THIRD WORLD
Economics
TRENDS & ANALYSIS

Published by the Third World Network KDN: PP 6946/07/2013(032707) ISSN: 0128-4134 Issue No 667 16 – 30 June 2018

Trade order at risk as trade war rages

Further salvos have been fired in the intensifying global trade war, with the US and China targeting more and more of each other's exports with tariff hikes. What started as a US-initiated trade conflict could now bring about the very breakdown of the multilateral trading system.

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131 Jalan Macalister
10400 Penang, Malaysia
Tel: (60-4) 2266728/2266159
Fax: (60-4) 2264505
Email: twn@twnetwork.org
Website: www.twn.my

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THIRD WORLD ECONOMICS
is published fortnightly by the Third World Network, a grouping of organisations and individuals involved in Third World and development issues.

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Printed by Jutaprint, No. 2, Solok Sungei Pinang 3, Sungai Pinang, 11600 Penang, Malaysia.

Escalating trade war threatening the world trading system

Both the United States and China have raised tariffs against more of each other's exports, in an escalating trade war that dims global economic prospects and threatens the world trading system.

by Martin Khor

24 September marked another milestone in the escalating global trade war that threatens to shake the foundations of the world trading system and cause economic uncertainty at a time of financial fragility. It's an altogether bad development that adds more gloom to global economic prospects.

The United States had announced it was going ahead with slapping an additional 10% tariff on $200 billion worth of imports from China. Hours later, China said it would impose 5-10% extra tariffs on $60 billion of imports from the US in retaliation.

Both sets of tariff increases came into effect on 24 September. But that's not all. The US also said it would raise the extra tariffs on the $200 billion of imports from 10% now to 25% at the end of the year. And if China retaliates (which it now has), the US might slap higher tariffs on yet another $267 billion of Chinese imports.

This comes on top of tariffs on an initial $50 billion worth of Chinese imports that the US had charged a few months ago, and equivalent tariffs on $50 billion of US imports that China imposed as retaliation.

And even before that, the US had put extra tariffs on steel and aluminium imports from all countries, except a few that were exempted for the time being. The US is also threatening to slap tariffs on imported auto vehicles and parts including from Europe. That is on hold because of a bilateral deal reached, but could be reignited if US President Donald Trump is not satisfied with European behaviour.

The US itself is experiencing negative effects of this trade war. The prices of the initial $50 billion of imported Chinese products have started to go up in the US, raising costs for both consumers and producers. The Chinese are similarly affected. Exports of both countries are also bound to decline, and this will eventually affect their overall economic growth.

There will be collateral effects on other countries. In Asia, those that are integrated in the global supply chain will find less demand for their exports of components to China. For Malaysia, for example, the effect is projected by analysts to be around 0.4 to 0.7 percentage point of GNP in 2019. This could be offset by positive effects. Some companies producing in China are considering relocating to other countries, including Malaysia, to escape the US' punitive tariffs. And some Malaysian products may become cheaper than Chinese products which will now be subject to extra duties. But it is likely that the bad effects will outweigh any such good effects, at least in the short run.

Unilateral actions

It is clear that the US is to blame for the trade war. Its unilateral actions go against the spirit and rules of the trading system, and have in fact undermined its legitimacy and viability.

The steel and aluminium tariffs were imposed under the security clause of the US' domestic trade law, while the other tariff increases are under Section 301 of the trade law. The US actions are against various WTO rules.

Challenges to the US unilateral measures have been brought by China and other countries at the WTO. If the US is found in violation, which is quite likely, it will have to stop its actions or face retaliation: the countries that win the cases heard by WTO panels of experts are allowed to impose equivalent tariffs on US products.

However, the US has engineered a crisis in the WTO's dispute settlement system so that soon the outcome of successful cases against it cannot be implemented. This is because the US is now paralyzing the WTO's Appellate Body by refusing to allow new appellate body members to be appointed to replace those retiring. Soon there will be only three members left, out of a full body of seven, and two more will have retired by

December 2019. A minimum of three members is needed to sit on a case.

Thus, if a lower-level panel rules against the US' unilateral actions, and the US lodges an appeal which cannot be heard because there are insufficient appellate body members, the panel decision cannot be enforced.

This would make the WTO a quite toothless organization. There would be no legal remedy to enforce penalties for breaking the WTO laws. Countries that impose unilateral tariff increases can get away with it. In turn, other countries would also do the same.

The rules-based trade system is already starting to break down. We are now seeing blatant protectionism by the US and retaliation by affected countries. Within months the t

rade war could spread, with the law of the jungle becoming more prominent.

There are some rules over which tears will not be shed in the developing countries if they cannot be upheld anymore, such as the WTO's TRIPS Agreement on intellectual property. The free trade economist Jagdish Bhagwati has said the TRIPS treaty does not belong in the WTO.

But what all member states like about the WTO is its role in ensuring the predictability that their exports can sell in the markets of its members, with tariffs at rates agreed to at the WTO. If that predictability is lost, then there can be a lot of uncertainty, as one country after another can unilaterally impose extra tariffs on other countries, which may then trigger retaliation.

This breakdown of the trading system may be the more serious effect of what started as a US-initiated trade war. President Trump may not care what happens to the system, as he has said many times that the WTO is a terrible organization which the US should leave. And his recent actions in fact seem calculated to undermine if not destroy it.

It is a new world we are looking at, in a scenario that would not have appeared possible a year or even months ago. Policymakers, companies, analysts and the public should ponder about this, even as they follow the details of the tit-for-tat trade war between the US versus China and other countries. ❐

Martin Khor is adviser to the Third World Network. This article was first published in The Star *(Malaysia) (24 September 2018).*

EU, US poised for combined assault on China's trade policies

The EU and the US may be forging a common front to push for WTO disciplines targeting China's trade policies.

by D. Ravi Kanth

GENEVA: The European Union and the United States seem to be ganging up against China for a combined assault on Beijing's trade policies, after closing ranks on some bilateral issues, according to people familiar with the development.

The EU and the US appear to be on the same wavelength when it comes to major changes to rules at the WTO, barring issues concerning reforms to the WTO dispute settlement system.

The two trans-Atlantic trade elephants on 10 September signalled their intention to conclude a partial agreement on technical barriers to trade.

"An early harvest in the area of technical barriers to trade" could be concluded between the EU and the US by November, according to a report in the *Financial Times* of 10 September.

The US Trade Representative (USTR) Robert Lighthizer indicated that the proposed deal on technical barriers to trade will reduce regulatory hurdles that "hamper commercial exchanges across the Atlantic, such as conflicting standards on car safety, medical devices and pharmaceuticals, which had been the subject of lengthy negotiations between the Obama administration and officials in Brussels", according to the *FT* report.

"We discussed how to move forward and identify priorities on both sides, and how to achieve concrete results in the short and medium term," EU Trade Commissioner Cecilia Malmstrom tweeted after a meeting with Lighthizer. "Lots of work remains this autumn," she wrote.

Significantly, the US had blocked several proposals from the EU in the WTO's Doha negotiations on industrial goods for addressing non-tariff barriers, particularly technical barriers to trade.

For example, in January 2011, the EU along with Norway, Switzerland, India, Malaysia, Thailand and the Philippines had floated a proposal which underscored the need for "international standardization" by taking into account several different dimensions for facilitating trade. The EU had also made several other proposals for addressing non-tariff barriers. The US, however, blocked any negotiations, saying that it would not engage until negotiations on tariffs were concluded.

Against this backdrop, the USTR's statement to the *FT* about an "early harvest" on technical barriers to trade with the EU is puzzling.

It is not clear what else was discussed during the bilateral meeting between the EU and the US, as the two sides remained coy about other major issues, particularly China, which is prompting the two sides to close ranks.

WTO rule changes

The EU along with Canada are spearheading efforts to bring fundamental changes to WTO rules in a manner that would please the US.

US President Donald Trump and the USTR have repeatedly called for comprehensive reforms in the WTO, threatening that Washington would leave the trade body without substantial changes.

