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IIAs hindering sovereign debt restructuring – study

Sovereign debt restructuring, undertaken to allow the debtor country to address debt sustainability problems, could be made “more difficult and more costly” by international investment agreements (IIAs) which have strengthened creditor rights, a recent study cautions. The paper argues the need instead to balance protection of creditor interests with policy measures to enable countries facing unsustainable debt burdens to return to normal economic functioning.

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IIAs have made debt restructuring more difficult and costly

Recourse to debt restructuring by countries facing unsustainable debt burdens could be undermined by international investment agreements which confer wide-ranging rights on creditors, warns a recent study.

by Kanaga Raja

GENEVA: International investment and trade agreements are legally binding international treaties which give investors an additional layer of legal protection on top of the host-country law and contract law, but little effort has been made in ironing out the interface between these different laws and treaties, according to a new paper from the South Centre.

The Investment Policy Brief by the South Centre, the Geneva-based inter-governmental think-tank of developing countries, said that inconsistencies and even contradictions have emerged in the process to enforce legal protection of the interest of investors through international arbitration and litigation, sometimes at the expense of public good, sovereignty and financial and economic stability. "An asymmetry seems to exist in the allocation of risks and benefits between investors and recipients of investments," it said.

The international investment agreements (IIAs) have markedly strengthened creditor/investor rights and made sovereign debt restructuring more difficult and more costly, the paper underlined.

The Investment Policy Brief, "How international investment agreements have made debt restructuring even more difficult and costly", was authored by Yuefen Li, Special Advisor on Economics and Development Finance at the South Centre.

According to Li, even though arbitration cases for creditor and sovereign disputes arising from sovereign bonds are few and much less numerous than those related to foreign direct investment (FDI), the potential of more such disputes in the future does exist, with the few cases becoming more publicized and with more and more developing countries including low-income countries floating bonds even with poor or no sovereign risk ratings.

The ongoing reform in the design of new IIAs, including provisions covering debt instruments and the review of existing ones, is reassuring and points to

the fact that many countries, though not all, are aware of the challenges posed by the IIAs and some countries have been trying to redress the problems.

Sovereign defaults and debt crises have long become a reality in the world. Since the 1980s, the occurrence of sovereign debt defaults has become more frequent. Debt default and restructuring have reached their height since the global financial crisis, with about 11 countries having defaulted and restructured their sovereign debt with private creditors. Among them, the Greek debt restructuring in 2012 was the largest in history.

Outright formal defaults have sometimes been averted through debt restructuring. Yet, complaints about debt restructurings being "too little too late" and often lacking fairness, transparency and orderliness have become stronger and more prevalent.

"However, up to now, the world still does not have a debt restructuring legal framework for the sovereigns," said Li.

After a few major countries thwarted the 2003 International Monetary Fund (IMF)-led initiative on a Sovereign Debt Restructuring Mechanism (SDRM), there have been various attempts, including the United Nations General Assembly resolution of September 2015 on "Basic Principles on Sovereign Debt Restructuring Processes", to revive the international efforts to formulate a treaty-based legal framework on sovereign debt restructuring. Unfortunately, these attempts have not yet won political support from major developed creditor countries.

"History repeats itself," said Li. "Like what happened after the SDRM debate, main attention has been turned to improvements of bond contracts like tightening up and strengthening the Collective Action Clause (CAC) and the *pari passu* clause."

The CAC, a common clause in bond contracts, makes decisions by a supermajority of bondholders (normally 75% and above) to agree to a debt restructuring legally binding on all holders of the

bond. *Pari passu*, which means “equal footing”, used to be an obscure common clause in a bond contract. The stretched interpretation of the clause at the US court in the case of *NML v. Argentina* has made it well known and also led to the tightening of the language to avoid repetition of the Argentina case.

While contractual improvements may not really solve the problems facing debt restructuring, they are certainly a welcome development which would make holdouts against debt restructuring more difficult, said the policy brief.

However, parallel with the international endeavour to make debt restructuring smoother and fairer, there has been an international tidal wave of signing IIAs.

The rush to sign IIAs has been mainly driven by the belief, though not empirically proven, that IIAs could attract more foreign direct investment to promote economic development. There were also cases when IIAs have been treated as political or foreign policy gestures or statements. By the end of 2016, there were a total of 3,324 IIAs worldwide.

