

## DID GATS CAUSE THE FINANCIAL CRISIS OF 2007?

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### ABSTRACT

*The Financial Crisis of 2007 has morphed into a global recession matching up to financial devastations caused by the Great Depression of 1930. Many theories and causes have been put forward to explain the crisis and theorise the prevention of such crises in future, with most agreeing that deregulation in the financial sector, especially the shadow banking sector, led to the financial crisis. However, most mainstream authors tend to overlook any link between GATS-led deregulation and the financial crisis. This article will investigate whether there was any causal link between the GATS led deregulation and the Financial Crisis of 2007.*

### I. INTRODUCTION

The Financial Crisis of 2007 has ravaged the world economy on a scale comparable to the Great Depression of 1930, scholars,<sup>2</sup> economic/political/financial institutions,<sup>3</sup> and

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<sup>2</sup> Paul Volcker, *The Time We Have Is Growing Short*, THE NEW YORK REVIEW OF BOOKS (2010), [www.nybooks.com/articles/archives/2010/jun/24/time-we-have-growing-short/?pagination=false](http://www.nybooks.com/articles/archives/2010/jun/24/time-we-have-growing-short/?pagination=false); John Authers, *Lay Blame on Wall St., Main St., and Central Banks*, FINANCIAL TIMES (1-2 September 2007); Michael Mah-Hui Lim, *Old Wine in a New Bottle: Subprime Mortgage Crisis—Causes and Consequences*, Working Paper No. 532, The Levy Economics Institute of Bard College (2008), <http://ssrn.com/abstract=1126274>; Calomiris Charles W., *Financial Innovation, Regulation, and Reform*, 29(1) CATO JOURNAL (2009), <http://www.cato.org/pubs/journal/cj29n1/cj29n1-7.pdf>.

<sup>3</sup> A. Blundell-Wignall, P. Atkinson and S. Hoon Lee, *The current Financial Crisis: Causes and Policy Issues*, Financial Market Trends, OECD (2008), <http://www.oecd.org/dataoecd/47/26/41942872.pdf>; De Larosière Report, Brussels, (25 February 2009), Turner Review (2009) *The Turner Review – A Regulatory Response to the Global Banking Crisis*, United Nations; *Report of the Commission of Experts of the President of the United Nations General Assembly on Reforms of the International*

governmental agencies<sup>4</sup> alike have tried to come up with various causes including rapid and prolonged deregulation, high risk taking behaviour in search of higher yield in financial institutions, financial product innovation, inaccurate credit ratings, rise of shadow banking system, etc., and solutions to the crisis including greater regulation, higher transparency, international monitoring, etc. Though some scholars/publicists<sup>5</sup> and advocacy groups<sup>6</sup> blame the General Agreement on Trade in Service (GATS) and 'Understanding on Commitments in Financial Services'<sup>7</sup> (referred hereinafter as Understanding on Financial Services) for encouraging deregulation of financial markets of the signatory countries and hence being one of the major reasons behind the Financial Crisis of 2007, the majority of reports tend to overlook the effect of GATS and related agreements/commitments, if any, in precipitating the financial crisis.<sup>8</sup>

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*Monetary and Financial System* (more famously known as the Stiglitz Report), (September 21, 2009), World Trade Organisation, Council for Trade in Services, Committee on Trade in Financial Services; *Financial Services: Background Note by the Secretariat S/C/W/312* (3 February 2010).

<sup>4</sup> Financial Services Authority, United Kingdom, Financial Stability Forum, *Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience* (7 April 2008), Archives of Financial Crisis Inquiry Commission, Government of United States of America, <http://www.fcic.gov/>.

<sup>5</sup> Ellen Gould, *Financial Instability and the GATS Negotiations*, 9(4) TRADE AND INVESTMENT SERIES, CANADIAN CENTRE FOR POLICY ALTERNATIVES, BRIEFING PAPER (2008), [http://www.policyalternatives.ca/sites/default/files/uploads/publications/National\\_Office\\_Pubs/2008/Financial\\_Instability\\_and\\_GATS.pdf](http://www.policyalternatives.ca/sites/default/files/uploads/publications/National_Office_Pubs/2008/Financial_Instability_and_GATS.pdf); Myriam Vander Stichele, *How Trade, the WTO and the Financial Crisis Reinforce Each Other*, CENTRE FOR RESEARCH ON MULTINATIONAL CORPORATIONS (2008).