The EU and the US are on board on changes to rules concerning the monitoring function and enhanced role for the WTO secretariat in overseeing the notification and monitoring aspects; pursuing plurilateral negotiations on electronic commerce and other issues; introducing differentiation to deny special and differential treatment for China, India and South Africa among others; and most importantly, crafting new rules to address issues concerning China's alleged trade-distorting policies.

In an unofficial "non-paper" issued in June on "modernizing" the WTO, the EU had set out the markers for rule changes at the WTO that are in line with US priorities.

(On 18 September, the EU issued a "concept paper" which expanded on the items raised in its non-paper.)

For example, the EU called for making the WTO "more relevant and adaptive to a changing world" on the grounds that "the accession of China in the WTO and its [Beijing's] failure to converge towards the market economy model has revealed gaps in the WTO rulebook that need to be addressed now."

"These gaps," according to the EU, "relate mostly to the way a government exercises its powers to either give preferential treatment to its domestic operators, i.e., through subsidies or skewed regulatory practices and policies, or to obtain the competitive advantages of foreign operators for its own use (i.e., through forced technology transfer or failure to protect intellectual property)."

"The EU should therefore work to develop new rules to address current gaps in the rulebook with regard to level playing field issues such as subsidies and state-owned enterprises; investment market access; regulatory barriers to services and investment, including rules on technology transfer," the EU's non-paper had explicitly argued.

The USTR had raised the same concerns about China well before Brussels mustered courage to highlight them at the WTO and outside. Clearly, there is a convergence between the US and the EU in forging a common front against China for crafting new disciplines on subsidies, state-owned enterprises and regulatory issues.

For the past several months, the EU along with the US and Japan were busy forging a common front as part of a "trilateral" process against China for bringing new disciplines on industrial subsidies, state-owned enterprises and intellectual property.

The alliance with the EU has also become important for the US, which is finding it difficult to make a significant dent in its trade war with China.

"The Trump administration has been seeking to temper its trade fights with its strategic allies in recent weeks, including the negotiation of a deal to reform NAFTA [North American Free Trade Agreement] with Mexico and Canada, in an effort to focus on its escalating trade dispute with Beijing," according to the *Financial Times* on 10 September.

The EU and the US are also on the same wavelength when it comes to pursuing "differentiation" that would allow a new approach "to development and special and differential treatment based on a case-by-case, needs driven analysis," and "encourage developing country members to move toward undertaking greater commitments."

Dispute settlement

It is only on the dispute settlement function of the WTO that the EU and the US differ significantly at this juncture (see following article).

The US is determined to terminate the WTO's Appellate Body after blocking a second term for AB member Shree Baboo Chekitan Servansing (see the article "US blocks AB member Servansing's reappointment" in this issue). Washington wants to revert to the pre-WTO phase of negotiating dispute settlement panel findings instead of resolving them before the Appellate Body.

In its non-paper, Brussels emphasized: "The EU should put forward a comprehensive proposal to address the concerns raised by the WTO member [the US] blocking the Appellate Body appointments to the extent that they have merit, while preserving and further strengthening the main features and principles of the WTO dispute settlement system. This proposal will – in a first stage, and in order to unblock the appointments – aim at improving the efficiency of procedures, at creating conditions for a better interaction between the Appellate Body and the WTO members while at the same time strengthening the independence of the Appellate Body. In a second stage, substantive issues concerning the application of WTO rules would be addressed."

Prior to the EU-US bilateral meeting on 10 September, the WTO Director-General Roberto Azevedo had dispatched his chef de cabinet Tim Yeend to Brussels to share the WTO secretariat's proposals for reform, according to a report in Politico on 5 September.

It is safe to conclude that there is a new bonhomie between the US and the EU for ganging up against China and for preparing the ground for fundamental reforms that would deny special and differential treatment to several countries of the Global South. *(SUNS8750)* ❐

EU's proposed changes to DSU unlikely to be accepted by US

The EU has put forward proposals to address US grievances against the WTO dispute settlement mechanism, but will these be sufficient to satisfy Washington?

by D. Ravi Kanth

GENEVA: The European Union has proposed several changes to the WTO's Dispute Settlement Understanding (DSU) in an attempt to appease the United States. But the proposed amendments are unlikely to be accepted by Washington, particularly with regard to preserving and strengthening the Appellate Body (AB), trade envoys told the *South-North Development Monitor (SUNS)*.

The EU discussed its concept paper called "WTO Modernization" on 20 September at the Canadian mission in Geneva with senior officials from Japan, Canada, Norway, Switzerland, Australia, New Zealand, Singapore, Korea, Kenya, Mexico, Chile and Brazil among others.

The changes proposed by the EU to the DSU are aimed at addressing a range of concerns repeatedly raised by the Trump administration, which seeks to move away from the AB-driven adjudicating process to the pre-1995 GATT system of negotiating dispute settlement panel rulings among the winning and losing parties.

Ironically, it was the EU which had a track record of blocking panel rulings during the GATT era, while the US successfully championed a binding adjudicatory process through the AB at the end of the Uruguay Round negotiations to establish the WTO in 1994.

However, the US subsequently launched a war against the AB after losing several major trade disputes, including disputes on the "zeroing" methodology used in anti-dumping investigations and subsidy disputes on the interpretation of what would constitute a "public body".

The Obama administration blocked the reappointment of a sitting South Korean member of the AB, Seung Wha Chang, in 2016, and the Trump administration took the war against the AB to a new high.

The US not only demanded abandonment of the "negative consensus" principle that effectively made dispute settlement rulings binding, but also raised several charges against the manner in which the AB functioned.

"Grave danger"

The EU concept paper says that "the dispute settlement function of the WTO is at grave danger, and swift action by Members is needed to preserve it."

"If the United States' blockage of Appellate Body appointments continues, it will undermine the WTO dispute settlement at the latest by December 2019," the EU has argued.

The US has already blocked the reappointment of existing AB member Shree Baboo Chekitan Servansing, whose first term expires on 30 September. Effectively, the AB would be reduced to three members from 1 October if the US continues to block the extension for Servansing.

And by December 2019, the AB would have just one member after the completion of the second terms of two sitting members, Ujal Singh Bhatia and Thomas Graham. That would be the end for the AB to exist as the highest adjudicating limb of a dispute settlement system which is often projected as "the jewel in the crown" of the WTO.

At that point in time, there would be fewer than three AB members, which is the minimum number required for the AB to hear an appeal. Any party to a dispute may thus effectively block the adoption of a panel ruling by appealing it to a non-functioning AB, which may undermine the operation of WTO dispute settlement as a whole.

The EU has listed the concerns raised by the US over the AB in the US President's 2018 Trade Policy Agenda, saying that some of these concerns had already been aired by the Obama administration:

(i) The AB's non-compliance with the 90-day deadline for issuing rulings under Article 17.5 of the DSU.

(ii) Rulings issued by persons who are no longer AB members.

(iii) The AB's issuance of advisory opinions on "issues not necessary to resolve a dispute": Washington has bemoaned "the tendency of WTO reports to make findings unnecessary to resolve a dispute or on issues not presented in the dispute". It has pointed in particular to "one egregious instance" where "more than two-thirds of the Appellate Body's analysis – 46 pages – was in the nature of obiter dicta".

(iv) The AB's review of facts and review of a member's domestic law *de novo*: The US has criticized "the Appellate Body's approach to reviewing facts". Under Article 17.6 of the DSU, appeals are limited to "issues of law covered in the panel report and legal interpretations developed by the panel". Yet, in the view of the US, the AB has "consistently reviewed panel fact-finding under different legal standards, and has reached conclusions that are not based on panel factual findings or undisputed facts". In the US' view, this is particularly the case with AB reviews of panel findings as to the meaning of domestic legislation (which should be an issue of fact).

(v) The AB claims its reports are entitled to be treated as precedent for panels to follow: The EU says the US has formulated a more substantive concern with the "adding or diminishing of rights and obligations" by the AB in various disputes.

The US has repeatedly accused the AB of "adding or diminishing rights" in "the interpretation of the notion of 'public body' under the Subsidies Agreement, the interpretation of the non-discrimination obligation under Article 2.1 of the TBT Agreement, certain interpretations relating to safeguard measures (notably on 'unforeseen developments'), outcomes in the cases launched by the EU against the Byrd amendment (giving the proceeds from anti-dumping/countervailing duties to US industry) and on Tax Treatment for 'Foreign Sales Corporations' (that was considered to be an export subsidy)."