The fact that they are legally binding and that non-compliance with the IIA clauses can lead to legal punitive actions does not seem to have been given due attention by some developing-country policymakers before the signing of the agreements. Only when IIAs started to give rise to millions and billions of dollars in compensation for investors as a result of arbitration awards did countries realize that IIAs can bite.

“The IIAs have strengthened markedly the creditor/investor rights and made sovereign debt restructuring more difficult and more costly,” said Li.

If the definition of “investment” in an IIA includes bonds, bond contracts cannot govern IIAs, which are legally binding international treaties, according to the policy brief. As a result, efforts to improve bond contracts have become futile unless otherwise stipulated in IIAs to allow bonds to be excluded or given special treatment in times of debt restructuring or financial crisis.

If a country has not signed any IIAs at all, debt restructuring may face litigation in the national courts stipulated in the bond contracts.

However, in the scenario in which a country has signed IIAs which could be interpreted as including bonds under the broad scope of investment, holdout creditors would have another avenue to

get compensation, namely the arbitration tribunal.

“A very pertinent question for the international community to consider is whether it is fair for the sovereign borrowers to face both litigation and arbitration and the scrutiny of both private law governing bond contracts as well as public law governing IIAs. Yet, in real life countries have been dragged to both.”

The economic cost of the two layers of legal protection of creditors could be very high for sovereign borrowers. On the one hand, there is the compensation for the holdout bond owners if a favourable ruling is won at designated national courts. On the other, the cost for the arbitration process itself can be a big burden for countries suffering from financial distress.

On top of this, some generally accepted debt crisis containment and prevention measures are seen as non-compliant with IIA provisions. For instance, IIA clauses like “national treatment”, “most favoured nation”, and “fair and equitable treatment” could provide investors grounds to argue that such policies as capital controls, bank deposit guarantees and nationalization of banks constitute a breach of IIAs.

The fear of being dragged to an arbitration tribunal could negatively impact on effective crisis containment, thus making debt restructuring bigger in scale and also “too late”.

“It is high time for the international community to address the interface between the private and public law. For countries having signed the first generation of IIAs, this interface could well be neglected,” said the South Centre paper.

Interface between IIAs and debt restructuring practices

Bond contracts always have a clause stipulating the jurisdiction of the bonds should disputes arise. Normally it is the national court of a country seen as an important international financial centre. New York and London are top on the list. Therefore, it is litigation at designated national courts and not arbitration tribunals should bond holders want to challenge the outcome of a debt restructuring.

However, with the signing of IIAs, a debt restructuring may very likely have to go through another layer of legal scrutiny as most IIAs have a clause on arbitration for settling disputes.

This means that if debt instruments are stipulated as a type of investment in the IIAs, bond holders from countries having IIAs with a country going through debt restructuring can resort to arbitration if they do not want to participate in the debt restructuring owing to various reasons.

An economist might be puzzled by such a phenomenon and wonder if a sovereign borrower entering into a bond contract is considered as giving up its sovereignty and treated at the same level of a private investor, with its assets abroad able to be attached (grabbed in normal language) in the case of a default.

With the International Centre for Settlement of Investment Disputes (ICSID) handing out awards on claims of holdout bond investors in the context of violation of IIA provisions, some scholars have been examining the blurring between public law (treaties) and private law (contracts), which is a very pertinent question waiting for an answer.

Li noted that the international community has made important efforts to improve bond contracts, in particular the CAC and the *pari passu* clause, in the past few years. As a response to events like the Greek debt restructuring and the US court rulings on Argentina’s restructured bond, there has been an intensification of contract improvements instead of a holistic attempt to resolve challenges facing sovereign debt restructurings, which is naturally more difficult.

In this context, the paper cited the International Capital Market Association (ICMA) as having proposed the super collective action clause and tightened language for the *pari passu* clause, with the IMF’s proposals being along the same lines. The revised and strengthened CACs would allow bond issuers to aggregate different series of bonds to be restructured, thus making holding out on a restructuring proposal more difficult since a blocking vote would require much greater financial power than for a single bond. In the same vein, the tightened *pari passu* clause has made stretched interpretation of this clause less possible.

“With these improvements, there is a sense of complacency that major weaknesses existing in the current bond contracts have been more or less addressed and the road for smoother debt restructuring has been paved.”

