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Do rules on financial services trade hinder macroprudential regulation?

Macroprudential policy to address systemic risk in the financial sphere has come to occupy a central spot on the financial regulation agenda following the global crisis. Questions arise, however, as to whether such regulatory measures may fall foul of existing rules governing cross-border banking and capital movements, including provisions enshrined in the WTO's General Agreement on Trade in Services (GATS).

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Global unemployment rose in 2013 amidst weak recovery

More people worldwide are joining the ranks of the jobless as the global economic recovery is held back by weak aggregate demand, according to the International Labour Organization.

by Kanaga Raja

GENEVA: The uneven economic recovery has impacted on the global employment situation, with almost 202 million people being unemployed in 2013, an increase of almost 5 million compared with the previous year, the International Labour Organization (ILO) has said.

In its latest *Global Employment Trends 2014* report, the ILO said that the bulk of the increase in global unemployment is in the East Asia and South Asia regions, which together represent more than 45% of additional jobseekers, followed by Sub-Saharan Africa and Europe.

By contrast, it noted, Latin America added fewer than 50,000 additional unemployed to the global number – or around 1% of the total increase in unemployment in 2013.

Overall, the crisis-related global jobs gap that has opened up since the beginning of the financial crisis in 2008, over and above an already large number of jobseekers, continues to widen, the ILO report cautioned.

In 2013, this gap reached 62 million jobs, including 32 million additional jobseekers, 23 million people that became discouraged and no longer look for jobs, and 7 million economically inactive people that prefer not to participate in the labour market.

"If current trends continue, global unemployment is set to worsen further, albeit gradually, reaching more than 215 million jobseekers by 2018."

During this period, around 40 million net new jobs would be created every year, which is less than the 42.6 million people that are expected to enter the labour market every year. The global unemployment rate would remain broadly constant during the next five years, at half a percentage point higher than before the crisis.

"What is urgently needed is a policy rethink. Stronger efforts are needed to accelerate employment creation and to support enterprises that create jobs," said ILO Director-General Guy Ryder in a press release.

Dampened demand

According to the ILO report, a faster recovery in global labour markets is held back by a deficit of aggregate demand. In this respect, the fiscal consolidation currently under way in many advanced economies constitutes a drag on faster expansion of output growth, in addition to weak private consumption.

A rebalancing of macroeconomic policies and increased labour incomes would significantly improve the employment outlook, the report said, adding that simulation results suggest that in high-income G20 countries, such a rebalancing could reduce unemployment by 1.8 percentage points by 2020, which corresponds to 6.1 million additional jobs.

The ILO further noted that monetary policy continues to be accommodative, providing a beneficial stimulus to aggregate demand. Estimates of the impact of the current monetary policy regime show that unemployment would have been 1-2 percentage points higher in large advanced economies if policymakers had not undertaken swift monetary action in the face of the financial crisis.

"Recent trends, however, indicate that an increasing share of the additional liquidity generated by such accommodative monetary policy is flowing into asset markets rather than into the real economy. This is generating the risk of future stock and housing price bubbles, potentially weighing on sustainable job recovery."

The ILO stressed that with 23 million people estimated to have dropped out of the labour market due to discouragement and rising long-term unemployment, active labour market policies need to be implemented more forcefully to address inactivity and skills mismatch.

It noted that currently only small amounts of public spending go into ac-

tive labour market measures. Even in OECD countries, which tend to have relatively advanced institutions and practices in this respect, an average of less than 0.6% of GDP was spent on such measures in 2011.

Estimates show that by bringing spending up to 1.2% of GDP, similar to those countries that spend the most on active labour market policies, an additional 3.9 million jobs could be created in the Developed Economies and European Union region.

Weaker economic growth

According to the report, in 2013, global economic growth slowed down to 2.9%, its lowest rate since 2009 and more than 1 percentage point below the average annual growth rate over the pre-crisis decade. Economic growth in emerging economies slowed down significantly whereas a modest pickup in activity was recorded in advanced economies towards the end of the year.

"However, downside risks continue to predominate at the global level as aggregate demand is weak and macroeconomic uncertainty remains elevated."

Weaker economic growth in emerging and developing countries reflects both low aggregate demand, particularly for their exports, and global financial instability associated with macroeconomic policy conditions in advanced economies.

"Recent outflows of capital from emerging markets in expectation of a less accommodative monetary policy stance in the United States have highlighted their vulnerability to volatile capital flows and external policy developments," said the report.

The slowdown in emerging and developing countries is also a result of adjustment problems that have clouded the medium-term economic horizon. After a rapid catch-up, some large emerging and developing countries are facing significant bottlenecks, notably in terms of infrastructure and human capital, which are likely to weigh on growth in the coming years.

According to the ILO, the world economy is expected to see a modest recovery, with growth of 3.6% in 2014, mainly driven by a pickup in activity in advanced economies.

However, the ILO argued that economic growth projections have consistently proved too optimistic over the past two years. In fact, several international organizations, including the International Monetary Fund (IMF), expected the recovery to occur much earlier. Projections had to be revised downwards repeatedly, illustrating a broader problem with the assessment of the foundations of future growth.

"Unless a more solid foundation for future growth is built, the growth projections for 2014 may fail to materialize once again, thereby adversely affecting the employment outlook," it cautioned.

(Un)employment trends

According to the report, labour markets have been affected by the slower-than-projected economic recovery. Employment growth slowed down in 2013 across most regions, leading to a further upward revision of unemployment rates. Global employment grew by a mere 1.4% in 2013 – broadly unchanged from 2012, but lower than in any year of the pre-crisis decade.

Employment growth deteriorated in every geographic region except South Asia and North Africa. Indeed, it was the strong acceleration of employment growth in South Asia that helped keep global employment growth stable in 2013 compared with 2012. The largest slowdowns occurred in Central and South-Eastern Europe and CIS (Commonwealth of Independent States), Latin America and the Caribbean and South-East Asia and the Pacific.

As a consequence, the crisis-related global jobs gap, measuring the number of jobs lost in comparison to pre-crisis trends, widened further to 62 million workers in 2013. As unemployment continues to persist, by 2018, the global gap is projected to rise to 81 million; this includes some 30 million discouraged workers who might never come back to the labour market.

The global unemployment rate remained at 6.0% of the global labour force, unchanged from 2012. The number of unemployed around the world is estimated to have reached 201.8 million in 2013, an increase of 4.9 million from a revised 196.9 million in the previous year. There were 31.8 million more unemployed persons around the world in 2013 than in 2007, prior to the onset of the global economic crisis.

On the basis of current macroeconomic projections, the ILO expects little improvement in the global labour market in 2014, with the global unemployment rate ticking up to 6.1% and the number of unemployed rising by a further 4.2 million.

In the Developed Economies and European Union region, 8.6% of the labour force is unemployed, which is almost 3 percentage points higher than in 2007. Unemployment rates in the United States and the United Kingdom have declined, whereas they have edged up further in Italy and France. Only small improvements in the unemployment rate were seen in Canada, Japan and Germany.

In the medium term, only the United States is expected to see substantially declining unemployment rates, and even there, the unemployment rate is projected to remain above pre-crisis levels. For other G7 countries, the unemployment rate is not projected to move substantially from current levels for the foreseeable future.

Across the regions, the highest unemployment rates are observed in North Africa and the Middle East, at 12.2% and 10.9% respectively in 2013, largely unchanged as compared with 2012.

In Central and South-Eastern Europe and CIS, the unemployment rate remained relatively high in 2013, at 8.2%, with an estimated increase of the unemployment rate in Turkey and the Russian Federation.

Latin America and the Caribbean only saw a marginal decline in its regional unemployment rate, which edged down from 6.6% to 6.5%. In Brazil, the unemployment rate went down slightly, while it ticked up in Mexico and Argentina. No significant changes in the regional unemployment rate are forecast in the year to come.

In all other regions, said the ILO, unemployment rates remained roughly unchanged in 2013 as compared with the year before.

It found that the labour market outlook for young people worsened in nearly every region of the world. The global youth unemployment rate rose to 13.1% in 2013, from 12.9% in 2012 and 11.6% in 2007.

The largest increase occurred in the Middle East region. This region has one of the highest youth unemployment rates in the world, with 27.2% of young people in the labour force without work in 2013, versus 26.6% in 2012.