Two-stage proposal

To address the US concerns, the EU in its concept paper has proposed a two-stage process. During the first stage, the EU has suggested, WTO members should, in order to unblock the AB appointments, "aim at improving the efficiency of procedures, at creating conditions for a better interaction between the Appellate Body and the WTO Members while at the same time strengthening the independence of the Appellate Body."

To achieve these goals, the EU has proposed a "comprehensive amendment of the provisions of the DSU relating to the functioning of the Appellate Body addressing all points of concern with the 'approach' of the Appellate Body." This amendment would include elements such as:

(i) Changing the 90-day rule in Article 17.5 of the DSU by providing an enhanced transparency and consultation obligation for the AB. In particular, Article 17.5 could be amended to provide that: "In no case shall the proceedings exceed 90 days, unless the parties agree otherwise." To "have a positive impact on the timeframes of appellate review", the EU also proposed increasing the number of AB members from seven to nine; making AB membership a full-time job; and increasing the resources for the AB.

(ii) Transitional rules for outgoing AB members that would involve "codifying Rule 15 (or similar) in the DSU, thereby addressing head on the US concern that this Rule was not approved by WTO Members. For example, the DSU could provide that an outgoing Appellate Body member shall complete the disposition of a pending appeal in which a hearing has already taken place during that member's term."

(iii) Modifying Article 17.12 of the DSU – according to which the AB "shall address each of the issues raised" on appeal – by adding "to the extent this is necessary for the resolution of the dispute".

(iv) Clarifying that '"issues of law covered in the panel report and legal interpretations developed by the panel' do not include the meaning of the municipal measures (even though they do and should include their legal characterization under the WTO law)". The EU suggested adding a footnote to Article 17.6

of the DSU "For greater certainty [...]"

(v) Constant exchanges between the AB and WTO members to address the issue of precedent.

(vi) Providing for one single but longer (6-8 years) term for AB members. This, the EU says, would address concerns with respect to the independence of the AB and "would also improve the efficiency of the Appellate Body (there would be certainty about the length of one's term and a longer term would allow to benefit from the experience on the job)."

The EU says that all these proposed amendments, which centre around Article 17 of the DSU, "could be made pursuant to the applicable (simpler) amendment procedure in Article X:8 of the WTO Agreement, according to which amendments to the DSU can be decided by the Ministerial Conference, on a proposal from any WTO Member. The decision is taken by consensus and amendments would take effect upon approval by the Ministerial Conference. In the intervals between meetings of the Ministerial Conference, amendments could be approved by the General Council..."

The second stage of changes proposed by the EU would involve addressing the US concerns about the interpretations developed by the AB especially, but not exclusively, in the trade defence field. The EU said that during this second stage, "once the AB appointment process has been unblocked, WTO Members would engage in discussions on … possible changes or authoritative interpretations" to the substantive WTO rules.

The moot issue is whether the US will agree to unblocking the appointments at the AB at this juncture. Having already blocked the reappointment of AB member Servansing, there is little to hope that the US would change the course of its actions.

"The US will not agree to the EU's proposal for unblocking the AB selection process, nor will it accept the EU's amendments," said a trade envoy who asked not to be quoted.

Brussels is chasing a mirage with the hope that the US will come back to the WTO, knowing full well that it is forced to clandestinely accept humiliating backroom demands from the US in relation to the latter's trade measures on steel, aluminium and probably automobile imports. The EU's trade policy since the creation of the GATT/WTO is replete with opportunistic deals and unethical practices, several trade envoys told *SUNS*. *(SUNS8758)* ❐

US blocks AB member Servansing's re-appointment

The US has continued to oppose moves to fill existing and impending vacancies in the WTO's Appellate Body, maintaining an impasse that threatens to paralyze the multilateral system for resolving trade disputes.

by Kanaga Raja

GENEVA: The United States informed the WTO Dispute Settlement Body (DSB) on 27 August that it was not in a position to agree to the reappointment of Appellate Body (AB) member Shree Baboo Chekitan Servansing to a second term, effectively reducing the seven-member adjudicative body to just three.

[Of the three now in the AB – the minimum needed to hear any appeal – one is due to retire in October and another at the end of next year. Unless the AB blockage is quickly resolved, the AB will be unable to hear and dispose of any appeals from October, and by end-2019 will have only a single member.

[Under the WTO's Dispute Settlement Understanding (DSU), a dispute panel ruling remains suspended once a party to the dispute notifies its decision to appeal the ruling. Thus, with no functional AB from October, panels may rule but the rulings may not take effect. The integrated DSU, the single enforceable dispute settlement mechanism in international agreements, would become non-functional. – *SUNS*]

Also at the 27 August DSB meeting, the US continued to block a joint proposal sponsored by some 67 WTO member states that called for the simultaneous launch of the selection processes to fill the three current vacancies on the AB as soon as possible.

In a related development, the US made a long statement criticizing the AB for what the US saw as the AB's consistent review and reversal of "fact-finding" by WTO panels.

Two of the three current AB vacancies are due to the expiry of the second and final four-year terms of Ricardo Ramirez-Hernandez and Peter Van den Bossche. Ramirez-Hernandez's term ended on 30 June 2017, while that of Van den Bossche expired on 11 December 2017.

The other vacancy pertains to Hyun Chong Kim from South Korea who had tendered his resignation with immediate effect on 1 August 2017, prior to taking up his appointment as a minister in the Korean government.

Reappointment blocked

At the DSB on 27 August, under the agenda item on the possible reappointment of one AB member, the Chair of the DSB, Ambassador Sunanta Kangvalkulkij of Thailand, reported that she had carried out further consultations with WTO members on whether Servansing, whose first term ends on 30 September, should be given a second term as AB member.

According to trade officials, the Chair said that, on the basis of her consultations, she understood that there would not be a consensus to support Servansing's reappointment.

The Chair said that given that her consultation process was now concluded, she would like to confer with all delegations on the way forward. She added that her door was open for any member who wanted to discuss the matter with her.

In its statement on this issue, the US said for more than 15 years, across multiple US administrations, it had been raising serious concerns over the AB's disregard for the rules set by WTO members. Through persistent overreaching, the AB had been adding obligations that were never agreed by the US and other WTO members, it maintained.

It said the President's 2018 Trade Policy Agenda outlined several longstanding US concerns:

- The US had raised repeated concerns that appellate reports have gone far beyond the text setting out WTO rules in varied areas, such as subsidies, anti-dumping duties, anti-subsidy duties, standards and technical barriers to trade, and safeguards, restricting the ability of the US to regulate in the public interest or protect US workers and businesses against unfair trading practices.
- On procedural, systemic issues, for example, the AB has issued advisory opinions on issues not necessary to resolve a dispute, reviewed panel fact-finding despite appeals being limited to legal issues, asserted that panels must follow its reports although there is no system of precedent in the WTO, and continuously disregarded the 90-day mandatory deadline for appeals – all contrary to the WTO's agreed dispute settlement rules.

And for the last year, the US said, it has been calling for WTO members to correct the situation where the AB acts as if it has the power to permit ex-AB members to continue to decide appeals even after their term of office – as set by the WTO members – has expired. This so-called "Rule 15" is, on its face, another example of the AB's disregard for the WTO's rules.

"Our concerns have not been addressed. When the Appellate Body abuses the authority it was given within the dispute settlement system, it undermines the legitimacy of the system and damages the interests of all WTO Members who care about having the agreements respected as they were negotiated and agreed," the US maintained.

The US said that it will continue to insist that WTO rules be followed by the WTO dispute settlement system.

"In this circumstance, the United States has determined that it is not prepared to support the reappointment of Mr. Servansing to the Appellate Body. This position is no reflection on any one individual but reflects our principled concerns," it said.

According to trade officials, no other delegation took the floor on this matter.