However, the paper noted, even if 75% or 90% of holders of several bonds have agreed to the terms of a debt restructuring and voted against litigation,

in line with the enhanced CAC, they cannot prevent holdout investors from filing an arbitral claim if the restructured bonds are deemed as protected investment according to an IIA and there is no special stipulation on negotiated restructuring in the IIA.

Cases have shown that private law cannot override public law as ICSID has already handled arbitrations over disputes arising from debt restructuring and the awards are supposed to be immediately enforceable.

With more bondholders aware of arbitration as a relatively easy avenue to get compensation for their bonds, more treaty claims could be lodged, thus increasing holdout risks. The treaty claims, depending on the specific wording of an IIA, could be based on IIA clauses like expropriation, fair and equitable treatment, and a few other clauses.

"The sovereign bond issuers are advised to study carefully their bond contract clauses as well as their IIA clauses before they plan for a debt restructuring," the South Centre paper said.

Whether or not holdout bond investors can drag a sovereign to the arbitration tribunal after a debt restructuring depends mostly on whether the definition of "investment" in the IIAs includes bonds as a "protected investment".

This means the definition or the scope of investment under an IIA would be crucial for deciding whether a claim arising from a debt restructuring is qualified as an investment claim. For debt-restructuring-related cases, tribunals normally start deliberation with determining whether a particular IIA applies to government bonds.

Strangely enough, said Li, ICSID, which claims jurisdiction over any legal disputes "arising directly out of an investment, between a Contracting State ... and a national of another Contracting State", does not have a clear definition for investment in the ICSID Convention. This gave arbitration tribunals no clear legal basis for deliberation of claims.

There had also been the uncertainty as to whether ICSID has jurisdiction over disputes over sovereign bonds. Then in 1996 ICSID accepted the arbitration case of *Fedax v. Venezuela*, which was a claim pursuant to the Venezuela-Netherlands bilateral investment treaty for failure to pay amounts due under promissory notes. This was the first time for a debt instrument to be classified as "protected investment" and also for ICSID to claim jurisdiction officially over such disputes. The case marked the start of taking ICSID by default as a forum for dispute settlement over debt restructuring, in addition

to the national courts mentioned in the bond contracts.

In view of the lack of a clear concept of "investment" and resultant difficulty in arbitration deliberations, in 2001, the tribunal in the *Salini v. Morocco* case (ICSID Case No. AR-B/00/4) identified four criteria for investment: (1) commitment or contribution of money or assets; (2) for a certain duration; (3) assumption of risks; (4) contribution to economic development of the host country. These are broad principles and it is not surprising that subsequent tribunals are seen as having applied these criteria flexibly.

To complicate things further, IIAs all have their own definitions of "investment" and the variation in wording and scope of these definitions ranges from small to large. In this kaleidoscopic range of definitions, debt instruments have been given different treatments.

In view of the absence of a uniform definition of investment, there has been difficulty in deciding whether a debt-restructuring-related dispute regarding a sovereign bond pertains to a protected investment.

The question arises as to whether the decision should be solely based on the provisions of the individual IIAs, on the *Salini* criteria, or on Article 25 of the ICSID Convention which refers generally to "any legal dispute arising directly out of an investment".

So far ICSID has handled three cases relating to debt instrument disputes under IIAs, the paper said: *Fedax v. Venezuela*, *Abaclat and Others v. Argentina*, and *Postova bank v. Greece*. From the three cases, it could be seen that different tribunals have relatively liberally applied different legal bases for the interpretation of "investment" and the jurisdiction of ICSID. In the *Abaclat* case on restructured Argentine bonds, there was actually discussion on whether the tribunal should arbitrate on the basis of the relevant IIA or on the wording of the ICSID Convention. Apparently the latter prevailed.

This case-by-case interpretative approach adopted by ICSID in affirming the status of sovereign debt as an investment has been challenged by some scholars regarding consistency in deciding on the awards of the cases. Some think that such an approach would result in greater ambiguity as to how these provisions will be interpreted in the next dispute, and that greater ICSID involvement in sovereign debt restructuring disputes does not necessarily imply greater predictability for how claims will be resolved.