<sup>6</sup> Public Citizen's Global Trade Watch, *To Promote Economic Stability, Nations Must Free Themselves from WTO Financial Deregulation Dictates*, (2009); Third World Network, *WTO claims financial crisis not due to GATS*, (5 February 2010), <http://www.twinside.org.sg/title2/wto.info/2010/twninfo100204.htm>.

<sup>7</sup> Legal text at [http://www.wto.org/english/tratop\\_e/serv\\_e/21-fin\\_e.htm](http://www.wto.org/english/tratop_e/serv_e/21-fin_e.htm).

<sup>8</sup> Most peer reviewed academic papers on the Crisis in the main stream journals *C.F.* (n 1) tend to avoid any correlation between the financial crisis and GATS, while most 'anti-WTO' organisations pin up 'GATS led deregulation' as one of the major causes of the financial crisis. *C.F.* (n 4, 5) for articles relating GATS to Financial crisis of 2007.

GATS, a constituent treaty of the World Trade Organisation (WTO), espouses promotion of trade in services ‘through progressive liberalization’.<sup>9</sup> One of the major obligations under GATS is the liberalisation of financial service; there is also a separate annex in WTO agreements the Understanding on financial services for higher standards of liberalisation in financial service than those in GATS.

This article will examine whether there is any causal link between ‘progressive liberalisation’ as promoted by GATS, and financial market deregulation, which has been blamed as the main reason for the Financial Crisis of 2007, and whether GATS and Understanding on financial services limits the ability of signatory States to regulate financial services. Part I of this article deals with deregulation as one of the causes of the Financial Crisis of 2007, Part II examines whether GATS and the Understanding on Financial Services limits the ability of States to regulate financial services and Part III analyses whether GATS-fuelled liberalisation led to any specific deregulations in the financial sector which caused the Financial Crisis of 2007, and if GATS and the Understanding on Financial Services restrict the ability of States to govern their financial sector.

## II. HOW DID THE FINANCIAL CRISIS OF 2007 ORIGINATE AND SPREAD AROUND THE GLOBE?

The global Financial Crisis of 2007 was the culmination of various microeconomic and macroeconomic factors. It would be hard to pin-point a single starting point of the crisis or a unitary strand of effects. Following most experts,<sup>10</sup> the Financial Crisis

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<sup>9</sup> The General Agreement on Trade in Services (GATS): objectives, coverage and disciplines: main purposes of GATS, [http://www.wto.org/english/tratop\\_e/serv\\_e/gatsqa\\_e.htm](http://www.wto.org/english/tratop_e/serv_e/gatsqa_e.htm).

<sup>10</sup> Austin Murphy, *An Analysis of the Financial Crisis of 2008: Causes and Solutions*, <http://ssrn.com/abstract=1295344>; See generally Ben S. Bernanke, *Causes of the Recent Financial and*

of 2007 can be divided into three distinct phases (Phase I and II deals with the cause and spread while Phase III deals with the domino effects): Phase I (2001-2006) starts with the dual bubble of easy credit and increasing house prices in the United States of America (USA) which led to rise of higher risk subprime mortgages;<sup>11</sup> Phase II (2002-2007) is marked by financial innovation which transformed the subprime mortgages into asset-backed 'risk spreading' securities like derivatives<sup>12</sup> and spread them to securities markets throughout the world<sup>13</sup> - these securities which were highly rated by private credit ratings authorities went into a cycle of speculative global price escalation linked to the USA housing price bubble;<sup>14</sup> and Phase III (2007-2010) when the housing bubble burst and the prices of houses in USA fell rapidly, simultaneously the value of US house price linked mortgage-securities depreciated and banks, insurance companies, private financial institutions all over the world which had invested on subprime mortgage markets in some form or other found their assets

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*Economic Crisis Before the Financial Crisis Inquiry Commission, Washington, D.C.* (2 September 2010), <http://www.federalreserve.gov/newsevents/testimony/bernanke20100902a.htm>; Carmen M. Reinhart and Kenneth S. Rogoff, *Is the 2007 U.S. Sub-Prime Financial Crisis So Different? An International Historical Comparison*, [http://www.economics.harvard.edu/files/faculty/51\\_Is\\_The\\_US\\_Subprime\\_Crisis\\_So\\_Different.pdf](http://www.economics.harvard.edu/files/faculty/51_Is_The_US_Subprime_Crisis_So_Different.pdf); *See also C.F.* (n 1,2,3).