Continued US blockage

Under the agenda item of AB appointments, a joint proposal was tabled at the DSB meeting by Argentina; Australia; Bolivia; Brazil; Canada; Chile; China; Colombia; Costa Rica; Dominican Republic; Ecuador; El Salvador; the European Union (28 member states); Guatemala; Honduras; Hong Kong-China; Iceland; India; Indonesia; Israel; Kazakhstan; Korea; Mexico; New Zealand; Nicaragua; Norway; Pakistan; Panama; Paraguay; Peru; the Russian Federation; Singapore; Switzerland; Chinese Taipei; Turkey; Ukraine; Uruguay; Venezuela; and Vietnam.

The proposal called for the DSB to:

(1) launch three selection processes to replace Ramirez-Hernandez, Kim and Van den Bossche;

(2) establish a selection committee composed of the WTO Director-General and the chairpersons of the General Council, the Goods Council, the Services Council, the TRIPS Council and the DSB, to be chaired by the DSB Chair;

(3) set a 30-day deadline for WTO members to submit nominations of candidates; and

(4) request the selection committee to carry out its work in order to make recommendations to the DSB within 60 days after the deadline for submitting nominations of candidates, so that the DSB can take a decision to appoint three new AB members as soon as possible.

Mexico, speaking on behalf of the 67 co-sponsors, said that the considerable number of members submitting the joint proposal reflected a common concern with the current situation in the AB that was seriously affecting its workings and the overall dispute settlement system against the best interest of WTO members.

WTO members had a responsibility to safeguard and preserve the AB and the dispute settlement and multilateral trading systems. "Thus, it is our duty to proceed with the launching of the selection processes for the Appellate Body members, as submitted today to the DSB," said Mexico.

Mexico said the proponents were flexible in the determination of the deadlines for the selection processes, but they should take into account the urgency of the situation.

"We continue to urge all Members to support this proposal in the interest of the multilateral trade and the dispute settlement systems," it added.

The US said that, as it had explained in prior meetings, "we are not in a position to support the proposed decision. The systemic concerns that we have identified remain unaddressed."

For example, it said, at the DSB meeting in August 2017, "we made clear our concerns with the issuance of appellate reports by individuals who are no longer members of the Appellate Body." Yet, one year later, an individual who was not currently a member of the AB continued to decide appeals.

"As we have explained many times, it is for the DSB, not the Appellate Body, to decide whether a person who is no longer an Appellate Body member can continue to serve on an appeal."

The US referred back to its statements at earlier DSB meetings for more elaboration on its concerns.

"We therefore will continue our efforts and our discussions with members and with the Chair to seek a solution on these important issues," it said.

Argentina, Canada, Brazil, Thailand, China, Australia, Norway, Switzerland, Korea, Japan, Singapore, Chinese Taipei, Chile, India, Hong Kong-China, New Zealand, Mexico, the European Union, Guatemala and Costa Rica (for the GRULAC group of Latin American and Caribbean countries) took the floor on this issue.

According to trade officials, these delegations reiterated their concerns on the continued impasse over the appointment of new AB members. They urged all WTO members to show flexibility in order to resolve the deadlock as soon as possible.

Several members highlighted the growing dangers that the continued impasse posed not only to the dispute settlement system but to the WTO as a whole, and that members had an obligation under the WTO rules to initiate the selection process.

Other members reiterated that the US concerns should be treated separately from the issue of appointment of AB members.

Several members said that the US should put forward concrete proposals on how to resolve the problem.

Mexico, on behalf of the 67 co-sponsors of the joint proposal, expressed regret that for the fourteenth occasion, "we have still not achieved consensus to start the selection processes for the vacancies of the Appellate Body and have failed to fulfil our duty as Members of this Organization".

It said that no discussion should prevent the AB from continuing to operate fully and members shall comply with their obligation under the DSU to fill the vacancies as they arise.

"By failing to act today, we will maintain the current situation which is seriously affecting the workings of the Appellate Body against the best interest of its Members," said Mexico. *(SUNS8743)* ❐

WTO secretariat causes stalemate over agreement to promote IF

The WTO secretariat's acceptance of funding for work in the contentious area of investment facilitation has come under scrutiny at the trade body.

by D. Ravi Kanth

GENEVA: The WTO secretariat caused a major stalemate at a meeting of the WTO Committee on Budget, Finance and Administration (CBF&A) on 13 September after it refused to share an agreement that Director-General Roberto Azevedo had reached with China for receiving $7 million to promote investment facilitation (IF) without multilateral approval, trade envoys told the *South-North Development Monitor (SUNS)*.

"The secretariat's brazen defiance to justify the Director-General's agreement in November 2017 had led to a stalemate at the CBF&A meeting that was convened to approve budgetary matters," said an envoy who was familiar with the meeting.

Further, the flat refusal by the secretariat to share the agreement raised serious "systemic" issues about the manner in which business is being conducted at the trade body on trade programmes without prior approval from the WTO General Council or multilateral consensus at a ministerial meeting, the envoy suggested.

More disturbingly, the secretariat and Director-General Azevedo have cocked a snook at the General Council when work on investment facilitation, including technical workshops, was blocked at the Council in May last year.

Despite the General Council's decision, the Director-General went ahead and signed an agreement with China to receive $7 million for the secretariat to conduct technical workshops for promoting investment facilitation.

Under the China Development Cooperation Research Fund, the Chinese government and the WTO set up a trust fund "to strengthen collaboration in research and research-related technical assistance and capacity building for trade."

"The Trust Fund aims to support the WTO in organizing a series of Investment Facilitation Partnership Fora and maintain a global database of investment facilitation measures and other related activities," the secretariat had informed members.

WTO Financial Regulations

At the CBF&A meeting on 13 September, Deputy Director-General of the WTO Karl Brunner and the CBF&A Chair, Ambassador Juan Esteban Aguirre Martinez from Paraguay, tried hard to justify the Director-General's agreement with China by citing Regulation 19 of the WTO Financial Regulations concerning "voluntary contributions, gifts or donations".

As per Regulation 19, "Voluntary contributions, gifts or donations from WTO Members and Observers may be accepted by the Director-General provided that the purposes for which the contributions are made are consistent with the policies, aims, and activities of the WTO, and provided that the acceptance of such contributions which directly or indirectly involve additional financial liability for the WTO shall require the consent of the Committee. Voluntary contributions, gifts or donations from Non-Governmental Donors are subject to the additional guidelines laid out in Annex C.

"Monies accepted for purposes specified by the donor shall be treated as trust funds. A standard overhead fee of up to 13% may be charged on direct expenditure incurred by trust funds to reflect supporting services provided by the Secretariat. The standard overhead rate can be reduced when implementing partners are being used and when defined in the agreement signed with the donor. The Programme Support Fund collects the overhead fees from all trust funds and pays expenditure incurred to support the trust fund's activities. The Programme Support Fund also releases a fee representing 10% of its expenditure to the WTO Secretariat that will record it as miscellaneous income.

"Monies accepted in respect of which no purpose is specified shall be treated as miscellaneous income and reported as 'gifts' in the accounts of the financial period.

"Monies received by a staff Member as honoria in his/her official capacity shall be remitted to the Organization and be credited to the WTO Staff Assistance Fund.

"Unless otherwise provided, such voluntary contributions, gifts or donations shall be administered in accordance with the present Financial Regulations."

Officials from the WTO secretariat told the CBF&A that the Director-General is well within his rights to accept "voluntary contributions, gifts, or donations from WTO members and observers" under Regulation 19. The officials maintained that the funds from China did not cause any financial liability.

However, it could be argued that the funds for investment facilitation technical workshops are not "consistent with the policies, aims, and activities of the WTO" after the issue was blocked at the General Council in May 2017.

The secretariat had informed members at the CBF&A in July that the proposal to undertake technical assistance programmes was "approved on a fast track basis" by the Director-General and had not been procedurally put up to the CBF&A, as laid down in the regulations for reporting and review, though it was approved in November 2017 and the expenditure on the project was incurred last year.

At the 13 September CBF&A meeting, the secretariat flatly refused to provide information on the specific agreement reached with China on the grounds that it was guided by past practices. It also suggested that technical assistance for investment facilitation was a "political" issue which could be settled only at the General Council.

Several members, including India and South Africa, urged the secretariat to share all the information so that a credible decision could be made as per the rules set out in the Marrakesh Agreement that guided the functioning of the WTO.