The paper also highlighted the lack

of an appeal system for ICSID awards. It noted that for litigation at national court, the borrowing country can go to the court of appeals after the lower court issues an injunction. This provides the debtor with an opportunity to further argue the case. For arbitration, however, once a tribunal hands out an award, it does not have the power to reconsider the award even though a party to the dispute has the right to request for interpretation of the award and / or to apply for annulment of an award on procedural grounds. Therefore, it is assumed that awards should be directly enforced.

More costly debt restructuring

According to the policy brief, debt restructuring is necessary when a country has an unsustainable debt burden ranging from debt overhang to severe liquidity problems. It is meant to allow the debtor country to address the debt sustainability problems and restore economic growth by extending the maturity through debt exchange, a debt re-profiling, or through both haircuts and prolongation of maturity. Timely and effective debt crisis containment and management could allow a crisis-stricken country to prevent a collapse of the economy, contain contagion and protect public interest.

For debt and financial crises in the past two decades and more, especially the current global financial crisis, it has become almost a normal practice for governments to intervene to prevent the economy from sinking into a deeper systemic meltdown and also to alleviate the social suffering of the population. Many governments functioned like fire brigades and adopted various policy measures such as capital controls, currency devaluation, freezing prices for the public sector, and even debt restructuring.

Should governments not adopt crisis management measures for fear of a breach of IIA obligations even though there are economic justifications, the cost of a debt crisis and the eventual debt restructuring would certainly increase, the paper cautioned.

"This has turned the investor-state dispute settlement (ISDS) mechanism under IIAs into a hindrance to timely debt restructuring and allowed individual bond-holders to hold out [against] debt restructuring arrangements agreed by the majority of bondholders and get compensation from the crisis-stricken states whose people are going through

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WTO chief, EU, US and China advocate plurilaterals

A recent forum on plurilateral trade initiatives saw the WTO head, the EU, the US and China each, in their respective ways, make a push for these non-multilateral endeavours.

by D. Ravi Kanth

GENEVA: The World Trade Organization Director-General Roberto Azevedo along with the European Union, the United States and China on 28 February mounted a concerted campaign for launching plurilateral negotiations on new issues albeit with differing justifications.

The new issues include rules on electronic commerce, investment facilitation, disciplines for micro, small and medium-sized enterprises (MSMEs), and even trade and gender.

There were recurring undertones and commonality of views in the separate statements made at the Graduate Institute in Geneva which conducted the meeting on "Plurilaterals, the New Way Forward in Global Trade?" on 28 February.

The overall impression was that the views voiced appeared to be a well-coordinated effort of the Director-General with the three WTO members.

The Director-General and the EU's trade envoy Ambassador Marc Vanheukelen echoed almost identical views on the need to emulate the Tokyo Round codes in advancing plurilateral outcomes on new issues that can be subsequently multilateralized.

[The Tokyo Round of trade negotiations (1973-79) and the codes (agreements) negotiated under it were under the auspices of the old General Agreement on Tariffs and Trade (GATT), a provisional treaty. The resulting view of a fragmented multilateral arrangement ultimately resulted in the "single undertaking" concept of the following round of trade negotiations, the Uruguay Round, whose final outcome was the establishment of a definitive international treaty organization (WTO) and the requirement that every participant sign on to every one of the agreements. This history of the old GATT and the WTO appeared to be slurred over by all the references to the Tokyo Round codes cited by the three major trading entities and the WTO head during the 28 February

meeting. – SUNS]

In sharp contrast to the position papers on e-commerce, investment facilitation and MSMEs that were unveiled at the WTO Ministerial Conference in Buenos Aires last December, the three dominant members of the global trading system echoed their openness to discussing these three new issues. At Buenos Aires, for example, the US did not join the group of countries that issued the statement on investment facilitation. China and Pakistan did not join the sponsors of the call for plurilateral negotiations on e-commerce. It is not clear whether the US joined the proponents who sought disciplines on MSMEs.

The three-hour discussion on 28 February was moderated by former WTO official Patrick Low. WTO Director-General Azevedo gave the concluding remarks.

Making a case for plurilaterals

Prof Bernard Hoekman, who had served at the WTO and the World Bank, delivered a keynote address as to why WTO members must embrace plurilaterals for regulatory practices.

Hoekman argued that the multilateral trading system is not in a good shape, with its negotiating function in a comatose state because of the Doha Development Agenda trade negotiations. He said the "bicycle principle" of uninterrupted trade liberalization was undermined because of the "misuse of consensus and the misuse of special and differential treatment (S&DT)."