<sup>11</sup> *See generally* Yuliya Demyanyk and Otto Van Hemert, *Understanding the Subprime Mortgage Crisis*, [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1020396](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1020396); Subprime lending can be described as loans which have less chances of being repaid these type of loans are also sarcastically called as NINJA (No Income, No Job & No Assets) loans. When subprime loans are issued against a mortgage it is known as subprime mortgage.

<sup>12</sup> Group of 30 (2009). *Financial Reform: A Framework for Financial Stability*. Washington: Group of 30 as cited in John Goddard, Phil Molyneux John O.S. Wilson, *The Financial Crisis in Europe: Evolution, Policy Responses and Lessons for the Future*, [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1414935](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1414935). To see the position of economists stating that derivatives did not precipitate the financial crisis *see* Financial Economists Roundtable, *Statement of the Financial Economists Roundtable Reforming the OTC Derivatives Markets*, 22 JOURNAL OF APPLIED CORPORATE FINANCE 40 (2010).

<sup>13</sup> *See generally*, Robin Blackburn, *The Subprime Crisis*, [http://www.newleftreview.org/?view=2715#\\_edn4](http://www.newleftreview.org/?view=2715#_edn4).

<sup>14</sup> B. Jameson, *The Blunders that Led to Catastrophe*, NEW SCIENTIST 8-9 (27 September 2008), as cited in Austin Murphy (n 11) 5.

halved within the first 2-3 months.<sup>15</sup> This rapid reduction of value of assets led to reduction of issuance of credit by financial institutions which led to a credit crunch.<sup>16</sup> Without credit, the manufacturing sector in USA slowed resulting in growing unemployment which in turn reduced demand for goods and services in USA, thereby pushing the US economy towards recession.<sup>17</sup> With the largest economy of the world in a downturn, the secondary effects of the Financial Crisis are felt in countries which are dependent mainly on export to US markets that suffered a slump.<sup>18</sup>

Now that we have looked into the origin and spread of the Financial Crisis, let us analyse whether financial deregulation was one of the causes of the crisis. Some of the deregulations pointed out are:

- In 1933, post the Great Depression, US congress legislated the Glass–Steagall Act of 1933, which differentiated between investment banks and commercial banks. By doing so there was a concerted effort to curb speculation and to ensure that financial market crashes do not affect the common persons who mainly use the services of commercial banks.<sup>19</sup> However, such regulations were slowly dismantled, first with Depository Institutions Deregulation and

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<sup>15</sup> American International Group got government bailout of US\$ 150 billion, New Century Financial Corporation, American Freedom Mortgage, American Home Mortgage, Lehman Brothers went bankrupt. Chrysler and General Motors filed for reorganisation. *See generally*, David Greenlaw, Jan Hatzius, Anil K Kashyap and Hyun Song Shin, *Leveraged Losses: Lessons from the Mortgage Market Meltdown*, U.S. MONETARY POLICY FORUM REPORT NO. 2, <http://faculty.chicagobooth.edu/anil.kashyap/research/MPFReport-final.pdf>.

<sup>16</sup> Finn Ostrup , Lars Oxelheim and Clas Wihlborg, *Origins and Resolution of Financial Crises; Lessons from the Current and Northern European Crises*, [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1407613](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1407613).

<sup>17</sup> C.F. Greenlaw (n 16).

<sup>18</sup> *Ibid*.

<sup>19</sup> *See generally*, James R. Barth, R. Dan Brumbaugh Jr. and James A. Wilcox, *The Repeal of Glass-Steagall and the Advent of Broad Banking*, ECONOMIC AND POLICY ANALYSIS WORKING PAPER 2000-5 (2000), <http://www.occ.gov/publications/publications-by-type/economics-working-papers/2008-2000/wp2000-5.pdf>.

Monetary Control Act of 1980, and finally the Gramm–Leach–Bliley Act of 1999.<sup>20</sup> Senator Phil Gramm, Chairman of the Senate Banking Committee summed up the direction of the bill as “it is a deregulatory bill. I believe that that is the wave of the future”.<sup>21</sup> Thus, the end result was that the regulatory overseeing structure of banking institutions reverted back to 1930s.