Under Article VII of the Marrakesh Agreement, "the Secretariat shall not seek or accept instructions from any government or authority external to the WTO. They shall refrain from any action which might reflect on their position as international officials."

Further, the secretariat's decision went "much beyond justifying approval for projects already undertaken without reporting to the membership" and raised "serious systemic issues, questions regarding the role of the secretariat, by engaging in activities in non-mandated areas without review or reporting, the consensus (decision-making) principle, allowing any member or group to set policies and objectives for the WTO with contributions even on non-mandated areas and even calling into question Article VII of the Marrakesh Agreement", India had said at the CBF&A meeting in July.

However, many countries, including China, supported the secretariat in accepting the funds for investment facilitation despite lack of multilateral consensus. They argued that the secretariat did not violate rules as set out in the financial regulations.

In short, the secretariat's refusal to share the specific agreement reached between the Director-General and China on the trust fund exposed the irregular and unconstitutional practices being adopted for advancing work on issues where there is no multilateral consensus or approval, trade envoys said. *(SUNS8753)* ❐

OPT has world's highest unemployment rate, says UNCTAD

Grim prospects confront a Palestinian economy already marked by declining per capita incomes and the highest unemployment rate in the world, a UN agency report says.

by Kanaga Raja

GENEVA: The Occupied Palestinian Territory (OPT) has the highest unemployment rate in the world, the United Nations Conference on Trade and Development (UNCTAD) has said.

In its latest report on UNCTAD assistance to the Palestinian people, UNCTAD said that reflecting weak GDP growth, unemployment edged up from 26.9% in 2016 to 27.4% in 2017.

It noted that the adverse conditions imposed by the Israeli occupation disproportionately affected women and young people.

According to UNCTAD, declining donor support, a freeze in the reconstruction of Gaza and unsustainable credit-financed public and private consumption paint a bleak picture for future growth in the OPT.

"Under international law, Israel and the international community have responsibilities not only to avoid actions that impede development but to take affirmative steps to foster development in the Occupied Palestinian Territory," said Mahmoud Elkhafif, Coordinator of the UNCTAD Assistance to the Palestinian People Unit.

According to the UNCTAD report, the constrained economy of the OPT continued to underperform in 2017. From a low baseline, gross domestic product (GDP) grew by 3%, implying further decline in per capita income. GDP grew by 4% in the West Bank but contracted in Gaza by 0.3%, implying a 4% drop in GDP per capita in the ravaged Strip. The economy has been driven by construction, wholesale and retail trade, and services, while agriculture contracted by 11%.

Poor economic performance is caused by restrictive measures imposed by the occupying power. World Bank conservative estimates indicate that removing Israeli restrictions could increase annual GDP growth up to 10%. In Gaza, lifting the economic siege could generate additional cumulative growth in the range of 32% by 2025. Some relaxation of the dual-use list alone (see below) could generate additional growth of 6% in the West Bank and 11% in Gaza by 2025.

On the other hand, said UNCTAD, persistence of the status quo means that growth will not significantly exceed 3%, combined with a steady decline in per capita income and extremely high unemployment rates.

Bleak prospects

Economic prospects are bleak due to negative political horizons and unfavourable trends in the three main factors that supported economic growth in recent years: donor support; reconstruction in Gaza; and credit expansion for public and private consumption. Prospects are further clouded by the acceleration of confiscation of land and productive resources and unfavourable regional dynamics in the Middle East.

The report said that despite the call by UNCTAD on the international community to shoulder its responsibility to promote development in the Occupied Palestinian Territory, the downward trend in donor support continued; successful bold fiscal reform efforts of the State of Palestine were not matched by positive donor engagement.

In 2017, budget support from donors dropped by 10.5% from the 2016 level. Total international support was $720 million, only a third of the $2 billion in 2008. For the same period, budget support shrank from $1.8 billion to $544 million, a 70% decrease.

The worsening weight of occupation, cuts in foreign aid and collapsing fiscal space hinder the ability of the State of Palestine to carry on with state-building efforts and the essential tasks of governance, including provision of vital public services, said UNCTAD.

Echoing UNCTAD reports and studies, the United Nations indicates that Palestinian fiscal resources, in the range of $300 million per year, continue to be leaked to Israel because of the arrangement whereby the government of Israel collects taxes on Palestinian international trade on behalf of the Palestinian government and then transfers the revenue from such taxes.

The UNCTAD report noted that the Palestinian economic policy framework is shaped by the customs union established in 1967 and later formalized by the Paris Protocol in 1994 whereby free trade prevails between Israel and the Occupied Palestinian Territory and the two economies share the same external tariffs on trade with the rest of the world.

Under the rubric of the customs union, the Occupied Palestinian Territory developed a large, persistent trade deficit rooted in an underdeveloped export sector and weak capacity of domestic producers of exportable and importable goods to compete in domestic and global markets.

In 2017, Palestinian exports were 19% of GDP, while imports were 56%; the trade deficit was 37% of GDP, among the highest in the world. Israel accounted for 54% of the Palestinian trade deficit, as trade with Israel accounted for 60% of total Palestinian trade. This massive deficit was financed by incomes of Palestinian workers in Israel and settlements, remittances of expatriate workers and foreign aid.

Over the years, said UNCTAD, Israel established a complex matrix of controls over the Palestinian economy featuring a permit system, roadblocks, earth mounds, trenches, road checkpoints, road gates and the Separation Barrier. These restrictions choke trade and investment by inflating costs and undermining competitiveness.

Another major constraint on productive activities is the dual-use list of civilian goods, which Israel does not allow Palestinians to import because they have potential military application. The list includes civilian machinery, spare parts, fertilizers, chemicals, medical equipment, appliances, telecommunication equipment, metals, chemicals, steel pipes, milling machines, optical equipment and navigation aids.

Unemployment

The report also said that the Palestinian people suffer from persistent unemployment and poverty crises rooted in their inability to utilize their human and natural productive assets.

Reflecting weak GDP growth, unemployment edged up from 26.9% in 2016 to 27.4% in 2017; 18% and 44% in the West Bank and Gaza respectively.

UNCTAD said even though the Occupied Palestinian Territory suffered the highest unemployment rate in the world, the situation would have been much worse were it not for employment in Israel and settlements, which is problematic, and the low labour force participation rate of 44%, among the lowest in the world.

According to UNCTAD, a dearth of jobs in the Occupied Palestinian Territory forces thousands of Palestinian workers to seek employment in Israel and settlements. Dependency on Israel is underscored by the fact that the labour market in Israel and settlements accounts for 20% of employed Palestinians in the West Bank; in 2017, the Palestinian workforce employed there grew by 11.5%.

While the expansion of Palestinian employment in Israel and settlements is a windfall for Israeli producers in labour-intensive sectors, it undermines the competitiveness of the Palestinian economy and its export capacity.

Furthermore, according to the International Labour Organization, employment in Israel and settlements is beset with hardship, abuse, vulnerability, exploitation and discrimination. Occupational injuries and fatalities at construction sites are among the highest observed in Organization for Economic Cooperation and Development (OECD) countries.

Adverse labour market conditions disproportionately impact women and youth. Half the Palestinians under age 30 are unemployed, and one-third of those in the 15-24 age group are considered "not in education, employment or training". The disenfranchisement of women is highlighted by the fact that their labour force participation rate is a meagre 19% compared with 71% for men, even though Palestinian women are well educated by international and regional standards.

Despite several United Nations resolutions, construction of illegal settlements accelerated in 2017 and 2018. During the first three quarters of 2017, approval for construction of new housing units reached 10,000, more than double the total for 2016. In early 2018, plans were approved for 5,000 housing units in existing settlements and for the establishment of new settlements.

Settlement expansion is combined with relentless destruction of Palestinian assets, including electrification projects, schools and residential property. Between 2009 and mid-2017, Israel demolished over 4,000 Palestinian-owned structures and 236 European Union-funded structures in Area C (in the West Bank).