Central and South-Eastern Europe and CIS, East Asia, South-East Asia and

the Pacific and North Africa all saw a substantial increase in youth unemployment rates, while in the Developed Economies and European Union, the region that registered the largest increase in youth unemployment rates over the period 2007-12, unemployment among young people rose further to 18.3% of the youth labour force.

In total, 74.5 million young people aged 15-24 were unemployed in 2013, an increase of more than 700,000 over the previous year. There were 37.1 million fewer young people in employment in 2013 than in 2007, while the global youth population declined by only 8.1 million over the same period.

The global youth labour force participation rate, at 47.4% in 2013, remains more than 2 percentage points below the pre-crisis level, as more young people, frustrated with their employment prospects, continue to drop out of the labour market.

According to the ILO, the global youth unemployment rate is expected to edge up to 13.2% in 2014, with increases projected in the three Asian regions and in the Middle East, partially offset by a projected decline in the Developed Economies and European Union region.

In addition to the slowdown in employment and increase in unemployment, the last year has also seen a notable deceleration in wage employment growth, which expanded by only 28.1 million in 2013, down sharply from the annual growth of more than 35 million over the previous two years. Central and South-Eastern Europe and CIS, East and South Asia saw the largest deceleration in wage employment growth as compared with 2012.

In contrast to wage employment trends, vulnerable employment (comprising own-account workers and contributing family workers) around the world increased by 13.4 million in 2013 compared with an increase of only 5.3 million in 2012 and 3.3 million in 2011.

The ILO also highlighted that the average duration of unemployment has gone up in many economies. In the United States, the average unemployed worker found a job after 3-4 months of job search prior to the crisis, but the average duration increased to around 6 months in 2012. In Spain, unemployment duration increased from around 5 months in 2008 to 8 months in 2012.

In Greece, where the average unemployment duration has always been high, the unemployed now wait on average more than 9 months before getting back into the workforce, more than 1 month longer than in 2009. Other developed countries experienced similar increases in unemployment duration.

In several developing and emerging countries, in contrast, the average unemployment duration has trended downwards and the global economic crisis had only a slight impact on unemployment duration, said the ILO.

Skewed incentives

Touching upon the issue of monetary policy, the report said that the extended period of low interest rates and unconventional monetary policy measures is likely to have adverse effects on employment by skewing firms' incentives towards an expansion of capital rather than hiring.

Indeed, it noted, currently stagnant labour market trends are a paradox when viewed alongside trends in corporate profits, which were at an all-time high at the end of 2013.

While hiring remains weak, many firms have been taking advantage of exceptionally low interest rates to issue debt. In 2012, firms in the United States issued $1.36 trillion in debt, up more than 20% even from the elevated levels during the boom years of 2006 and 2007 and an increase of around 90% compared with the average annual debt issuance registered between 2000 and 2005.

The trend persisted into 2013: in the first 10 months of 2013, US corporate debt issuance was up a further 5.2% compared with the same period in 2012.

The rise in corporate profits and inexpensive borrowing did not, however, spark an investment boom in the real economy. Rather, companies have decided to pay ever larger dividends to their shareholders.

Over the 12 months to September 2013, dividend payments from S&P 500 firms totalled $329 billion, which is more than double the level from 2003 and 37.6% greater than the average over the prior 10 years. In addition, firms have been buying back their own shares, and issuing debt to do so, with the aim of further bolstering share prices.

"A situation has thus emerged in which fiscal support remains too weak to jump-start a strong economic and labour market recovery, and monetary policy, which remains strong and has provided needed support, may also be contributing to some of the observed weaknesses in labour markets and to increased inequality."

In this context, the ILO recommended three key areas of policy focus, namely addressing weak aggregate demand through improved labour incomes and less fiscal consolidation; addressing high hiring uncertainty through better policy coordination; and addressing inactivity and skills mismatch through active labour market policies. *(SUNS7726)* ❒

TPPA talks to hot up in early 2014

Due to the United States political calendar and Congressional politics, the negotiations for a Pacific region trade pact will heat up in the first few months of the year.

by Martin Khor

One of the major developments in the new year will be the negotiations and in fact the fate of the Trans-Pacific Partnership Agreement (TPPA), which has stirred a lot of interest and controversy in the United States, whose government is its prime mover.

The first half of 2014 will be decisive because the US will hold mid-term Congressional elections in November, and that nation's attention will focus on that after mid-year.

Since free trade agreements are so controversial and in fact unpopular among the public in that country, the TPPA and other FTAs will be hard for the US president and his administration to champion near the election period.

This may explain why the US is in such a hurry to finish the TPPA negotiations as soon as possible. It had placed a deadline of end of 2013, but that has passed without success. Indeed, the ministerial meeting in Singapore in the first half of December revealed many outstanding differences.

So, the negotiations will become even more intense in the next few months, with a possible ministerial meeting in February.

Malaysian concerns

Malaysia is one of the significant countries in the TPPA talks that have raised several concerns about the negotiating proposals by the US. Prime Minister Najib Abdul Razak, at a meeting in

Bali last October, highlighted government procurement, state-owned enterprises, the investor-state dispute system and intellectual property as some of the issues that may infringe on sovereignty, implying that there should be careful consideration and caution during the negotiations.

The US Trade Representative Michael Froman visited Malaysia a number of times to meet with some ministers and parliamentarians. He reportedly assured them of the US' understanding of Malaysia's concerns, which he implied would be taken into account.

Malaysians are thus waiting to see how much flexibility will be given to accommodate the various concerns of the public and the government.

For instance, Malaysia formally proposed a comprehensive "carve-out" (exclusion from disciplines in the TPPA chapters) for tobacco control measures, a move that was advocated by health groups and the Health Ministry, and which has won warm congratulations from the public and media around the world, including in a *New York Times* editorial.

According to media reports, Malaysia has also opposed proposals for tight intellectual property rules that for instance extend the present terms for patents for medicines, and asked for high thresholds for government procurement, and exemption for its Bumiputra affirmative action policies, while also challenging the proposed disciplines on state-owned enterprises and the investor-state dispute system.

On goods market access, Malaysia will also find difficulties with the proposed ban on export duties. Recently the association of palm oil refining companies warned that their operations would be threatened or have to shut down if the TPPA forces the country to abolish its longstanding export tax on crude palm oil. A ban would also cause the government to lose around RM2 billion annually in revenue, which would be a serious blow to efforts to reduce the budget deficit.

The question is whether Malaysia's demands will be met. Even if compromises or flexibilities are offered, it is crucial to examine how genuine or adequate they are.

Often, the only "flexibility" is a longer period granted to implement the specific rule in question. That is not really much use.

Even if an exemption is given, it may be limited or useless. For example, in an early version of the investment chapter of the TPPA, available on the Internet, there is a clause that nothing in the chapter prevents the countries from undertaking health and environmental policies. But it also says that this is provided those policies are consistent with the chapter, thereby negating the apparent space provided for exclusion.

Thus the devil is really in the details, as the saying goes. And the details have to be carefully scrutinized, because it is an old negotiating tactic to show a spirit of understanding and compromise politically but remain steadfast and uncompromising in the legal text, and it is the latter that counts.

Constrained on compromise

Another key point is that the US negotiators and government have little room to provide compromises even if they want to. That is because it is the US Congress that has the real power over trade matters, including the TPPA.

In January some members of Congress introduced a bill to provide the US president with "fast-track authority", which means that a trade agreement like the TPPA can only be adopted or rejected by Congress but cannot be amended by it. Without this fast-track authority, there is no confidence among other countries that what the US negotiators agree to or sign will be agreed to by Congress, which can reject certain parts of the TPPA and demand changes.

As a condition for giving the fast-track authority, the advocates are asking the US government to take a strong stand on issues. This puts pressure on the US negotiators not to compromise, even if they wanted to.

For example, the bill says that on state-owned enterprises the US should seek commitments that eliminate unfair competition favouring SOEs doing commercial activity and ensure that their practices are based solely on commercial considerations. Government policies and the SOE practices would have to abide by eliminating discrimination and market-distorting subsidies.

The US is already proposing that SOEs cannot discriminate when they buy and sell goods and services, and that they cannot receive any advantages such as cheaper loans or land and business from the government.

If the definition of SOEs also includes private companies in which government agencies have a share, the net will be cast very wide.

It is however still unlikely that the proposed bill will pass, as many Democrats in Congress are opposed to fast-track authority and some Republicans just don't want to give President Barack Obama anything he wants.