With "consensus" being used to block negotiations, and S&DT flexibilities constraining the system, people are not engaging in the negotiations, Hoekman argued. There is a growing shift to preferential trade agreements, which he said are discriminatory.

Therefore, trade cooperation on the lines of the Trade Facilitation Agreement (TFA), which is aimed at bringing down trade costs, must be considered in

plurilateral initiatives, Hoekman said.

(The TFA was negotiated multilaterally and was not the outcome of plurilateral negotiations. – SUNS)

"Moving on plurilaterals can do more to advance the trade costs agenda and thereby, provide some oxygen to the system," said Hoekman. Plurilaterals on regulatory policies on non-tariff issues must be considered, he said.

He said that what groups of countries attempted to do in Buenos Aires on plurilaterals would be a good practice. He spelt out the necessary conditions – leadership, open and transparent process monitored by the WTO and dissemination of information – essential for the success of the plurilaterals.

In a short statement, Benin's trade envoy Ambassador Eloi Laourou said the developing and least-developed countries want multilateralism with synergies for addressing the outstanding problems. He said outstanding agricultural issues, as well as fisheries subsidies, must be addressed as per the Sustainable Development Goals.

Laourou said the developing and least-developed countries want to ensure the "development dimension" of the multilateral trade negotiations as set out in the Doha trade agenda. He said plurilaterals cannot address the development dimension, as was the case with the plurilateral agreements on civil aircraft, bovine meat and government procurement.

EU trade envoy Vanheukelen said it is a political imperative that no one can impose anything on anybody, suggesting that there would not be any pressure exerted on those who are not members of the plurilaterals.

He said the EU is comfortable with a sub-set of issues being pursued at this juncture. The EU, he said, wants "flexible multilateralism", a point that was also echoed by the WTO Director-General at the end of the meeting.

Vanheukelen said plurilaterals are by no means going to be easy, maintaining that the voluntary codes of the Tokyo Round, which were later multilateralized in the Uruguay Round, could become the best route for achieving plurilateral outcomes that would subsequently be multilateralized.

He said a critical mass of membership in the plurilaterals is essential. Besides, the plurilateral outcomes must be enforceable in the dispute settlement system, he said. Further, they must not lead

to any deviation.

China's trade envoy Ambassador Xiangchen Zhang said he is a "fundamentalist on multilateralism but I'm open to new issues." When the multilateral system is strong and robust, supplementary approaches could be followed for e-commerce and investment facilitation, he said. "Otherwise, the WTO will lose relevance."

The Chinese envoy said it is fine if some members don't want to join in the plurilaterals, emphasizing that pressure must not be exerted on those members who remain outside the plurilaterals.

US deputy trade envoy Chris Wilson said the WTO's negotiating function is working well as it had produced an agreement on trade facilitation and even an enhanced Information Technology Agreement-II. The US perspective is one of "optimism" as the Buenos Aires meeting allowed members to experiment with new processes. He said the utility and appropriateness have to be considered on a situational process, arguing that the US is open to plurilaterals on fisheries subsidies and agriculture.

He said the US is participating in e-commerce and remains interested in MSMEs. The US is open to discussing investment facilitation, though it remains sceptical on some aspects concerning the issue.

Wilson said that certain structural aspects such as transparency and differentiation must be sorted out before starting plurilaterals. While it is important to have the broadest participation, it is equally important to grapple with the contributions of members that must be commensurate with their trading status, the US trade official maintained.

The Chinese representative said plurilaterals are only a process for conducting negotiations for establishing rules among like-minded members. The developing countries remain reluctant about plurilaterals because they don't have the capacity. They need special and differential treatment flexibilities in the plurilateral agreements, China maintained. The Chinese envoy argued that members need to make a distinction between the Tokyo Round and the current new plurilaterals.

Flexibility

WTO Director-General Azevedo, who did not participate in the deliberations and arrived only at the end of the

meeting, was asked to give a concluding statement.

He said there were many reasons why there were no substantive outcomes at Buenos Aires but "one important reason was that there were few potential trade-offs that would force flexibility."

Azevedo said "flexibility is essential in the process of consensus-based decision making that we follow at the WTO", suggesting that members "who want a particular outcome often calculate: 'If I block progress in other areas, the others will agree with what I'm asking.'"