Area C continues to be nearly entirely off-limits for the Palestinian government, producers and investors, even though it represents more than 60% of West Bank area and contains the most valuable natural resources. Under the discriminatory planning regime, only 1% of Area C remains available for Palestinians to apply for building permits, with an approval rate of less than 4%. These restrictions force Palestinians to build without permits and suffer the real risk of demolition, eviction, loss of property and displacement, said UNCTAD.

De-development in Gaza

With respect to the Gaza Strip, the report said that over 2 million people now live under full blockade, confined to a Strip with a surface area of 365 sq km and the third-highest population density in the world.

The blockade, now in its eleventh year, eviscerated Gaza's economy and productive base and reduced the Strip to a humanitarian case of profound aid-dependency. The past quarter of a century was not only lost but has been one of ongoing de-development.

Six years ago, the United Nations warned that unless ongoing trends were reversed, Gaza would be unfit for human inhabitancy by 2020. Since then, all socioeconomic indicators have worsened.

"Efforts at revival have been feeble and all interventions necessarily focused on reconstruction and humanitarian relief, leaving few resources for development or resuscitating the productive base."

Gaza's productive capacity has been entirely erased by three major military strikes and a crippling air, sea and land blockade. According to the International Monetary Fund, the 2008-09 Israeli military strike wiped out over 60% of Gaza's total capital stock, while the 2014 strike destroyed 85% of what was left of capital stock.

The United Nations Relief and Works Agency for Palestine Refugees in the Near East (UNRWA), the second biggest employer in Gaza, faces funding cuts that could significantly worsen the humanitarian situation. The Agency provides social assistance to 80% of the population and operates 267 schools and 21 health facilities.

Dwindling donor support, reduction in PNA (Palestinian National Authority) wage expenditure in Gaza and the funding shortage affecting UNRWA together represent a significant aggregate-demand shock that will deal another blow to an economy already operating under daunting supply constraints, said UNCTAD. *(SUNS8754)* ❐

Great recession, greater illusions

The world economy has remained sluggish in the decade since the global crisis, no thanks to policy failures and missed opportunities, write *Anis Chowdhury* and *Jomo Kwame Sundaram*.

In 2009, the world economy contracted by -2.2%. Growth in all developing countries declined to 2.6% from around 8% in 2007 as the developed world contracted by -3.8%. The collapse of the Lehman Brothers investment bank in September 2008 symbolized the US financial crisis that triggered the Great Recession of 2008-09.

In its immediate aftermath, a new consensus reversed the neoliberal Washington Consensus of the last two decades of the 20th century. Proclaimed by the London summit of the G20 major economies in April 2009, it envisaged a return to Keynesian macroeconomic policies, including large-scale fiscal stimulus, supported by expansionary monetary policy.

The new policies were largely successful in tempering the recession, although much more should have been done. But with modest recovery, public debt, not economic stagnation, was soon sold as public enemy number one again.

G20 leaders at the June 2010 Toronto summit turned to "fiscal consolidation", with monetary policy accommodation to "contain" its contractionary consequences, and "structural" (mainly labour market) reforms, ostensibly to boost growth, especially in advanced economies.

Meanwhile, despite the G20 leaders' pledges eschewing protectionism, trade restrictions grew.

Synchronized fiscal consolidation precipitated some eurozone sovereign debt crises. Soon, several eurozone countries experienced double-dip recessions, as unemployment in Greece and Spain rose well over 25% following punitive policies required to qualify for European Union and International Monetary Fund (IMF) funding which mainly went to creditors.

Misleading, ideologically driven empirical analyses claimed to support the new policy reversal. Alesina and his associates promoted the idea of "expansionary fiscal consolidation", that contractionary government expenditure cuts would be more than offset by private spending expansion due to boosted investor confidence. Then, Reinhart and Rogoff exaggerated the dangers of domestic debt accumulation. Although soon exposed for major methodological flaws and suppressing relevant information, these studies had served their purpose.

The IMF *Fiscal Monitor* ahead of the June 2010 G20 summit grossly exaggerated public debt's destabilizing effects, advocating rapid fiscal consolidation instead. Later, the IMF admitted it had underestimated the fiscal multiplier and hence potential growth from such debt!

Faltering recovery and rising unemployment in the eurozone caused the public debt-GDP ratio to rise instead. Meanwhile, supposedly unavoidable short-term pain caused prolonged suffering for millions without the promised medium- and long-term gains.

Ahead of the curve

Besides the Bank for International Settlements' legendary William White, the United Nations had been ahead of the curve, not only in warning of the impending crisis, but also by providing appropriate policy advice, albeit largely ignored.

For example, the UN's 2006 and 2007 *World Economic Situation and Prospects (WESP)* reports warned of instability and growth slowdowns due to disorderly adjustment of growing macroeconomic imbalances among major world economies. *WESP* warned that falling US house prices could cause defaults to spike, triggering bank crises.

The IMF and the Organization for Economic Cooperation and Development (OECD) simply ignored such warnings, projecting rosy futures and a "soft landing" at worst.

The April 2007 IMF *World Economic Outlook (WEO)* emphatically dismissed widely held concerns about disorderly unwinding of global imbalances, claiming economic risks had subsided.

The July 2007 issue claimed: "The strong global expansion is continuing, and projections for global growth in both 2007 and 2008 have been revised up."

The June 2007 OECD *Economic Outlook* insisted that the US slowdown was not heralding a period of worldwide economic weakness. "Rather, a 'smooth' rebalancing was to be expected, with Europe taking over the baton from the United States in driving OECD growth ... Indeed, the current economic situation is in many ways better than what we have experienced in years."

Although the IMF's November 2008 *WEO* belatedly acknowledged the crisis' severity, it forecast global recovery of 2.2% in 2009, suggesting the worst was over, thus supporting the reversal from fiscal expansion to consolidation.

With the "green shoots" of recovery depicted as self-sustaining, fiscal stimulus was abandoned after selective financial bailouts.

The IMF and OECD recommendations of structural reforms and fiscal consolidation have since failed to provide the long-awaited sustained global economic recovery.

In 2008, the then President of the UN General Assembly set up a commission led by Nobel laureate Joseph Stiglitz to study the crisis' impact, especially for development, and recommend policies to prevent future crises. Yet, most remain unaware of its wide-ranging findings and policy recommendations, including international financial architecture reforms and re-regulating finance to better serve the real economy.

The UN Secretary-General proposed a Global Green New Deal in 2009 to accelerate economic recovery and job creation while addressing sustainable development, climate change and food security. It envisioned massive, multilateral, cross-subsidized public investments in renewable energy and smallholder food production in developing countries.

The UN also consistently advocated policy coordination and warned against prematurely ending recovery efforts.

(continued on page 16)

Development banks: A potential game changer

Kavaljit Singh **highlights the potential of development banks to redress market failures in financing and to support economic development and structural transformation beyond narrow commercial objectives.**

Although development banks are financial institutions with a substantial part of their equity owned by the state, there is no precise definition of a development bank. According to the World Bank, a development bank is defined as "a bank or financial institution with at least 30 percent state-owned equity that has been given an explicit legal mandate to reach socio-economic goals in a region, sector or particular market segment." The United Nations defines development banks as "financial institutions set up to foster economic development, often taking into account objectives of social development and regional integration, mainly by providing long-term financing to, or facilitating the financing of, projects generating positive externalities."

Their creditworthiness is ensured due to their backing by government funds and guarantees that also enable them to raise capital from national and international markets.

Development banks across the world differ in size, ownership, funding and business activities. National development banks usually operate within a country. Most national development banks are relatively small in relation to other financial players. They focus on the promotion of the domestic economy and offer loans, equity and other financing instruments. The Small Industries Development Bank of India, the Banco Nacional de Desenvolvimento Econômico e Social (BNDES) in Brazil, and the British Business Bank are some prime examples of national development banks.

Bilateral development banks finance development projects and activities in the poor and developing countries. They provide a wide range of assistance including grants, loans, structured funds and technical advice. Examples of bilateral development banks are the Japan International Cooperation Agency and Germany's Kreditanstalt für Wiederaufbau (KfW). In addition, there are regional development banks (such as the African Development Bank) and multilateral development banks (such as the World Bank) performing similar functions as those of bilateral development banks.

There are also development finance institutions (DFIs) that make investments or lend money to private sector companies in sectors or countries that are otherwise unable to attract capital.