But here's the problem. If fast-track authority is given with the conditions attached, the US negotiators will have to abide by them and can't show required flexibilities. On the other hand, if there is no such authority, the proposed texts agreed to by the US can more easily be rejected by Congress.

Either way, there is only so much the US negotiators can give in response to demands made by other countries in the TPPA talks, and even then the compromises can be rejected by Congress.

All this goes to show how difficult free trade agreements are to negotiate or conclude when the US is involved, for commerce and politics are all mixed up in the pot. ❒

Martin Khor is Executive Director of the South Centre, an intergovernmental policy think-tank of developing countries, and former Director of the Third World Network.

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Macroprudential regulation: Potential implications for rules for cross-border banking

Despite recognition of the importance of macroprudential policy in the wake of the global financial crisis, existing rules governing trade in banking services may afford inadequate scope for such regulation.

by Andrew Cornford

In the post-crisis agenda of the reform of financial regulation, macroprudential policy has been assigned central importance. Macroprudential policy is directed at the financial system as a whole rather than individual financial institutions. In the words of a recent report of the Group of Thirty, "Macroprudential policy aims to enhance the resilience of the financial system and to dampen systemic risks that arise and propagate internally in the financial system through the interconnectedness of institutions by virtue of common exposure to shocks and the tendency of financial institutions to act in procyclical ways that magnify the extremes of the financial cycle" (Group of Thirty, 2010: 21).

So defined, the scope of macroprudential policy covers not only banking crises but also macroeconomic or sovereign crises whose impact extends to the banking sector. The role now attributed to macroprudential policy is having major effects on the landscape of regulatory measures included in both national and international reform agendas. Systemic risk is a longstanding concern of financial regulation and supervision, and is part of the rationale for lender-of-last-resort financing for banks. But the attention given to macroprudential policies, i.e., policies targeting systemic risk, since the start of the current crisis is leading to the development of a more unified and better articulated framework for measures for this purpose.

Much of the discussion which follows concerns the rules of the General Agreement on Trade in Services (GATS) in the World Trade Organization (WTO) for international trade in banking services, a term which covers not only cross-border transactions in banking services but also the commercial presence of foreign banking firms. The reason for this approach to discussion of the implications of macroprudential regulation is that the GATS constitutes a single coherent set of rules that highlights major dimensions of the relationship between banking regulation and cross-border banking transactions which are also relevant for other international agreements. Thus problems potentially posed by macroprudential regulation to GATS rules have implications also for bilateral and regional trade and investment agreements which include provisions for capital movements and cross-border transactions in banking services with often more far-reaching obligations as to liberalization than the GATS. For such agreements, as for the GATS, there is a question as to whether they provide adequate policy space for the prudential regulation of banking transactions currently being developed and introduced.

Capital controls, prudential regulation and GATS rules

Since the completion in 1997 of the negotiation of commitments on international trade in financial services under the GATS, several organizations and commentators have raised questions as to what prudential measures are covered by the prudential defence measure (PDM) of the Annex on Financial Services of the GATS, and as to whether the PDM together with other GATS rules provide adequate scope for the use of capital controls.

Under the section on domestic regulation of the Annex, according to the PDM, "Notwithstanding any other provisions of the Agreement, a Member shall not be prevented from taking measures for prudential reasons, including for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial service supplier, or to ensure the integrity of the financial system." However, the latitude thus provided for regulatory measures is followed by an anti-circumvention qualification: "Where such measures do not conform with the provisions of the Agreement, they shall not be used as a means of avoiding the Member's commitments or obligations under the Agreement."

The inclusion of the PDM in the GATS was the outcome of contentious negotiations during which several developing countries sought substantial freedom from possible challenge under the GATS for prudential measures. The qualified acceptance in the PDM of countries' right to take prudential measures reflected also the conflict with the dominant view of the developed countries participating in the negotiations regarding the benefits in comparison with the costs of the liberalization of international trade in financial services, that is to say of both cross-border financial transactions and of restrictions on the commercial presence of foreign financial institutions.

The practical scope of the PDM has been the subject of much disagreement. The definitions of the terms "prudential" and "fiduciary" were left open. This lacuna seemed important primarily with respect to prudential measures. As the Asian financial crisis unfolded during the same period as the completion of the WTO negotiation of commitments on international trade in financial services at the end of 1997, the question arose whether the PDM covered only measures taken to protect financial sectors from collapse during and in the immediate aftermath of the banking crises or whether it also covered prudential reforms undertaken as part of the longer-term restructuring of countries' banks and regulatory regimes which followed. This question has re-emerged with a vengeance in the context of the massive, long-term restructuring of prudential regimes in response to the faultlines – primarily in the regimes of developed countries – revealed during the current financial crisis which began in 2007.

A second question concerned relations between prudential measures, banking crises and capital controls. Although typically imposed in response to balance-of-payments prob-

lems, capital controls will generally have effects not only on the country's macroeconomy but also on its banks owing to the effects of capital inflows and outflows on both the scale and currency denomination of assets and liabilities in banks' balance sheets. In a report of 2000 a working group on capital flows of the Financial Stability Forum, the predecessor body of the Financial Stability Board (FSB), accepted the idea that there are circumstances in which the introduction of capital controls can be justified as a prudential measure both for macroeconomic reasons (for example, unwanted movements of the exchange rate and consequent complications of domestic monetary policy) and "to reinforce or complement prudential requirements on financial institutions" (Financial Stability Forum, 2000: 34-37).

The connection drawn here between the prudential and the macroeconomic objectives of capital controls would appear to place such controls in the category of macroprudential measures, although "macroprudential" was not yet a standard term. The working group of the Financial Stability Forum limited its imprimatur to controls over capital inflows. Controls over capital outflows were excluded, not altogether convincingly, on the grounds that these "should be thought of more as an element of crisis management and, as such, are beyond the scope of this paper".

Since the beginning of the current crisis the official view of the relation between macroprudential measures and capital controls has been clarified and extended.

For example, in a recent document on capital flow management measures (CFMs, the current IMF term for capital controls) and macroprudential measures (MPMs), the International Monetary Fund (IMF) draws a distinction between the two on the basis of their primary objectives: "CFMs are measures ... that are designed to limit capital flows, while MPMs are prudential tools that are primarily designed to limit systemic financial risk and maintain financial system stability." However, the IMF also acknowledges that there are situations where CFMs and MPMs overlap: "To the extent that capital flows are the source of systemic financial risks [which they have been in several financial crises], the tools used to address those risks can be seen as both CFMs and MPMs. An example could be when capital inflows into the banking sector contribute to a boom in domestic credit and asset prices. A restriction on banks' foreign borrowing ... would aim to limit capital inflows, slow down domestic credit and asset price increases, and reduce banks' liquidity and exchange rate risks. In such cases the measures ... would be considered both CFMs and MPMs" (IMF, 2012: 21).

The IMF now accepts a temporary role for CFMs on capital outflows for countries which face domestic or external shocks which are large relative to the ability of either macroeconomic adjustment or financial sector policies on their own to handle. "When a crisis is considered imminent, CFMs may be desirable if they can help prevent a full-blown crisis" (IMF, 2012: 25). Although in the IMF's view "the outflow CFMs should always be part of a broader policy package that also includes macroeconomic, financial sector, and structural adjustment to address the fundamental causes of the crisis" (i.e., part of a policy package generally including a number of macroprudential measures), the IMF avoids the use of the term "macroprudential" in the context of outflow CFMs. Such fine distinctions are likely to be lost outside the institutional setting of IMF discussions, with the result that in many situations and for many people the terms MPM and CFM are likely to be used interchangeably.

How far are these changing views concerning capital controls and macroprudential regulation accommodated by the rules of the GATS?

Restrictions on capital movements are covered in Articles XI and XII and in a footnote of Article XVI of the GATS. Article XI.2 prohibits restrictions on capital transactions related to a country's commitments as to market access and national treatment. However, according to Article XII, this prohibition may be overridden by a country's need to undertake actions to safeguard the balance of payments in the event of serious external financial difficulties. Consultations concerning the need to take such actions are to be based on statistical and other empirical findings of the IMF and on the Fund's assessment of the country's external financial position. The footnote of Article XVI, which covers the rules for the granting of market access to services suppliers, specifies that capital movements integrally related to commitments regarding cross-border supply of banking services must be allowed, as must transfers of capital related to commitments regarding supply of services through a commercial presence.