- The Commodity Futures Modernization Act (CFMA) of 2000, made the role of government regulators redundant<sup>22</sup> by advocating self regulation in the highly volatile financial market of derivatives.<sup>23</sup> CFMA is yet another example of the application of the neo-liberal *laissez-faire* doctrine which aims at reducing government intervention and letting the market govern itself.
- Apart from overt deregulation, the US government indulged in passive deregulation when it did not intervene to stabilise the falling interest rates, high housing prices and the resultant complex asset backed securities. Warren Buffet had in 2003 warned that derivatives could be the financial “weapons of mass destruction”,<sup>24</sup> but the US government chose to ignore such warnings and allowed the shadow banking system to grow unregulated. Thus, the loose monetary policy of the US Federal Reserve and the artificially induced low interest rate contributed to continued easy availability of credit which led to the credit bubble.<sup>25</sup>

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

<sup>21</sup> Gramm’s Statement at the signing ceremony for the Gramm–Leach–Bliley Act, November 12, 1999, <http://banking.senate.gov/prel99/1112gbl.htm>.

<sup>22</sup> Joseph Karl Grant, *What the Financial Services Industry Puts Together Let No Person Put Asunder: How the Gramm-Leach-Bliley Act Contributed to the 2008-2009 American Capital Markets Crisis*, ALBANY LAW REVIEW 371 (2010), [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1525670](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1525670).

<sup>23</sup> Michael Greenberger, *Is Our Economy Safe? A Proposal for Assessing the Success of Swaps Regulation Under the Dodd-Frank Act*, U. OF MARYLAND LEGAL STUDIES RESEARCH PAPER NO. 2010-50 (2010), [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1689174](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1689174).

<sup>24</sup> Buffett warns on investment 'time bomb', <http://news.bbc.co.uk/1/hi/business/2817995.stm>.

<sup>25</sup> C.F. Lim (n 1) 8.

Though commentators have blamed human greed<sup>26</sup> and systemic faults in the theory of capitalism as the cyclic origin of economic crises,<sup>27</sup> if we were to find a more tangible, less philosophical cause, we can safely assume from the discussion above that the Financial Crisis of 2007 originated in the USA with deregulation as one of the major reasons.

### III. DID GATS CAUSE DEREGULATION IN THE FINANCIAL SERVICE SECTOR?

The aim of GATS, as stated earlier, is ‘transparency and progressive liberalisation’ of the service sector.<sup>28</sup> Towards this goal, GATS has undertaken several steps which freezes newer anti-service measures and urges States to make more commitments towards greater market access. Let us look at some of those regulations with an emphasis on Understanding on Financial Services and try to find out if it hampers the ability of a signatory State to govern its financial market:

- **Article XVI(2) of GATS** – If the State has agreed to full market access it would mean that in that particular sector the government cannot put any restriction
  - a) limiting the number of services suppliers in any form be it numerical quotas, monopolies or even the economic needs test;
  - b) limiting the total value of service transactions or assets of the service provider in the form of quotas or requirement of economic needs test;
  - c) limiting the total number of service operations or on the total quantity of service output;
  - d) limiting the total number of natural persons that may be employed in a particular service sector;
  - e) limiting measures which restrict or require specific types of legal entity or joint venture through which a service supplier may supply a service; and

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<sup>26</sup> *Ibid.*

<sup>27</sup> HYMAN MINSKY, *STABILIZING AN UNSTABLE ECONOMY* (1986).

<sup>28</sup> Preamble to GATS, *see also*, The General Agreement on Trade in Services (GATS): objectives, coverage and disciplines, [http://www.wto.org/english/tratop\\_e/serv\\_e/gatsqa\\_e.htm](http://www.wto.org/english/tratop_e/serv_e/gatsqa_e.htm).