The following are some of the key characteristic features of a development bank:

- It does not operate with the primary objective of maximizing profits. A development bank believes that profitability can go hand in hand with meeting development objectives. Different development banks pursue different developmental objectives. Some focus on infrastructure and industrial development while others pursue social development and inclusive growth.
- It is backed by government funds and guarantees ensuring its creditworthiness.
- Due to public ownership, the government determines its mandate and strategic direction.
- Unlike a commercial bank which usually provides short-term working capital financing, a development bank can offer medium- and long-term loans for projects that require 15-25 years of funding.
- It has in-house technical expertise to understand the business dynamics of a particular sector. By building partnerships and imparting specialized skills, a development bank can provide business support services and advice when it is needed.
- A development bank has an explicit public policy mandate to enhance economic development and to achieve other socioeconomic goals such as the development of backward areas and structural transformation of the rural economy.
- A development bank provides a high level of "additionality", financing investments and activities that would not otherwise have happened.
- Apart from correcting market failures, a development bank can also support new initiatives aimed at tackling urgent societal challenges (such as climate change, food security, financial crises, inequality and inclusive growth), thereby contributing to social value creation.
- It can invest in setting up new greenfield projects or at the beginning of new sectors (such as IT and clean energy technology) with an objective of nurturing innovations. It can provide first-time funds to businesses that may struggle to attract commercial investors for a variety of reasons.

Revival of interest in development banks

The global financial crisis of 2008 has brought the role of development banks and development finance institutions back in the policy spotlight. Governments across the world are considering these institutions as a part of the countercyclical policy toolkit besides recognizing their role in supporting economic development and structural transformation.

Post-crisis, one is witnessing the formation of new development banks and DFIs in both developing and developed countries. Most of the recently established institutions in developed countries put greater emphasis on promoting green finance, new technologies, development of small and medium-sized enterprises (SMEs), and startups. The UK, for instance, established the Green Investment Bank in 2012 to finance green projects. In 2013, the British Business Bank was launched to meet the financing needs of SMEs. In 2012, France created a new institution, Banque Publique d'Investissement (BPI), by bringing together Oséo, CDC Entreprises, the FSI and FSI Régions. BPI aims to support small businesses and create local jobs. In 2014, Portugal established a development bank, Instituição Financeira de Desenvolvimento (IFD), to support SMEs. Similarly, the Strategic Banking Corporation of Ireland (SBCI) was established in 2015 to support Irish SMEs.

In many developed countries, industrial policy is back in fashion. The revival of discussion on industrial policy may encourage governments to explore the potential role of development banks in financing long-term strategic industrial projects or sectors.

The recent positive experience of many development banks in Asian and Latin American countries during the financial crisis may also encourage other developing countries to create new or revive existing institutions to pursue economic growth and structural transformation. In all likelihood, development banks and DFIs will play an important role in the arena of development finance in the coming years.

This is in contrast to the 1980s and 1990s when development banks almost disappeared in many countries in the wake of market-oriented financial reforms.

For instance, in India, where development banks were seen as key actors in providing long-term funding for industrial and infrastructure projects in the post-independence period, their role in financing long-term projects drastically diminished with the withdrawal of low-cost funds from the government in the early 1990s. Consequently, the Industrial Investment Bank of India was folded up while the Industrial Credit and Investment Corporation of India and the Industrial Development Bank of India were converted into full-fledged commercial banks. The sharp decline in long-term credit in the post-reform period has revived demands for creating a new state-funded DFI in India that can provide medium- and long-term credit to the manufacturing and infrastructure sectors.

The countercyclical role of development banks

The recent attraction of development banks and DFIs is primarily due to the countercyclical role played by such institutions during the global financial crisis. In many Latin American and European countries, the state-owned development banks played a countercyclical role by stepping up lending when private sector loans dried up.

Below are some examples of development banks playing a countercyclical role, especially during the early years of the global financial crisis.

In Brazil, BNDES was the most critical policy tool used by the government as a countercyclical response to mitigate the adverse effects of the financial crisis on the Brazilian economy. BNDES received a big capital injection of R$100 billion in 2009 from the government and used it to disburse credit to domestic firms. Loans from BNDES were given at subsidized rates – considerably lower than the prevailing market rates. Credit by BNDES surged from R$160 billion (at 2005 prices) in September 2008 to R$277 billion in December 2010. BNDES played a crucial role in stabilizing the level of domestic investment by ensuring the flow of funds to long-term projects. Without the support of subsidized loans offered by BNDES, many Brazilian companies may not have undertaken long-term investments in adverse times. The countercyclical role played by BNDES helped Brazil face the crisis much better than many other developing countries although concerns have been raised about the bulk of the subsidized credit going to large firms.

In Mexico, development banks played a countercyclical role by expanding credit when risk-averse commercial banks curtailed credit growth in 2009. Domestic demand experienced a severe decline in 2009 when Mexico's GDP contracted by 6%. The Mexican development banks supported the housing and commercial paper markets through public guarantee credit schemes. Specialized development banks such as Nafin and Bancomext rapidly expanded their credit and guarantee programmes to ensure that firms involved in manufacturing and exports did not face a credit crunch. The development banks played a crucial role in economic recovery in 2010-11, supported by strong manufacturing exports and domestic demand.

Established in 1948, Germany's KfW has played an essential role in financing the reconstruction of its economy in the postwar period. KfW is a state-owned DFI and is active in the financing of infrastructure, SMEs, housing, environmental and development projects in Germany and abroad. Composed of five primary units, the objective of KfW is to overcome market failures and promote socially beneficial projects that are underfunded. During the global financial crisis, KfW played a countercyclical role by launching a special programme in 2009 which issued €13.3 billion of credit to SMEs. In addition, KfW implemented a multi-year economic stimulus plan for German enterprises (€40 billion) and energy efficiency and infrastructure measures (€10 billion). According to KfW, its financial activities saved around 360,000 jobs at suppliers and roughly 370,000 jobs at the ultimate borrowers by 2012.

In Poland, PKO Bank Polski came to the rescue of the domestic economy by increasing lending to households and firms when Polish subsidiaries of foreign banks drastically cut credit supply during the crisis. In Poland, foreign banks control nearly three-fourths of the total assets of the banking system.

In many other European countries including Spain, Italy, Austria and Bulgaria, development banks increased lending and guarantee support during the 2008 crisis. In some instances, they took on additional activities to revive investments in a stuttering economy. In Europe, it has recently been observed that some national development banks and DFIs supported each other by providing loans and policy advice.

Of late, some national development banks (such as KfW) have enlarged their international presence, particularly in the poor and developing world. Besides, one is witnessing the emergence of new regional and South-led development banks such as the New Development Bank (NDB) established by the BRICS states; the Asian Infrastructure Investment Bank (AIIB), a China-led multilateral development bank aiming to finance the building of infrastructure in the Asia-Pacific region; and the Bank of the South (BancoSur), a monetary fund and lending institution established by Argentina, Brazil, Paraguay, Uruguay, Ecuador, Bolivia and Venezuela. The motivations behind the establishment of these new institutions are myriad, but the under-representation of developing countries in the governance structures of existing international financial institutions and regional development banks also added momentum to these initiatives.

In addition to fulfilling their traditional mandate of addressing market failures, successful development banks in many countries have provided financing and other support to initiatives aimed at tackling urgent societal challenges such as climate change, food security, women's empowerment, poverty elimination and human development. There is no gainsaying that such public financial institutions are well positioned to address broader social and economic challenges.

Traditionally, the impact assessments of development finance institutions have been focused on micro-level impacts, but given their important role in tackling global challenges, the time has come to measure impacts in terms of their contribution towards tackling global challenges.

By scaling up lending operations of development banks and DFIs, their importance as major players in sustainable development will get recognized.

Leveraging development banks for the SDGs

Adopted by all member states of the United Nations in 2015, the 2030 Agenda for Sustainable Development provides a shared global framework for building a fairer, more prosperous, peaceful and sustainable world. With a commitment to "leave no one behind", it consists of 17 Sustainable Development Goals (SDGs) – also known as the Global Goals – and 169 targets, indicators and means of implementation. The SDGs came into effect in January 2016 and are supposed to be met by 2030.