In the context of macroprudential policy, capital controls may be necessary not only in classical balance-of-payments crises where the policy challenge is the exhaustion of a country's foreign-exchange reserves but also for handling difficulties caused by excessive upward pressures on exchange rates due to capital inflows (as acknowledged in the IMF document quoted earlier). A number of emerging-market countries have experienced such pressures during the current crisis.

Capital controls in response to such pressures have a history which also includes their deployment by developed countries during periods of currency turbulence in the 1960s and 1970s. Capital controls during that period included the requirement of approval, not always granted, for sales to non-residents of German money-market paper and fixed-interest securities issued by German entities with less than four years to maturity; bans on interest on balances held for non-residents at German and Dutch commercial banks; the requirement that Swiss banks charge commissions equivalent to negative interest on deposits owned by non-residents; and discriminatory reserve requirements imposed by Germany, Switzerland and Japan on bank liabilities to foreigners (Mills, 1976: 180-211).

The thinking behind Article XII of the GATS concerns classical balance-of-payments crises. Thus according to Article XII.1, "in the event of serious balance-of-payments and external financial difficulties or threat thereof" restrictions on (cross-border) trade in services are permitted. However, the statement which follows suggests that the Article was intended to be directed at balance-of-payments difficulties associated with capital outflows: "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."

Only case law developed through dispute settlement will determine whether Article XII can justify the deployment of capital controls in the face of difficulties caused by excessive capital inflows as well as by excessive outflows. However, the increased official acceptance of the overlap between pruden-

tial objectives and the objectives of the macroeconomic management of balance-of-payments crises would appear to reinforce the scope which GATS rules provide countries for the use of capital controls. Thus, failing justification under Article XII, the implication of the changed official view is that justification of such controls under the PDM would now be more likely to be effective (although uncertainty due to the anti-circumvention provision which follows the PDM would still remain).

These arguments also have implications for bilateral and regional agreements on trade and investment. If the combination of Article XII of the GATS and the PDM of the Annex on Financial Services does provide scope for the acceptance of capital controls (as suggested above), then in a world where volatile capital movements can pose serious problems for both macroeconomic and prudential policy, analogous scope for the deployment of such controls should surely be included in the rules of such agreements.

Discussion of macroprudential measures and GATS rules in the WTO

The initiative for the first dedicated discussion of macroprudential issues in the WTO came from Ecuador in early 2012. Consultations with other member countries led Ecuador to conclude that there was no consensus on preparing a legal interpretation of the GATS rules in relation to macroprudential regulation or on analysis in the WTO of specific macroprudential measures. Such alternatives, many countries believed, risked narrowing the scope of the existing rules to the possible detriment of WTO members. Ecuador's revised proposal for a free-ranging discussion of the experience of member countries in the implementation of macroprudential policies was subsequently accepted.

The discussion took place at a meeting of the WTO Committee on Financial Services in March 2013.

The discussion was led by Ecuador which described the financial crisis experienced by the country in 1998. The fiscal cost of the bank bailouts amounted to 30% in a single year and 13 of the 15 banks which received government funds became insolvent. The economy was dollarized and an extensive programme of macroprudential regulation was introduced. This included a constitutional ban on bank bailouts, the separation of commercial and investment banking, and the establishment of a liquidity fund to perform the functions of lender of last resort and of a fund for deposit insurance. The impression left by Ecuador was that, in view of the inflexibility introduced into its financial system by dollarization and by the ban on bailouts, the country was conscious of its need for maximum flexibility regarding the other instruments of financial policy in a possible future crisis, including recourse to capital controls.

Two of the countries which explicitly addressed the issue of measures permitted under the PDM were Australia and Canada, both of which expressed the belief that the PDM provided them with the required flexibility for effective prudential regulation. A third was the Republic of Korea (see below).

Other participants in the debate such as Argentina and Brazil expressed concern over volatility of international capital movements since the outbreak of the financial crisis and the resulting need for according countries policy space regarding the use of capital controls. Moreover there was widespread agreement during the debate concerning the need for coordination between the WTO and other bodies responsible for the setting and implementation of financial standards such as the FSB, the Basel Committee on Banking Supervision (BCBS) and the IMF.

An interesting but only briefly fleshed out intervention was made by the Republic of Korea, which saw the need for a distinction between ex-ante measures designed to prevent a crisis and ex-post measures designed to address problems due to the outbreak of crisis. The country accepted that the PDM provided sufficient flexibility regarding ex-ante macroprudential measures. However, it also believed that further discussion was needed on whether the PDM provided sufficient flexibility regarding ex-post macroprudential measures – in particular regarding the issue of whether the measures taken involved the subsidization of government-owned banks.

The reference here sounds as if it was inspired by the country's concern as to whether the sort of measures it took in response to its banking crisis beginning in late 1997 would be covered by the PDM. The restructuring programme of the Republic of Korea included mergers, fresh equity injections, enforced redundancies, management reform, and fiscal support through the Korea Asset Management Corporation (KAMCO) and Korea Deposit Insurance Corporation (KDIC) which amounted to $50 million. During the programme many of the financial institutions involved, owing to their insolvency, were effectively government-owned (Golin, 2000: 489-494). The measures taken by the Republic of Korea could be categorized as ex-post macroprudential.

Omissions from the WTO discussion

Missing from the exchanges at the WTO was detailed discussion of not only the relation of GATS rules to capital controls but also several other issues currently being addressed as part of the agenda of macroprudential regulation. The sequel here takes up the implications for the GATS – and, by extension, for bilateral and regional trade and investment agreements – of two categories of regulation directed at the corporate structure of banks as well as of several measures directed at both banking transactions and the assets and liabilities of cross-border banks.

Resolution of cross-border banks

The development of rules for handling insolvencies of banks with cross-border operations is a longstanding item of the agenda of international financial reform. Progress has been slow owing to the difficulty of achieving agreement concerning the required harmonization of significantly different existing national laws and definitions and concerning the distribution of the costs of the insolvencies among the countries in which firms affected by the insolvency have a commercial presence. Development of rules for the cross-border insolvencies of financial firms is closely linked to the regulation of financial firms too big to fail (TBTF), i.e., financial firms whose failure is a source of systemic risk. Classification of a financial firm as TBTF reflects a view of the systemic risk posed by the failure of such a firm, thus making such a failure an issue for macroprudential policy.

Work on cross-border bank insolvencies by the BCBS and

the FSB was given a fillip by experience of such insolvencies of large cross-border banks during the financial crisis. However, although issues connected to bank insolvencies have been extensively ventilated as part of this work, international agreement is still limited to arrangements designed to smooth resolution when more than one jurisdiction is involved, and does not include an agreed set of model procedures.

Thus the key document of the FSB on resolution regimes (Financial Stability Board, 2011: 13-15 and Annex I) includes the following principles (home jurisdiction being that of the parent bank of a group of cross-border banking entities):

- The mandate of the resolution authority should empower and encourage the resolution authority to achieve a co-operative solution with foreign resolution authorities.
- Regulation should not include provisions that trigger automatic action in response to official intervention or the initiation of resolution or insolvency proceedings in another jurisdiction.
- The resolution authority should have resolution powers over local branches of foreign firms and the capacity to use its powers to support a resolution carried out by a foreign home authority or to take measures on its own initiative where the home jurisdiction is not taking action or is acting in a manner that does not take sufficient account of the need to preserve the local jurisdiction's financial stability.
- Jurisdictions should provide for transparent and expedited processes to give effect to foreign resolution measures, either by way of a mutual recognition process or by taking measures under the domestic resolution regime that support and are consistent with the resolution measures taken by the foreign home resolution authority. Such recognition or support measures would enable a foreign home resolution authority to gain rapid control over the firm or the assets of the firm that are located in the host jurisdiction in cases where the firm is being resolved under the laws of the foreign home jurisdiction.
- The resolution authority should have the capacity, subject to adequate confidentiality requirements, to share information pertaining to the banking group as a whole or to individual subsidiaries and branches with the relevant foreign authorities where such sharing is necessary for the implementation of a coordinated resolution.

In the case of global systemically important financial institutions (G-SIFIs) there are additional provisions concerning the establishment of official crisis management groups with the objective of enhancing preparedness for and facilitating the management and resolution of cross-border crises affecting the firms involved. Key elements of such preparedness are also specified.