- f) limiting the participation of foreign capital in terms of maximum percentage limit on foreign-shareholding or the total value of individual or aggregate foreign investment. Thus, full market access in the financial sector takes away the regulatory power of States to impose almost any restriction or pre-condition on a foreign financial company pre or post entry to the domestic market. What is even more alarming is that it takes away the requirement of economic needs test which may have given the State the power to regulate foreign financial service providers in times of economic need.<sup>29</sup>
- **Articles XVII(3) and VI(1)** - Some consumer advocacy organisations like Public Citizen's Global Trade Watch claim<sup>30</sup> that Art. XVII(3)<sup>31</sup> of GATS on National Treatment would make non-discriminatory domestic regulations GATS inconsistent if they adversely affect the foreign entrant. Similar arguments are also raised about the interpretation of Art. VI(1)<sup>32</sup> of GATS on domestic regulation, Public Citizen's Global Trade Watch claims that Art. VI is:

“an extremely broad provision, as it applies to regulations of general application that may affect service sector operations, not only those designed to regulate a specific service sector or the service sector generally. The provision also provides enormous discretion to a WTO

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<sup>29</sup> See generally, Wei Wang, *National Treatment in Financial Services in the Context of the GATS/WTO*, 6 STUDIES IN INTERNATIONAL FINANCIAL, ECONOMIC, AND TECHNOLOGY LAW 149 (2003); Erich Vranes, *WTO and Regulatory Freedom: WTO Disciplines on Market Access, Non-Discrimination and Domestic Regulation Relating to Trade in Goods and Services*, 12 (4) JOURNAL OF INTERNATIONAL ECONOMIC LAW 953 (2009).

<sup>30</sup> Public Citizen's Global Trade Watch, *To Promote Economic Stability, Nations Must Free Themselves from WTO Financial Deregulation Dictates*, 7 (2009), [www.citizen.org/documents/IntroductionToWTODe regulation.pdf](http://www.citizen.org/documents/IntroductionToWTODe%20regulation.pdf).

<sup>31</sup> Formally identical or formally different treatment shall be considered to be less favourable if it modifies the conditions of competition in favour of services or service suppliers of the Member compared to like services or service suppliers of any other Member.

<sup>32</sup> In sectors where specific commitments are undertaken, each Member shall ensure that all measures of general application affecting trade in services are administered in a reasonable, objective and impartial manner.

tribunal to determine if the manner in which a country implements its policies are ‘reasonable, objective and impartial’ – all highly subjective measures”.<sup>33</sup>

- **Standstill Arrangements** - The Understanding on financial services declares that the signatory States agree to lock their regulations to “any conditions, limitations and qualifications to the commitments noted below shall be limited to *existing non-conforming measures*.”<sup>34</sup> This provision prevents signatory States from bringing in new restrictions to regulate foreign service providers. Further, it locks the State in the deregulatory mode of 1995. Thus the Understanding on Financial Services makes legislations go only one way, that is, into the path of deregulation.
- **New Financial Services** - Under Article B(7) of the Understanding on Financial Services, a State is bound to allow foreign financial service providers ‘to offer in its territory any new financial service’. Thus, if the State is a party to the Understanding on Financial Services and has committed to full market access in the financial service sector, even if it is aware that a foreign bank is selling risky securities to its citizens, it cannot regulate the foreign bank.
- **Progressive Liberalisation through Non-Discriminatory Measures** - Under Art. B(10) of the Understanding on Financial Services, the signatory States agree to “endeavour to remove or to limit any significant adverse effects on financial service suppliers of any other Member”. The measures sought to be relaxed are: “(a) non-discriminatory measures that prevent financial service suppliers from offering in the Member’s territory, in the form determined by the Member, all the financial services permitted by the Member; (b) non-discriminatory measures that limit the expansion of the activities of financial

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<sup>33</sup> C.F. Public Citizen’s Global Trade Watch (n 31).

<sup>34</sup> *Understanding on Commitments in Financial Services*, [http://www.wto.org/english/tratop\\_e/serv\\_e/21-fin\\_e.htm](http://www.wto.org/english/tratop_e/serv_e/21-fin_e.htm).

service suppliers into the entire territory of the Member; (c) measures of a Member, when such a Member applies the same measures to the supply of both banking and securities services, and a financial service supplier of any other Member concentrates its activities in the provision of securities services; and (d) other measures that, although respecting the provisions of the Agreement, affect adversely the ability of financial service suppliers of any other Member to operate, compete or enter the Member's market; provided that any action taken under this paragraph would not unfairly discriminate against financial service suppliers of the Member taking such action.”<sup>35</sup>