Being a former negotiator, he said, "I know that this is how many approach negotiations in the WTO." Such a rationale "does not always work as there may be no strong push to get outcomes somewhere else, so others would have no reason to agree with one's demands" and "one's demands may be too costly for the others."

"If the costs of agreeing to demands exceed the benefits sought in other areas of the negotiations, you are unlikely to find a way forward," he said. He added that "a careful analysis of these forces and trade-offs before Buenos Aires would likely have shown that such 'hostage-taking tactics' would not work."

It was not clear whether the Director-General was pointing a finger towards India, which had blocked new issues, particularly institutional issues such as trade and gender, after the permanent solution for public stockholding programmes for food security was blocked by the US.

Did the Director-General mean that for countries like the US, there is no interest in issues like food security or reduction commitments in domestic farm subsidies?

His remarks did not address these questions.

Azevedo said "under any circumstances, the major problem with this approach is that it does not encourage flexibility or a search for compromise. Instead, it encourages an all-or-nothing game of 'mutually assured destruction'."

In what seemed a subtle critique of the "consensus-based system", he said it leads to a "zero risk" approach, where "a member can look at any initiative they don't particularly like and simply stop it from even being discussed." "Of course, the outcome of such an approach is paralysis, because virtually all issues will meet some opposition from someone," Azevedo argued.

"For a consensus-based system to work, participants must realize that the indiscriminate usage of the power to block will paralyze and ultimately destroy it."

Clearly, the Director-General seemed worried that like India, which had blocked the discussion on investment facilitation at the WTO General Council last year, any one member could block further discussions on new plurilateral initiatives that he and his office had assiduously worked to promote in the run-up to the Buenos Aires meeting.

His remarks also seemed to gloss over the fact that the WTO is structured on specific rules and mandates as set out in the Marrakesh Agreement Establishing the WTO, which clearly lay out what issues can be discussed and what issues cannot be brought to the WTO.

Thus, he seemed to be asking members not to insist on consensus but work for the system and its "common good" and "be ready to compromise and seek common ground from day one."

Without mentioning a word about the Doha Development Agenda negotiations and why they were not being pursued, Azevedo said the "new normal" is "we have to be more flexible."

"No one should be forced to accept anything or to negotiate anything they don't want to," he said. "But, at the same time, everyone should be free to discuss issues that are of importance to them."

He did not address how any issue can be discussed in the WTO without formal Ministerial Conference / General Council approval. But his remarks suggested that in his thinking, there is no sanctity of a round of negotiations launched by trade ministers with specific issues, since anybody can raise any issue.

Azevedo went on to espouse the GATT rules that had "inbuilt flexibilities, in different forms", which is what the current US Trade Representative Ambassador Robert Lighthizer is pressing for as a means of resolving trade disputes, unlike the current binding dispute settlement mechanism.

Azevedo said "people often see WTO disciplines as a monolith, or as a rigid, one-size-fits-all set of rules", arguing that it is "far from true." "While our core rules do apply to everyone, specific obligations vary considerably across the membership."

Effectively, he brought in differentiation under the garb of flexibilities. "Look

at the Tokyo Round in the 1970s, for example,” he said, arguing that “a series of agreements on non-tariff measures emerged” after the Tokyo Round. “However, only a relatively small number of GATT members – mainly industrialized – subscribed to these agreements. Because they were not accepted by the full GATT membership, they were often informally called ‘codes’.”

The codes covered such areas as subsidies and countervailing measures, technical barriers to trade, anti-dumping, import licensing, safeguards and others.

“These codes were not multilateral, but they were a beginning, and helped to plant the seeds for our existing WTO multilateral agreements,” he said.

In short, he made a case for the plurilateral initiatives which were launched in Buenos Aires, “which may be testing yet other forms of flexibility.”

“The open-ended groups created at [Buenos Aires] are a somewhat new approach,” he said, suggesting that “they respond to the risk of paralysis brought about by objections to any conversation on issues not already covered by the Doha Work Programme, regardless of how important they are to others or to the trade environment today.”