But these principles fall short of agreement on the way in which losses should be distributed between different entities in a cross-border banking group – whether, as noted by Paul Tucker, the Deputy Governor for Financial Stability of the Bank of England, to use the Single Point of Entry strategy, under which losses flow to the group's top company, or the Multiple Point of Entry strategy under which the group is broken up into constituent parts for the purpose of resolution (which implies that the host authority of a subsidiary identified for separation must ensure that it has the required capital and operational independence to make possible resolution by the authority) (Tucker, 2013).

In the same speech Tucker notes that the development of international policy on the resolution of insolvent banks is exposing vagueness as to precise requirements of adequate banking regulation and supervision in key international agreements negotiated in the BCBS as they apply to the parent bank and other entities of a cross-border banking group. The agreements in question are the Concordat which establishes the division of labour between home and host authorities, Core Principles for Effective Banking Supervision which enunciates minimum standards for prudential supervision, and the various versions of the Basel Capital Accord. The emphasis in these agreements is on consolidated supervision of the group, accompanied by solo supervision of local entities in different jurisdictions. Overriding supervisory responsibility is attributed to the supervisor of the parent bank but without any guarantee that the capital of the group as a whole is distributed in such a way that each constituent entity is adequately capitalized. The distribution of loss-absorbing capital becomes particularly important when cross-border banks face insolvency.

Corporate form

Enhanced consciousness of this ambiguity and of the inadequate levels of capital at some major international banks during the current crisis (despite apparent conformity with the levels required by the Basel Capital Accords) is leading to a widespread re-examination among banking regulators of the respective merits of the subsidiary and branch forms for cross-border entities.

A recent proposal of the Federal Reserve Board in the United States announced in December 2012 appears to reflect such a re-examination in the context of addressing the risks associated with the increased complexity, interconnectedness and concentration of the US operations of foreign banking organizations. The proposal is as follows:

- A foreign banking organization with both $50 billion or more in global consolidated assets and US subsidiaries with at least $10 billion in total assets would be required to organize its US subsidiaries under a single United States Intermediate Holding Company (IHC), which would facilitate the consistent regulation and supervision of the bank's US operations and, if necessary, the resolution of these operations in the event of failure.
- IHCs would be subject to the same risk-based and leverage capital standards as those applicable to US bank holding companies. This would help to bolster the consolidated capital positions of the IHCs and to promote a level competitive playing field among banks operating in the US.
- Foreign banks with combined US assets of at least $50 billion would be required to meet enhanced liquidity risk-management standards, conduct liquidity stress tests, and hold a 30-day liquidity buffer of highly liquid assets.

This proposal is unlikely to be inconsistent with the WTO commitments of the US. However, the proposal will impose additional costs on some foreign banks with an existing presence in the US. But, more interestingly, the US proposal is consistent with what appears to be part of a more general trend in many countries favouring subsidiarization for foreign banks, that is to say policies which grant foreign banks access to the national market primarily or exclusively in the form of subsidiaries and which may also entail pressure on foreign institutions to transform existing branches into subsidiaries.

Arguments pertinent to subsidiarization not only generally but also in the context of procedures for the resolution of cross-border banks were stated by Duvvuri Subbarao, then Governor of the Reserve Bank of India (RBI), in a speech to the Indian Banks' Association as follows: "First, managerial decisions in subsidiaries are mainly driven by local economic decisions. Second, there is a clear delineation of the capital of the domestic bank from its parent bank, which protects the interests of domestic depositors ... Finally, local incorporation affords greater leverage to host-country authorities than does a branch operation to ringfence the operations of the bank" (quoted in Mehon, 2011: 66).

Considerations such as these no doubt explain the place of wholly owned subsidiaries in the policy recently announced by the RBI under which a larger role will be accorded to foreign banks in India but the granting of "near national treatment" will be linked to the condition of local incorporation. Existing foreign banks, especially those which are systemically important, will be encouraged to adopt local incorporation (Bandyopadhyay, 2013).

In its announcement the RBI linked this new policy to current international discussion of whether the resolution process for global financial institutions should be driven at the level of supervision in the institution's parent country or in its host country: "banks with complex structures, banks which do not provide adequate disclosure in their home jurisdiction, and banks from jurisdictions giving a preferential claim to depositors of home country in a winding up proceeding" would be given access to the Indian market only in the form of a wholly owned subsidiary (*Global Risk Regulator*, 2013: 17).

The question of banks' corporate form has also been raised in other contexts under the reform agenda. For example, the new international regulatory regime will have to accommodate reforms in the US, the United Kingdom and European Union countries designed to achieve the legal separation of many of the activities of retail or traditional commercial banking, on the one hand, and of investment banking, on the other. The three main initiatives or proposals for this purpose are the Volcker Rule in the US, the proposals of the Vickers Report in the UK, and the Likanen Report of the High-level Expert Group on reforming the structure of the EU banking sector (Gambacorta and van Rixtel, 2013).

The Volcker Rule is included in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. With limited exceptions it prohibits deposit-funded, licensed commercial banks in the US and bank holding companies with US affiliates from engaging in proprietary trading and investing in or sponsoring hedge funds and private equity funds.

Under the proposals of the Vickers Commission [embodied in the draft Financial Services (Banking Reform) Bill published in October 2012] banking groups headquartered in the UK would be required to "ringfence" banking services whose temporary interruption would have a significant, unfavourable impact on the domestic economy, in particular households and small and medium-sized enterprises (SMEs). Within its group the ringfenced bank would be a separate legal entity meeting capital and liquidity requirements on a standalone basis and subject to special, higher capital requirements. Certain financial services such as the taking of retail deposits and the provision of overdrafts to individuals and SMEs would be provided only by ringfenced entities. Services excluded from ringfenced banks include those which impede resolution or increase the bank's exposure to shocks from financial markets.

Where the Vickers Commission ringfences domestic deposit-taking activities in a separately capitalized subsidiary, the Likanen Report would carve out proprietary trading and assets, liabilities and derivatives positions incurred in the process of market-making from other banking activities and, with limited exceptions for asset management, securities underwriting and some hedging activities, assign them to a separate legal entity which would have its own capital but could be part of a holding company also including deposit-taking subsidiaries.

In December 2012 the French Ministry of Finance presented a draft law which places certain investment banking and speculative activities in separate banking subsidiaries, while continuing to permit certain investment banking activities to be conducted from the deposit-taking subsidiary of the bank. In February 2013 the German government tabled a proposal broadly along the lines of the Likanen Report but applying only to banks with trading activities exceeding 100 billion euros or 20% of total assets.

At the beginning of the 1990s when "measures which restrict or require specific types of legal entity or joint venture through which a service supplier may supply a service" were included amongst the limitations which countries are to include in their specific commitments according to Article XVI.2 of the GATS, there was a definite preference among the developed countries participating in the negotiation of the GATS in favour of according market access in the form of branches rather than subsidiaries since market access in this form was regarded as the most liberal of the alternatives.

This preference was not generally shared among developing-country participants. Curiously, more recently nonetheless there would appear to have been no public shift in the position of developed countries in the WTO on corporate form. In spite of the regulatory initiatives described above and indications of the more favourable view of subsidiarization even among important developed countries, developing countries have continued to be subject to pressure at the WTO to drop all limitations on legal form in their commitments on market access. However, the trend in official opinion in favour of subsidiarization suggests that, even where measures favouring subsidiarization are not explicitly included in the limitations of a country's GATS commitments under Article XVI, they would now be more likely to be defensible under the PDM.

Capital and liquidity requirements

The rules of the Basel Accords Basel I, Basel II and Basel III – on capital requirements for credit, market and operational risk, and (in Basel III) on the control of liquidity risk – have been the subject of laborious negotiations amongst the member countries of the BCBS and of consultations with non-member countries. The intention of the drafters is that the implementation of the rules should be as far as possible globally uniform to avoid regulatory arbitrage between different jurisdictions.

However, one of the rules concerning capital requirements will inevitably be associated with variations at the level of both countries and individual banks. This is the countercyclical

capital buffer, a macroprudential measure which is designed to prevent financial destabilization due to large losses in the banking sector during an economic downturn following a period of excessive credit growth. National authorities will monitor credit growth and other indicators of potential system-wide risk and put in place countercyclical capital requirements of up to 2.5% of risk-weighted assets when they view such requirements as warranted. The capital buffer will be released when the system-wide risks either crystallize or dissipate.