- **WTO Jurisprudence** - Apart from the regulatory regime as enshrined in the provisions of GATS and the emphasis on the Understanding on Financial Services, yet another worrying development is the 2005 case of *United States - Measures Affecting the Cross-Border Supply of Gambling and Betting Services*<sup>36</sup> (hereinafter referred to as the *US Gambling* case) which brought forth the problems associated with market access and its effects on domestic regulations.<sup>37</sup> The USA had committed to full market access in “recreational services (except sporting)”. It had strict gambling regulations in the form of the Wire Act of 1961, the Travel Act of 1961 and the Illegal Business Gambling Act of 1970, which effectively prohibited “cross-border supply of gambling and betting services”. Antigua, an island neighbour of the USA, approached the WTO Dispute Settlement Body contending that US domestic laws interfered with cross border gambling activities originating from Antigua. In

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<sup>35</sup> Art. B(10), Understanding on Commitments in Financial Services.

<sup>36</sup> *Appellate Body Report*, WT/DS285/AB/R (7 April 2005), [www.wto.org/english/tratop\\_e/dispu\\_e/285abr\\_e.doc](http://www.wto.org/english/tratop_e/dispu_e/285abr_e.doc).

<sup>37</sup> See generally, Pangiotis Delimatsis, *Don't Gamble with GATS - The Interaction between Articles VI, XVI, XVII and XVIII GATS in the Light of the US - Gambling Case*, 40(6) JOURNAL OF WORLD TRADE 1059 (2006); Noe Hamra Carbajales, *No More Bets: The United States Rolls the Dice One More Time regarding International Relations and Foreign Internet Gambling Services*, 19 (1) TULANE JOURNAL OF INTERNATIONAL AND COMPARATIVE LAW 397 (2010).

2004, the WTO panel ruled in favour of Antigua. The case was then taken before the Appellate Body which in 2005 again ruled in favour of Antigua and held that USA had acted inconsistently with its market access obligations. The reasons given by appellate body were that first, the exclusionary clause in the market access schedule “recreational services (except sporting)” only ruled out sporting activities, thus by inference gambling which is a recreational service but not a sports should qualify to have full market access.<sup>38</sup> Secondly, as per Article XVI, once full market access has been committed to a particular sector without reservation, the domestic government has almost no powers to regulate the entry and operation of foreign business in that sector and in the *US Gambling* case, the Appellate Body concluded that prohibition of cross border gambling by various US Federal and State laws limited the supply to zero and was thus an imposition of a numeric quota.<sup>39</sup>

If we analyse the previous few points we would find that the so-called GATS-based ‘progressive liberalisation’ has taken away powers of States to differentially treat foreign financial service providers in any meaningful manner. The *US Gambling* case shows that post full market access commitments in a particular sector, regulating foreign service providers in that sector is virtually impossible even if compelling public issue reasons are present.<sup>40</sup> For States which have signed the Understanding on Financial Services, the commitments move from the sphere of liberalisation to outright deregulation. If we look at the commitment to new financial services, it provides a blanket ban on any regulation on new financial products. It creates a

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<sup>38</sup> *US Gambling* 70-73 (n 37).

<sup>39</sup> *Ibid.* at 78-89.

<sup>40</sup> See generally, Markus Krajewski, *Playing by the Rules of the Game - Specific Commitments after US - Gambling and Betting and the Current GATS Negotiations WTO Appellate Body*, 32 (4) LEGAL ISSUES OF ECONOMIC INTEGRATION 417 (2005); Donald H. Regan, *Gambling Paradox: Why an Origin-Neutral Zero-Quota is Not a Quota under GATS Article XVI*, 41(6) JOURNAL OF WORLD TRADE 1297 (2007).

paradox insofar as while a State may be able to stop domestic firms from introducing any new financial product, the foreign financial service provider would be immune to such regulation. Thus, we can safely conclude that GATS and the Understanding on Financial Services have significantly limited the ability of States which have committed to unbound market access to regulate foreign financial service providers.

#### **IV. WAS THE FINANCIAL CRISIS OF 2007 CAUSED BY GATS DEREGULATION?**

Now that we have found out that the main cause behind the Financial Crisis of 2007 was deregulation, and that GATS and the Understanding on Financial Services promote deregulation by limiting the ability of States to regulate financial services, let us investigate whether the deregulation caused by GATS was the source of the global economic crisis.

