that “the National Bank may prescribe different capital and reserve requirements to be maintained by different banks depending on their risk profile.”<sup>158</sup> Accordingly, the NBE has issued various directives aimed at providing prudence and performance requirements. They include Directive No. Sbb-50-11 on minimum capital requirement for Banks, Licensing and Supervision of Banking Business, Directive No. SBB/4/95 and SBB/37/2004 Reserve Requirement on Legal Reserves, Licensing and Supervision of Banking Business, Directive No. SBB/12/1996 Limitation on Investment of Banks, Directive No. SBB/39/2006

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<sup>152</sup> National Bank of Ethiopia Establishment (as amended) Proclamation No. 591/2008. Micro-Financing Business Proclamation No. 626/2009.

<sup>153</sup> Banking Business Proclamation No. 592/2008, Article 23.

<sup>154</sup> *Ibid*, Article 24.

<sup>155</sup> Banking Business Proclamation No. 592/2008 Article 26.

<sup>156</sup> Generally see Article 28 (titled Disclosure of Information) of the Banking Business Proclamation No. 592/2008. It provides the following: (1) Every bank shall, within a time period to be determined by the National Bank, send to the National Bank duly signed financial statements and other reports as prescribed by it. (2) Every bank shall: a) exhibit at every place of its business, including its branches, in a conspicuous place throughout the year, a copy of the last audited balance sheet and profit and loss account in respect of all of its operations; b) cause such balance sheet and profit and loss account, together with the notes thereto, to be published in a newspaper of wide circulation.

<sup>157</sup> Proclamation No 592/2008, Article 18.

<sup>158</sup> *Ibid*.

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Amendment for New Bank Licensing on Approval of Directors and CEOs, and Directive Sbb-44-08 Liquidity Requirement (3rd replacement). The Banking Business Proclamation separates the banking businesses from non-banking and other commercial activities and the insurance businesses from non-insurance activities.<sup>159</sup> It also requires banks to adhere to single borrower limits to diversify their investments as the NBE prescribes.<sup>160</sup>

Having seen the nature of the above legal instruments and prudential supervision from the National Bank, one might wonder whether GATS rules will prohibit such kinds of government interventions in the financial sector. The aforementioned regulations in Ethiopia are not incompatible with the GATS since they have the purpose of protecting the prudence and stability of the financial system against *contagion* and the GATS do not prescribe and impose particular regulatory provisions on domestic regulations. It does not also put a limit on the choice and preferences of how a member would like to discipline its banks or the functioning of the entire economy as long as the measures employed are not discriminatory and thus act as a disguised trade barrier.<sup>161</sup>

On final note, if Ethiopia's negotiators/regulators are concerned about whether a particular measure would be generally accepted as prudential, there is the option of listing that measure as a limitation when making initial market access and national treatment commitments, thereby avoiding the need to rely on the prudential carve-out. This seems preferable considering the different positions of member states as to what sort of measures fall under the prudential

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<sup>159</sup> Proclamation No 592/2008, Art 22 (2), 50; Licensing and Supervision Of Banking Business, Directive No. SBB/12/1996; which inter alia provides; 1, No bank shall engage in insurance business but may hold up to 20% in an insurance company and up to a total of 10% of the bank's equity capital in such business. 2. Banks are prohibited from engaging directly in non-banking businesses such as agriculture, industry, and commerce. 3. A bank may hold shares in a non-banking business only up to 20% of the company's share capital and total holdings in such business shall not exceed 10%.

<sup>160</sup> Proclamation No 591/2008, Art 15 (1) lit. a and (2); Proclamation No. 592/2008, Art. 22 (1); Proclamation No 86/1994, Arts 14, 42 lit. e and f; Proclamation No 626/2009, Arts. 3 (1), 14 (2) lit. a and d and 16; Directives National Bank of Ethiopia, *Licensing and Supervision of Banking Business Directive* No SBB/16/1996 on *Amendment of Single Borrower Loan Limit* Directive No SBB/8/1995 (1996); National Bank of Ethiopia, *Licensing and Supervision of Banking Business Directive* No. SBB/29/2002 on *Amendment of Single Borrower Loan Limit*, 13 May 2002; National Bank of Ethiopia, *Licensing and Supervision of Insurance Business Directive* No SIB/25/2004 on *Investment of Insurance Funds*, (2004).

<sup>161</sup> Bart De Meester (2010), *The Global Financial Crisis And Government Support For Banks: What Role For The GATS?*, Journal of International Economic Law Vol. 13 No. 1, p 48.

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exception. For instance, some WTO members imposed lending and other operating limits based on branch capital-equivalency requirements; Korea and Turkey, for example, listed the measures as limitations in their schedules of commitments, which could be interpreted as an acknowledgement that the measures may not be generally accepted as prudential. By contrast, there are members that imposed the measures but did not list them as limitations in their schedules; Chile for example, clearly believed that the measures are within the scope of the prudential carve-out.<sup>162</sup> The EU practice shows that branches (as opposed to subsidiaries) of third-country financial firms are, in general, not subject to harmonized EU prudential measures and that each member state may therefore impose its own measures for prudential purposes.<sup>163</sup> This shows that members have different views towards what sort of measures are prudential and thus need not be schedules based on the annex on financial services. Thus, Ethiopia should not take any risk if a particular measure (which is not anticipated during accession) can possibly be challenged on prudential grounds; and should thus have it scheduled.

## Conclusion

This article began with a brief discussion on the central role of the negotiation on financial services in Ethiopia's accession bid to the WTO. In doing so, the article did not discuss the macroeconomic relevance and market efficiency emplacements of financial services liberalization, whether within and outside the WTO system. Rather the central inquiry in this article focused on whether Ethiopia can maintain the existing status-quo and hold back on any GATS commitments in financial services so as to retain the freedom to pursue certain domestic policy and regulatory objectives.

These concerns are legitimate mainly for two reasons. Primarily, financial services play key roles in any economy, including Ethiopia, while at the same time the risk of market failures in the services sector is equally high. State regulation in financial services is thus expedient. Acceding WTO member countries such as Ethiopia make sure that the relevant WTO instruments are flexible enough to allow sufficient level of macroeconomic and regulatory autonomy. The second reason relates to the recent worldwide financial crisis which clearly shows the potential vulnerabilities of the highly liberalized, deregulated and overwhelmingly intermingled financial systems of the western world. Important pressures have thus emerged pushing countries all over the world to rethink and maintain the regulatory role of the government in the financial services market.

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<sup>162</sup> See Sydney J. Key (2003), *supra* note 64.

<sup>163</sup> *Ibid.*



The discourse on the cause, nature and degree of these risks and their ultimate solutions is still underway. No one can possibly know precisely where and how the next global crisis will unfold or what measures national governments should take to protect their economies from a global contagion. In this extremely fluid and unpredictable situation, it is thus essential that governments retain the necessary policy space.

With regard to Ethiopia's WTO accession package, the evaluation of the WTO framework and the GATS obligations in financial services demonstrates that commitments under GATS need not compromise the ability of the Ethiopian Government to pursue sound regulatory and macroeconomic policies. A review of the relevant obligations in this article shows that states acceding to the system will still be left with considerable freedom to achieve macroeconomic and regulatory policy objectives. After examining the possible commitment scenarios which Ethiopia can possibly commit to, it is argued that there exists no definite reason why GATS commitments on financial services will have to compromise Ethiopia's ability to pursue sound regulatory and macro-economic policies. \_\_\_\_\_■

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