The level of the countercyclical buffer may vary between jurisdictions and could thus be a potential cause of regulatory arbitrage or leakages via the substitution of cross-border credit provided by banks benefiting from lower buffers or by local branches of such banks. This is to be precluded under Basel III by mutual recognition of national countercyclical capital buffers. All of a bank's lending to a country – cross-border or through a local branch – will be subject to the same countercyclical capital requirement up to the level of 2.5% of risk-weighted assets. Thus the countercyclical capital buffer of cross-border banks and banking groups will be a weighted average of the buffers for credit exposures which apply in each of the jurisdictions to which they have an exposure.

However, there are no such uniform rules for special sectoral capital and liquidity requirements which several jurisdictions (50% of a sample of 46 covered in IMF, 2013: 50) have also imposed or are expected to impose in addition to the capital and liquidity requirements of the Basel Capital Accords.

Special sectoral capital requirements additional to those of Basel III may be applied to exposures such as mortgage lending, unsecured consumer credit or particular subcategories of such credit, lending on commercial property, and lending to other parts of the financial sector – of which the last can be justified on the basis of the role played by intra-bank lending in precipitating and spreading the current financial crisis.

Special liquidity requirements which also supplement or adjust the rules of Basel III may target either banks' assets or their liabilities or funding. Increasing buffers of liquid assets during credit booms can provide banks with larger reserves which can be drawn down to meet margin calls or withdrawals of financing when the boom is followed by contraction. Increasing liquidity during booms can help to moderate cyclical increases in maturity mismatches by curbing credit expansion financed by volatile short-term funding. Supplementary reserve requirements for banks can also be deployed to restrain credit growth.

Included in its list of possible sectoral liquidity requirements by the Bank of England are adjustments to the classification of the liquidity of different instruments and sources of funding covered by the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR) of Basel III. Under the LCR banks must have sufficient high-quality liquid assets to offset short-term cash flows, and under the NSFR banks must have minimum amounts of stable funding in relation to the liquidity profiles of their assets as well as potential liquidity needs arising from off-balance-sheet commitments. The objective of the Bank of England's proposal is to discourage reliance on particular funding sources and overexposures or underexposures to particular illiquid or liquid asset classes (Bank of England, 2011: 35).

Under liquidity requirements New Zealand has introduced a minimum Core Funding Ratio of 65%. A Core Funding Ratio is a regulatory guideline which measures funding considered sustainable throughout the economic cycle (such as retail deposits and long-term wholesale funding) in relation to funding from all sources, which include shorter-term volatile deposits and money-market borrowing. The Republic of Korea has also introduced a series of measures designed to shift banks' funding structure away from the more volatile forms of funding. These include a cap on the loans-to-deposits ratio, ceilings on foreign-exchange derivatives positions (which can be used to hedge short-term foreign-currency funding) and a tax on banks' non-core foreign currency liabilities.

Special sectoral capital requirements may be rendered less effective through various leakages: lending by local branches of foreign banks which are not subject to local regulation; cross-border lending by foreign banks which are not subject to local requirements on prudential capital; and cross-border lending by non-bank financial companies. Similarly leakages could impair the effectiveness of sectoral liquidity rules.

The Bank of England, which expects to apply special sectoral capital requirements to the exposures of banks, building societies and large investment firms to residential property, commercial property and to other parts of the financial sector, has acknowledged the potential risks to the measures' effectiveness from leakages. Thus it intends to monitor leakages to financial firms not covered by its requirements, including those which are cross-border. Action to stem the latter will be taken after consultations with other countries' authorities but presumably could entail restrictions on cross-border lending and discriminatory restrictions on the lending of foreign banks' branches.

Other macroprudential measures

Reduced effectiveness due to cross-border leakages may also apply to other macroprudential measures. For example, restrictions on the levels of Loan-to-Value Ratios and of Loan-to-Income Ratios in the case of mortgage lending could be evaded by cross-border lending by foreign banks, evasion which could be facilitated by the presence in the country of branches of such banks.

Likewise measures restricting lending for macroprudential reasons are also potentially vulnerable to cross-border leakages. For example, foreign banks could lend through wholesale financial markets to non-bank financial institutions not covered by the macroprudential restrictions, which in turn lend to non-financial entities. Non-financial corporations could borrow abroad from foreign banks and then lend within the corporate group to finance local operations. Attention has been drawn to both of these possibilities by the UK authorities (Group of Thirty, 2010: 37).

As in the case of special capital and liquidity requirements, such leakages through cross-border transactions may require efforts to improve policy coordination with the countries of the institutions which are the source of the leakages or, failing the success of such efforts, discriminatory restrictions on the institutions and transactions involved. Defence of such measures if challenged under the GATS rules would probably involve recourse to the PDM. Such a defence would exemplify the way in which the range of prudential measures has been extended from that in the minds of the original negotiators of the rules of the GATS at the beginning of the 1990s.

Concluding reflections

Banking crises typically start with events which trigger changes in sentiment towards a single institution or a group of similar institutions among other banks, the public or both. Their initial manifestation is illiquidity of the institution or institutions affected, i.e., the inability to meet financial obligations as they arise. Illiquidity may not initially be associated with insolvency, liabilities in excess of the value of assets, but generally becomes a threat to institutions' solvency as the value of their assets is threatened by the difficulties of realizing them.

Banking crises are generally associated with both internal and external factors – poor quality of assets and in consequence fragile solvency, management incompetence, and the impact of deteriorating local or national market conditions on both the assets and liabilities of the banks affected. Thus macroprudential policies target banking structure, risk management and the features of crises once they have started.

Whilst systemic and non-systemic banking crises are easy to distinguish at a conceptual level, the distinction is more difficult to make in actual cases. Here one is confronted with the problem of the limits of transparency which chronically dogs analysis of, and thus forecasting based on, available financial data concerning banks such as those for capital, and thus for solvency, which can be – and in times of stress frequently are – manipulated. This problem is well characterized by the statement of two experienced bank credit analysts (Golin and Delhaise, 2013: 701), "What you see is not always what you get."

A consequence is that the character and range of banking interconnections which are capable of causing a systemic crisis can frequently only be identified ex post so that the policies to stem a systemic crisis and to deal with its consequences have to respond as it unfolds and its scope becomes clearer. This opacity implies that the authorities need flexibility regarding the policy response.

The current crisis has highlighted the way in which systemic banking crises originating in one or more advanced countries can become global. As described above, the policy response has included a wide-ranging agenda of prudential reforms, including what are now classified as macroprudential reforms. Some of the measures included in this agenda at national or international level involve restrictions on financial flows and discriminatory restrictions targeting particular cross-border financial institutions and activities. Others target banks' corporate structure and relations between the constituent units of banking groups.

Many of the measures implemented or proposed as part of the reform agenda, especially those classified under the heading of macroprudential which involve (sometimes discriminatory) controls over capital movements in situations where there is no balance-of-payments crisis, may be inconsistent with the GATS or not satisfactorily covered by its rules – unsurprisingly since these rules were drafted during the high noon of global financial liberalization at the beginning of the 1990s. Such inconsistencies also characterize bilateral and regional trade and investment agreements in place or currently being negotiated despite the changes in the intellectual climate concerning banking regulation since the outbreak of the financial crisis, which now places greater emphasis on the need for caution regarding rules concerning cross-border banking activities.

Revisions of provisions on cross-border banking and capital movements in existing bilateral and regional agreements on trade and investment in response to the rethinking of regulation under the head of macroprudential policy will be resisted by major developed countries which are parties to them, but under provisions common to most of these agreements this does not mean that revisions can be indefinitely excluded. One can also hope that the rethinking will have an impact on the treatment of cross-border banking and capital movements in future bilateral and regional agreements.

Member countries in the WTO for the moment have shown sensitivity to the rethinking now under way on cross-border banking and on capital movements. The current situation could be characterized as a mutually agreed armistice in the form of reluctance to test which macroprudential measures might and which might not be challenged as exceeding the latitude for prudential policy that is provided by the PDM of the Annex on Financial Services. The armistice seems likely to continue at least during the period of formulation of the global agenda of financial reform and perhaps well beyond. Nonetheless the question of the scope which the GATS provides for macroprudential as well as microprudential regulation seems likely eventually to need revisiting. ❐

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What happened at the Bali WTO meet and why

The recent Bali Ministerial Conference may have salvaged the WTO's credentials as a negotiating forum, but the deal that was struck was an unequal one. *D. Ravi Kanth* examines how the lopsided Bali outcome was pushed through and what it portends for the future of the WTO.