The Gramm–Leach–Bliley Act of 1999 is cited as a major cause for reduction in differences between commercial and investment banks, which in turn led to the higher risk appetite of commercial banks, and subsequently the failure of such banks which marked the lowest point of the Financial Crisis of 2007. Interestingly the WTO website itself concedes that:

“With falling barriers to entry in the financial services industry, the differences between financial institutions have been eroded, and an increasing number of competitive services and products are being offered by different types of institutions. For example, commercial banks have been allowed to enter into investment banking, finance companies provide

banking products, and insurance companies also provide different forms of financing.”<sup>41</sup>

Thus, *prima facie*, it seems that GATS-led deregulation led directly to the Financial Crisis of 2007. But let us have a look at the empirical data. 102 countries<sup>42</sup> made varying commitments towards banking and other financial services, 33 countries<sup>43</sup> signed the Understanding on Financial Services, and although the global economic situation affected all the national economies, the most affected primarily are: USA and Iceland;<sup>44</sup> Greece, Ireland, Portugal, Italy, and Spain (affected by the secondary ripple in the form of the European Sovereign Debt Crisis) and developing countries which depended on exports. As per the Department for International Development, UK, “By the end of 2009, developing countries may have lost incomes of at least \$750 billion – more than \$50 billion in sub-Saharan Africa”.<sup>45</sup>

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<sup>41</sup> WTO, Development in Financial Sector, [http://www.wto.org/english/tratop\\_e/serv\\_e/finance\\_e/finance\\_devel\\_e.htm](http://www.wto.org/english/tratop_e/serv_e/finance_e/finance_devel_e.htm).

<sup>42</sup> Refer to the appendix for the complete list of countries.

<sup>43</sup> Includes almost all the OECD members, as well as a few developing countries like Nigeria, Sri Lanka and Turkey, [http://www.networkideas.org/featart/feb2010/print/prnt080210\\_WTO.htm](http://www.networkideas.org/featart/feb2010/print/prnt080210_WTO.htm).

<sup>44</sup> With the collapse of 3 major domestic commercial banks of Iceland – Landsbanki, Kaupthing and Glitnir, a partial bankrun in UK, rapid devaluation of Icelandic króna – Iceland is thought to have suffered most (relative to its size) in the global economic crisis of 2007. *See also, Cracks in the Crust*, THE ECONOMIST (11 December 2008), [http://www.economist.com/node/12762027?story\\_id=12762027](http://www.economist.com/node/12762027?story_id=12762027); Rok Spruk, *Iceland's Financial and Economic Crisis: Causes, Consequences and Implications*, EUROPEAN ENTERPRISE INSTITUTE POLICY PAPER NO. 2010-1 [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1574296](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1574296).

<sup>45</sup> DFID, Statement by Douglas Alexander, Secretary of State, Chatham House, London (2009), <http://www.dfid.gov.uk/news/files/speeches/sos-wb-speech.asp> as cited in Dirk Willem te Velde, *The global financial crisis and developing countries: taking stock, taking action*, OVERSEAS DEVELOPMENT INSTITUTE BRIEFING PAPER 54 (2009), <http://www.odi.org.uk/resources/download/2822.pdf>.

Similar to the USA, Iceland had also deregulated its financial sector starting in 2000,<sup>46</sup> which allowed the banks to incur heavy debts and at the time of the credit crunch when the banks could not refinance their debts they collapsed.<sup>47</sup>

It would be tempting to blame the deregulation of financial service in the USA and Iceland in 1999 and 2001 to their commitments to GATS and the Understanding on Financial Services. However, the primary ‘beneficiaries’ of these deregulatory legislative amendments were domestic banks and financial institutions.<sup>48</sup> Although one may argue that these deregulations would be equally applicable to foreign institutions, empirical evidence shows that the crisis was never borne by the foreign institutions. In the USA, the crisis was led by New Century Financial Corporation, American Freedom Mortgage, American Home Mortgage, Lehman Brothers, Bear Stearns, Fannie Mae and Freddie Mac, among others. All these financial institutions were home-grown just like Landsbanki, Kaupthing and Glitnir, the failed banks of Iceland. Deregulation by GATS should logically always benefit the foreign entrant as it is fundamentally based on liberalisation, but evidence shows that deregulations in the USA and Iceland did not help any foreign institution in any greater way than domestic institutions and the crisis was largely brought about by the domestic financial sector.