The Agenda 2030 is universal in nature, and therefore it applies to all countries irrespective of the level of development. The SDGs build on the successes of the Millennium Development Goals and cover a wide range of issues including poverty, hunger, climate change, gender inequality, peace and justice, among others. The Agenda 2030 calls for partnerships among governments, business and civil society to realize the SDGs.

To meet the investment needs of the SDGs, a considerable amount of financial resources from a variety of sources are required. The UN Conference on Trade and Development (UNCTAD) has estimated that achieving the SDGs will require global investment of between $5 trillion and $7 trillion per year, with an investment gap of $2.5 trillion in developing countries. Even if one may question the basis of the investment estimates made by UNCTAD, the fact remains that the SDGs require substantial financial resources from all sources: public and private, domestic and international.

To bridge the investment gap, the Organization for Economic Cooperation and Development (OECD) and some experts emphasize on mobilizing commercial finance for SDGs by adopting new financing mechanisms such as blended finance.* Blended finance may appear attractive in concept but can be problematic in practice. The evidence base on blended finance is limited so far. Much of its focus has been on middle-income countries, thereby raising questions about its effectiveness in the poor countries. There is very little cross-country evidence to show how blended finance enabled projects with high development impact. Besides, there are significant shortcomings in monitoring systems that make it difficult to assess the performance and impact of blended finance in any meaningful way.

There is no denying that the private sector has an important contribution in the realization of the SDGs but the role of the public sector is fundamental to the delivery of public goods and services. There is a need to scale up public investment to meet SDG-implied demands for financing.

Given private investment (both domestic and foreign) has remained muted in the aftermath of the global financial crisis, the demand for public funds has increased in the poor and developing countries. In this context, development banks can act as catalysts in mobilizing development finance and help in bridging financing gaps to achieve the SDGs.

The role of development banks becomes even more critical as the development finance landscape has rapidly changed in recent years, with official development assistance (ODA) falling far short of the UN target of 0.7% of the gross national income of donor countries. The prospects of achieving the target remain bleak, at least in the near future.

The unique characteristics of development banks enable them to deliver on the SDGs with their ability to raise financial resources through various sources; provide funding to projects that would not otherwise have received it; and provide technical expertise to undertake long-term development projects. Besides, their willingness and experience in incorporating environmental, social and governance (ESG) factors in business activities place them in a strong position to play a leading role in meeting the SDGs.

In India and elsewhere, many development banks emphasize different developmental challenges such as housing, agriculture, women's empowerment and small-scale industries. Some of them have shown that developmental success can go hand in hand with financial success. Such success stories can be replicated across the world.

The poor and developing countries can set up new development banks to undertake this challenging task. A development bank should not necessarily be wholly government-owned although some level of government ownership is desirable for achieving broader social and economic objectives. Development banks can mobilize finance required for development-oriented projects by borrowing from both domestic and international capital markets. To ensure that they raise funds at reasonably low costs, development banks can be offered direct financial support by the national governments or allowed to issue tax-free bonds. Another option is to raise concessional funds from international development banks such as KfW.

Governance matters

As many more governments are taking a fresh look at various types of state-owned financial institutions, it is essential that greater attention be paid to their governance, performance and public accountability, given their mandate to serve the public interest.

As development banking is inherently risky, state-owned banks and financial institutions face a particular challenge – how to remain financially viable while pursuing broader socioeconomic objectives. Some well-managed development banks often find it difficult to reconcile these conflicting objectives. However, they can face this challenging task under the right circumstances with appropriate governance and policy frameworks.

Studies on the performance of state-owned financial institutions show mixed results. Some poorly managed state-owned financial institutions failed, leading to substantial fiscal costs and poor development outcomes, while some have performed spectacularly in terms of their economic sustainability as well as the fulfilment of broader development objectives. Needless to add, policymakers can learn from both past failures and past successes of state-owned institutions.

There is no "one-size-fits-all" model for the governance of state-owned banks and financial institutions as it is influenced by a wide range of factors including a country's institutional environment and regulatory regime. As pointed out by Janine Thorne and Charlotte du Toit, a state-owned financial institution is unlikely to achieve its desired objectives if the institutional environment in a country is weak coupled with weak regulation and supervision; its mandate is not clearly defined; its staff lack critical skills in management and operations; and there is interference by corrupt officials, board members and politicians in its business activities.

To begin with, a development bank needs an enabling environment to accomplish its desired objectives. The prospects of a "successful" development bank tend to be bleak in countries with weak political institutions, high levels of corruption, weak rule of law and higher macroeconomic instability.

In addition, well-functioning legal and regulatory institutions are as much a prerequisite for public-owned development banks as for private banks.

Secondly, the mandate of a development bank should be clearly articulated regardless of whether the mandate is narrow or broad. In particular, the board of directors and the executive team of a state-owned financial institution should have a clear understanding of its purpose and objectives and their role in achieving this. It is likely that the mandate of a state-owned bank may change over time, but it should be clearly articulated. Otherwise, a development bank may drift away from its stated objectives, leading to undesirable outcomes.

Thirdly, under state ownership, the government is both the owner and the regulator of banks. Therefore, the government should establish a clear ownership policy ensuring that it will regulate state-owned financial institutions in a transparent and accountable manner, avoiding any potential conflict of interest.

Fourthly, the quality of internal governance and management systems also plays an essential role in the functioning of a development bank. The board of directors and the executive team of a development bank should have relevant expertise and experience to steer and manage the bank. This is a challenging task because not all countries have a deep pool of local expertise and talent to create and run a development bank.

It is essential that the board of directors be independent and reflect the highest standards of competence. Even though ownership remains with the government, the senior executive team of a state-owned bank should have operational autonomy to run the day-to-day operations. Besides, strong internal control structures should be embedded in a bank's governance system to ensure a high quality of transparency and accountability not only to the government but to all stakeholders.

Fifthly, the board and senior management team should have a commitment to integrity and be held accountable for their actions by the government, regulatory agencies and the wider public.

Finally, alternative regulatory frameworks should be worked out specifically for development banks as commercial banking regulations may not be appropriate for development banks that do not raise money from depositors. ❒

Kavaljit Singh is Director of Madhyam, a New Delhi-based non-profit policy research institute. The above is extracted from the Madhyam research report Scaling Up Finance for Sustainable Development *published in September 2018. The full report is available at www.madhyam.org.in.*

Note

* Blended finance is a mix of public and private capital to fund a particular development project or programme. The OECD defines blended finance as "the strategic use of development finance for the mobilization of additional finance towards sustainable development in developing countries. Additional finance is commercial finance that does not have an explicit development purpose, and that has not primarily targeted development outcomes in developing countries. Development finance is public and private finance that is being deployed with a development mandate."

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Missed opportunity, heightened vulnerability

With UN and similar policy advice largely ignored, global economic recovery has remained tepid for the last decade. This has prompted the "secular stagnation" thesis obscuring the role of political and policy failures and missed opportunities.

Unconventional monetary policy, e.g., "quantitative easing", has also widened income and wealth gaps besides fuelling financial asset bubbles.

Earlier capital inflows are now exiting following monetary policy normalization in the West and new fears of emerging market vulnerabilities.

Having failed to ensure robust recovery despite accumulating more debt, both developed and developing countries have less policy and fiscal space to address the looming problems threatening them.

Meanwhile, the redistributive potential of fiscal policy has been weakened by reducing progressive direct taxes and increasing regressive indirect taxes, while cutting social expenditure.

Also, powerful vested interests have blocked attempts to limit obscene executive remuneration and enforce minimum wages, arguing that such measures discourage business and job creation.

Also, the hyped notion of "inclusive inequality" has served to justify rising economic disparities, by arguing that deregulation has enabled wealth accumulation and middle-class expansion. *(IPS)* ❒

Anis Chowdhury, Adjunct Professor at Western Sydney University (Australia), held senior United Nations positions in New York and Bangkok. Jomo Kwame Sundaram, a former economics professor, was United Nations Assistant Secretary-General for Economic Development, and received the Wassily Leontief Prize for Advancing the Frontiers of Economic Thought in 2007.