Just 84 days after assuming office, Roberto Carvalho de Azevedo, the new Director-General of the World Trade Organization, managed to produce a successful outcome to a WTO ministerial meeting, something that had eluded his predecessor for eight years. The WTO's ninth ministerial meeting, held on 3-7 December in Bali, Indonesia, was a "personal triumph" for Azevedo, who took office only three months before the ministerial.

Given the pronounced descent of the organization towards irrelevance since 2005 under the leadership of the previous Director-General Pascal Lamy, the "Azevedo effect" has dispelled the cycle of negative perceptions that the WTO cannot deliver. The Bali outcome has brought the WTO back into the negotiating orbit. It has suddenly raised the prospect of a revival of the comatose 12-year-old Doha Round of trade negotiations or the Doha Development Agenda (DDA) as it is otherwise called.

An unequal package

The industrialized countries along with a group of advanced developing countries, including China, left no stone unturned in harvesting, at Bali, a WTO agreement on trade facilitation (TF), an agreement that is meant to simplify customs procedures and ease the flow of goods across borders.

Although TF forms part of the Doha Round remit, the manner in which it was plucked out from the DDA single undertaking constitutes an important victory for the United States and the European Union. Without having to deliver on agriculture, which was to be the engine of the Doha trade negotiations, or the "developmental" benefits promised to the least developed countries (LDCs), the trade elephants succeeded in pushing through a grand but grossly unequal Bali package. Without making any "payment" in the other two pillars – agriculture and development – of the Bali package, the industrialized countries have walked away with a prize that can allow them to close their eyes to the need to rescue the larger 12-year-old DDA.

The proclaimed goal of the first "multilateral TF agreement" since the creation of the WTO in 1995 is "to simplify customs procedures by reducing costs and improving their speed and efficiency". In reality, the new agreement streamlines market access in developing countries and LDCs, and further expands the WTO's remit into domestic policy governance. Azevedo, when he was the trade envoy representing Brazil at the WTO, had argued that TF was nothing but market access for industrialized countries. It is another matter that as the WTO chief he campaigned on a war footing for a binding agreement.

The mantra that Azevedo and think-tanks in Washington have chanted endlessly is that the TF agreement will generate an additional $1 trillion to the global economy. There is no consensus on how this estimate has been arrived at, particularly the underlying assumptions. However, this number captured headlines in the global media. "Unfortunately, these figures [about the gains from the TF agreement] depend on too many unjustifiable assumptions to be relied on," says Jeronim Capaldo, an academic at the Global Development and Environment Institute at Tufts University in the US. Capaldo argues that the costs of the TF agreement will be so high that it would divert resources in developing and poor countries from the provision of social safety services.

The future direction of the multilateral trade negotiations will only become clear in the course of this year. The "post-Bali work" programme – on which there was little discussion either in the run-up to the meeting or at the ministerial itself – takes up five paragraphs in the Bali Ministerial Declaration. On the DDA, the declaration says, "We instruct the Trade Negotiations Committee to prepare within the next 12 months a clearly defined work programme on the remaining Doha Development Agenda. This will build on the decisions taken at this Ministerial Conference, particularly on agriculture, development and LDC issues, as well as other issues under the Doha mandate that are central to concluding the Round. Issues in the Bali Package where legally binding outcomes could not be achieved will be prioritized. Work on issues in the package that have not been fully addressed at this Conference will resume in the relevant Committees or Negotiating groups of the WTO."

The Bali declaration candidly admitted that there are no legally binding outcomes in the agriculture and development pillars of the package. There are four issues – general services, public stockholding for food security purposes, understanding on tariff rate quota administration and export competition – in the agriculture pillar. And then there is the issue of trade-distorting subsidies for cotton (provided mainly by the US) that have been hurting some of the poorest countries in Africa and have not been addressed since the Hong Kong ministerial meeting of 2005 which called for an "ambitious, expeditious, and specific" outcome to help the cotton farmers in Benin, Chad, Mali and Burkina Faso. In the development and LDC areas, four issues have been pending since 2005. They include preferential rules of origin for the poorest countries, operationalization of waiver concerning preferential treatment to services and services suppliers in LDCs, duty-free and quota-free market access for these countries, and a monitoring mechanism on special-and-differential-treatment flexibilities. None of these issues were comprehensively addressed in Bali and nothing was treated on par with TF.

Uncertain future for the DDA

The Bali declaration, however, contains a caveat on all these unresolved issues which are presented as best-endeav-

our outcomes so as to enable the US to turn its back on the declaration. "The work programme will be developed in a way that is consistent with the guidance we provided at the Eighth Ministerial Conference, including the need to look at ways that may allow members to overcome the most critical and fundamental stumbling blocks," the declaration says.

This is where the nub lies: at a time when the two trade elephants – the US and the EU who created the WTO as part of the overarching Uruguay Round agreement – are marching ahead with bilateral, regional and plurilateral agreements, the so-called fresh lease of life from the Bali accord to prepare the "work programme" on the core issues in the DDA, especially agriculture, remains uncertain. Indeed, at an informal closed-door meeting in Geneva a week after the Bali meeting, the US was already cautioning about member countries rushing to deal with the difficult issues in the DDA.

After the industrialized countries have tasted victory at the WTO thanks to the able leadership provided by a Director-General from Brazil, it will be a litmus test as to whether the US will support negotiations so that "issues in the Bali Package where legally binding outcomes could not be achieved will be prioritized". More importantly, those who established the WTO like a banyan tree based on a single undertaking of different agreements that include binding dispute settlement rules, intellectual property rules, services, agriculture and various other traditional areas, now want to ditch the multilateral negotiating format because there is nothing more that the WTO as a multilateral body can now offer after the TF agreement.

That the Bali declaration is an eyesore is vividly exposed. A binding TF agreement standing like Mukesh Ambani's 27-floor residence in Mumbai is now surrounded by many unregularized slum dwellings such as an unbaked deal on public stockholding for food security purposes, and several other agreements in the agriculture and development pillars. How these dwellings of the Bali package will be regularized remains a challenge for the developing and least developed countries in the coming months and years.

Dividing countries

The Bali conference provided an early glimpse of what is likely to happen at the WTO. The run-up to the ministerial meeting as well as the proceedings at the conference brought to the fore several inconsistent practices that were adopted to divide the developing and least developed countries, and prevent them from adopting common positions on TF and public stockholding programmes for food security and other issues of interest to them.

Azevedo had deployed all his energies from day one towards aggressively pursuing a strategy that emphasized that a failure at Bali would reduce the organization to an "empty building and empty chairs". Success at Bali, he said in the weeks before the meeting, would restore "confidence" and "breathe" new life into the multilateral trading system. Otherwise, "the world will not wait for the WTO indefinitely". "It will move on ... and it will move on with choices that will be not as inclusive or efficient as the deals negotiated within these [WTO] walls," the Director-General argued. Several members privately likened Azevedo's strategy to "crying wolf" and painting doomsday scenarios for the WTO.

At Geneva ahead of the Bali meeting, the WTO Director-General opted for a combination of sustained open-ended informal meetings as well as closed-door small-group meetings. Though Azevedo has said that "transparency and inclusiveness" are his priorities, he also took recourse to practices that are secretive and difficult to fathom. For example, how descriptive and non-binding outcomes on issues in the development dossier of the Bali package were finalized remains a mystery. The four decisions in this area – duty-free and quota-free market access, cotton, preferential rules of origin for the LDCs, and the services waiver – involved Nepal (the coordinator for the LDCs), the US and the Director-General. In all the four LDC decisions, the US adopted intransigent positions and refused to agree to any binding commitments. Much of the membership was clueless about the actual negotiations. The language that has emerged in the development dossier is all based on "should endeavour to" text and does not contain any binding decisions. Effectively, the four outcomes failed to provide any "concrete", "tangible" and "measureable" immediate market access to bread-and-butter issues of the LDCs. The development dossier was finalized in Geneva in which the poorest countries agreed to the outcomes with which they remained unhappy.

Focus on trade facilitation

The 31-page TF text basically prescribed how developing countries and LDCs "shall publish import procedures, duty rates, and classification/valuation rules; shall issue advance customs rulings where requested; shall provide administrative/judicial review of customs rulings; shall create infrastructure and procedures for expedited shipments of goods coming through air cargo [basically for American courier services]; shall establish procedures for pre-arrival processing; and shall allow authorized operators to move their goods on a fast track."