Furthermore, in order to effectively tackle the Financial Crisis of 2007, the USA brought in a number of legislations like the Banking (Special Provisions) Act of 2008,

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<sup>46</sup> Robert Jackson, *The big chill*, FINANCIAL TIMES (15 November 2008), <http://www.ft.com/cms/s/0/8641d080-b2b4-11dd-bbc9-0000779fd18c.html?ftcamp=rss#axzz19ocNFIMw>; Gudrun Gunnarsdottir and Maria Strömquist Sveriges, Vol. 2010:2 *Money Market Funds and Financial Stability*, RIKSBANK ECONOMIC REVIEW (2010), [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1632474](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1632474); *See also*, Spruk (n 32) for an alternative view that deregulation did not cause/lead the Icelandic banks to fail.

<sup>47</sup> Glitnir bank was nationalised. Landsbanki and Kaupthing were placed into receivership and reorganised

<sup>48</sup> *See* Gould (n 4).

the Economic Stimulus Act of 2008, the Emergency Economic Stabilization Act of 2008, and the Housing and Economic Recovery Act of 2008. The common thread running through all these legislations was regulation of the respective markets and offsetting any prior deregulation. If the prior deregulation which brought about the Financial Crisis was because of GATS commitments, then, arguably, the regulatory measures imposed post crisis would be GATS incompatible. However there is little argument in the public domain that any action taken by the governments, including bailouts, is in any way contrary to GATS. On the contrary, the Background Note by the WTO Secretariat in fact indirectly supports regulation when claiming that the cause of the Financial Crisis of 2007 was “excesses in monetary policy or the build-up of a bubble in real estate markets, and the policies that could potentially curb the detrimental effects arising from those situations, are in no way connected to liberalization commitments undertaken by Members. On the other hand, malfunctions of the financial services sector in recent years seem to be more related to idiosyncrasies of the sector (e.g. search for yield, absence of due diligence, lowering of lending standards) and regulatory loopholes (e.g. regulatory arbitrage, inadequate capital and liquidity regulation, unregulated suppliers). Even though a large exposure to foreign financial institutions and markets may exacerbate the transmission of shocks (IMF 2007), the crisis cannot be attributed to the involvement of foreign financial institutions *per se*.”<sup>49</sup>

## V. CONCLUSION

Thus we have three apparently conflicting findings: first, GATS and the Understanding on Financial Services promote deregulation “of financial institutions and instruments of capital flow”; second, deregulation was the main cause of the

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<sup>49</sup> C.F. WTO secretariat (n 2) 25.

Financial Crisis of 2007; and third, the measures to offset the Financial Crisis of 2007 are not GATS incompatible. The only way to harmonise the seemingly insurmountable disagreement is to conclude that though by making specific commitments under GATS and signing the Understanding on Financial Services, States have significantly limited their ability to regulate financial services, such a 'GATS specific deregulation', this did not lead to the spread of the global economic crisis.

However the Financial Crisis of 2007 does call into question the neo-liberal economic policies of *laissez faire*. It may have been that the present crisis was not borne by foreign financial institutions, but the ascendancy of neo-liberalism was definitely one of the root causes of deregulation of domestic financial services which culminated in the financial crisis. Thus, the deregulation caused by GATS may as well lead to the next economic crisis and such a danger can never be ignored as pointed out by the United Nations in the following words, "The framework for financial market liberalization under the Financial Services Agreement of the General Agreement on Trade in Services (GATS) under the WTO and, even more, similar provisions in bilateral trade agreements may restrict the ability of governments to change the regulatory structure in ways which support financial stability, economic growth, and the welfare of vulnerable consumers and investors."<sup>50</sup>

The Financial Crisis of 2007 has shown that there are systemic failures in the argument of neo-liberalism and thus the need of the hour is "an inclusive and comprehensive international regulatory framework" which can pre-empt and effectively tackle crisis. To sustain and stimulate financial growth it is imperative that attention and efforts are diverted towards promoting real growth through

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<sup>50</sup> *Stiglitz Report (n 2) 82.*

manufacturing and service sectors rather than encouraging shadow banking practices and financial innovations. While financial liberalisation may be beneficial to developed economies and a select few large developing countries, there has to be a critical review of the 'assured benefits' of financial service liberalisation, in a multilateral trade framework, to developing and least developed countries.<sup>51</sup> Until then the developed countries should refrain from asking for greater liberalisation in the financial sector from such countries.

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<sup>51</sup> *See generally*, Stiglitz Report (n 2) 104.