While the industrialized countries are not required to make any legislative changes for these disciplines as they already have them in place, the developing countries and LDCs are required to make many legislative changes as well as create new physical infrastructure.

The TF agreement is structured into two sections. Section I sets out all the new comprehensive binding disciplines that developing countries and the LDCs are required to implement. Section II contains the roadmap for implementing commitments by these groups of developing countries in Section I, based on technical and financial assistance and a phased time frame. Though the developing and the poor countries sought internal "balance" between the comprehensive binding commitments in Section I and the provision of financial and technical assistance to developing countries and LDCs, the language in Section II is ambiguous and non-binding as regards the financial commitments by the industrialized countries.

Further, the Geneva text on public stockholding programmes for food security was not acceptable to India and Pakistan for different reasons. Argentina expressed reservations on the weak language on export competition disciplines. Despite the sombre and frank assessment delivered at the last WTO General Council meeting in Geneva before members proceeded to Bali, Azevedo chose to pursue a different plan that was not known to members. First, he ensured that the coordinators of the African Group, the African, Caribbean and

Pacific (ACP) Group, and the LDCs sorted out their differences with the US and the EU over the language in Section II of the TF agreement. On a parallel track, a group of countries referred to as Friends of the System goaded the WTO Director-General to do everything possible to reach an agreement at Bali notwithstanding many unresolved technical and legal issues in relation to TF. The Friends included Australia, New Zealand, Canada, Switzerland, Norway, Singapore, Korea, Hong Kong, Malaysia, Costa Rica, Chile and Mexico among others. The EU's Trade Commissioner Karel De Gucht also encouraged the Director-General to do everything that he deemed fit to achieve success at the Bali meeting. The US, however, remained silent without commenting on whether the Director-General must take things into his own hands to deliver an outcome at Bali.

But it is an open secret that the Director-General's overall strategy was premised on the understanding that nothing would move at the trade body without Washington's concurrence. And in order to secure US support, Azevedo believed that issues in the Bali agenda – notwithstanding the structural imbalances – would have to be finalized according to the broad parameters decided by the US. Unlike his predecessor Lamy, who failed to secure Washington's support despite delivering whatever the White House or Congress demanded, Azevedo had built strong and enduring relationships with key US officials ever since he negotiated the compromise package with Washington in the cotton dispute that Brazil won at the WTO.

Negotiations at Bali

So, when the trade ministers started trickling into the Indonesian island, two things happened. India, which had been soft during the finalization of the draft texts on TF and the public stockholding programmes for food security following a series of meetings with Washington since July 2013, caused a negotiating tsunami at Bali. Despite the strong understanding between some very senior officials outside the commerce ministry and key officials in Washington on TF and public stockholding programmes for food security, the sudden public uproar at home on the draft text on food security forced the Indian government to change its negotiating position overnight. Although the concerted opposition from the US and the EU to the Group of 33 (G33, a grouping of like-minded developing countries in the WTO) proposal on food security had been well known since 2012, the Manmohan Singh government woke up only at the 11th hour. By the time Commerce Minsiter Anand Sharma arrived at Bali on 2 December, the focus had shifted to what India would do.

There was a grand effort to isolate India within the G33 where the Indian negotiators had played a central role in pressing for changes in the Agreement on Agriculture, especially the need to update the external reference price of 1986-88 (which plays a crucial role in estimating the total size of agricultural subsidies). The G33 consistently demanded language to ensure that there is an umbilical link between the interim provision giving exemption to subsidies incurred in food stockholding programmes and the final decision. But in Geneva the US had been willing to concede only a "peace clause" for two years, which it later extended to four years. However, the US, the EU, Canada, Pakistan and others vehemently rejected language providing for a linkage between the interim mechanism and a permanent solution as well as for protection from the WTO's Agreement on Subsidies and Countervailing Measures (SCM).

Meanwhile, at Bali the Director-General quietly began pursuing negotiations on the TF text with a small group of members on special issues such as expedited shipments, transit, consularization and penalty disciplines. Even though India raised strong reservations on expedited shipments – which is basically a market access issue for the US courier companies – and penalty disciplines, Azevedo did not invite the Indian minister or his officials for any discussion on the TF issue at Bali.

In the face of growing opposition from several countries who made strong statements at the plenary session about the need to ensure a "balance", the Director-General along with the Indonesian chair of the conference, Gita Wirjawan, held a meeting of heads of delegation on 4 December. The 50 countries who took part at the meeting stuck to different narratives. The so-called Friends of the System gave the Director-General carte blanche to do anything he deemed appropriate for concluding the Bali package.

However, several developing countries such as India, South Africa, Namibia, Kenya, Argentina and Cuba made it known that the draft texts were not ready for concluding the Bali package. Cuba said that the WTO chief had said that there would not be any negotiations at the ministerial conference itself while efforts were being made at Bali to negotiate on issues in trade facilitation and agriculture.

Public stockholding deal

Along with the Indonesian chair, Azevedo held a series of meetings with the Indian minister on the possible language that could satisfy New Delhi. It was basically a negotiation between Azevedo and Anand Sharma who was assisted by a senior Indian official. After initial discussions on the linkage between the interim mechanism and the roadmap to negotiate the final solution for public stockholding programmes, India gave three alternative formulations with language about the interim solution leading to a final solution for food security.

In response, the Director-General informed the Indian minister that the language in the interim mechanism would be close to what India had proposed. However, the Indian delegation was not given any language. In the face of what seemed like a cat-and-mouse act, the final compromise offered to India failed to satisfy New Delhi. When things were drifting, India gave its final alternative in the early hours of 6 December. Apparently, the US created a "ruckus" on the Indian proposal and was not ready to accept it. That is when India told the Director-General that if the Indian proposal was not acceptable to the US, New Delhi would reject the Bali package.

Finally, there was a face-to-face negotiation between the US, India and the Director-General in which the US Trade Representative accepted the language "in the interim, until a permanent solution is found" for members to refrain from challenging the public stockholding programmes for traditional staple food crops. But in return, the US inserted strong language on notification requirements as well as safeguard requirements. The US managed to include language that stocks

procured under public stockholding programmes "do not distort trade or adversely affect the food security of other Members". Washington also ensured that there was no explicit protection from the disciplines in the Agreement on Subsidies and Countervailing Measures as was the case with the previous peace clause that the US and the EU enjoyed during 1995-2004.

An agriculture trade expert says it would be difficult for countries to challenge India under the Bali agreement despite lack of protection from the SCM Agreement. The *pacta sunt servanda* principle will ensure that the dispute settlement panels do not make adverse pronouncements against countries availing themselves of the interim mechanism. However, India may find it intrusive and difficult to comply with the notification requirements under the interim solution, he added.

Following this understanding on food security, India meekly agreed to give up its opposition to expedited shipments and several other provisions in the TF text. The Indian minister, who had mentioned New Delhi's outstanding concerns on the TF text during the first three days of the meeting, generously conceded to his American counterpart that New Delhi would remove the square brackets (denoting lack of consensus) on its sensitive issues in the TF text. These issues require India to carry out legislative amendments as well as create new infrastructure. Perhaps the Manmohan Singh government seemed more eager to satisfy Washington even though what it got on the food security issue was only a reprieve with several conditions. The Bali outcome on food security is only a prelude to the battle that will unfold between now and the WTO's 11th ministerial meeting in four years.

A WTO beyond the DDA?

More importantly, the Bali outcome has provided a ruse to launch negotiations on new issues regardless of what happens to the vitals of the DDA. *The Economist* magazine, which showered wholesome praise on Azevedo for a successful Bali outcome, wants "opening discussions on fresher subjects". "Investment is one possibility: the WTO could work to rein in subsidies and set rules protecting cross-border investment," the magazine helpfully suggested. "Trade in environmental goods and services, which covers everything from air filters to green consulting, is another candidate," it says. "Not all subjects need to be negotiated among all WTO members, as the Bali deal was," it has cautioned. "Some can be passed to those countries that are eager to press forward ('plurilateral' talks, in the jargon, as opposed to multilateral ones), as long as other WTO members are free to sign up to any resulting agreement."

So will the WTO now abandon the DDA and move into new areas? ❐

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