(In advancing this view, Azevedo seemed to overlook the fact that the decision that no other issue should be addressed before the conclusion of the Doha Work Programme negotiations, was a fundamental part of the July 2004 General Council decision that enabled the re-launch of the negotiations after the collapse of the 2003 Cancun Ministerial Conference of the WTO. – *SUNS*)

The Director-General also remained silent on the role played by his office in propping up these open-ended groups starting from last August, according to an authoritative source, who closely monitored the developments in his office.

These groups, according to Azevedo, “do not represent a north-south divide, unlike some previous initiatives of the times of the GATT. Instead, they encompass developed, developing and least-developed countries, big and small”.

Credit goes to him for stitching these groups behind the scenes to demonstrate no “North-South divide” in these groups, the source said.

Azevedo said that these groups must “afford any and all WTO members the opportunity to participate actively and constructively from day one” and “any discussions in those groups should

already be taking into account the perspectives of others – including of those who are not at the table.”

He said discussing issues inside the WTO “with everybody or with those who are willing to do so” would remain “open and transparent, where anyone and everyone has a chance to shape the conversations if they so desire.”

As regards whether plurilaterals are “the new way forward”, he said, “In my view, the future is not plurilaterals – the future is flexibility. Plurilateral initiatives may be part of that – but as I have set out, there are ways of delivering flexibility within multilateral approaches as

well.”

He said “flexibility will not lead to fragmentation. In fact, in a system with 164 members of different sizes, different priorities and different stages of development, flexibility is precisely the way to avoid fragmentation.”

The Machiavellian views advanced by the Director-General seemed to pose the greatest threat to the developing and poorest countries, turning every rule to advance the interests of the US and other industrialized countries, according to a trade envoy at the meeting who asked not to be quoted. (*SUNS8633*) □

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Ongoing reforms on IIAs

economic and social sufferings because of the shortage of financial resources.”

There is an urgent need, Li stressed, to balance between adherence to the treaty obligations for protecting creditor interests and the policy space for macro-economic measures in times of financial and economic emergencies in order for a country facing unsustainable debt to return to normal economic functioning as soon as possible.

The paper also noted that the cost of the arbitration process is normally quite significant for the sovereigns.

For ICSID, all costs relating to a case are borne by the claimants and the respondents of the claim including expenses of the tribunal comprising travel, salary, lodging and other costs, ICSID charges, administrative fees and expenses. For cash-strapped governments going through debt crises, the costs could be a significant burden. The paper cited the Greek case as an example:

(a) The respondent’s (the Greek government) legal fees and expenses amounted to €4,650,232.73 as of 30 September 2014. The respondent had advanced \$300,000 to ICSID to cover costs of the arbitration. (As the ICSID tribunal took the decision on 9 April 2015, the cost would certainly be higher.)

(b) The fees and expenses of the tribunal and ICSID’s administrative fees and expenses (the costs of arbitration), including expenses relating to the hearing, amounted to approximately \$600,600. These costs are paid out of the advances made by the parties.

Argentina has spent at least \$12.4 million in legal fees for its defence during the *Abaclat* case. The compensation paid by the Argentine government to the claimants as stipulated in the April 2016 award was \$1.35 billion.

The South Centre paper said recent years have seen a more cautious and pragmatic attitude towards IIAs on the part of various governments, leading to a slower increase in the number of newly signed IIAs.

Countries have also been reevaluating/reviewing the signed IIAs and reforming the new IIAs in the pipeline. Some IIAs have been terminated. The new generation of IIAs are getting longer as provisions are becoming more detailed, restrictive and complex.

The main objectives for the ongoing reform of IIAs are to reduce cases of arbitration and preserve policy and regulatory space for governments. Such reform and scrutiny have also impacted on provisions related to debt instruments and the treatment of debt restructuring. Clearly countries have realized that debt instruments have different features from FDI, the paper noted.

Many of the new generation of IIAs have modernized some standard yet expansive core provisions to make them more precise to avoid very broad interpretations for arbitration claims. Some new IIAs have also dropped certain problematic standard provisions and/or added information in the form of footnotes and annexes to allow special qualifications and limitations for some standards.

This, like bond contract improvements, would reduce chances of unjustifiable arbitration claims and contribute to smoother and less costly debt restructuring, said the paper. (*SUNS8626*) □

The full paper including charts and endnotes can be found at: <https://southcentre.us5.list-manage.com/track/click?u=fa9cf38799136b5660f367ba6&id=099952ab9a&e=74268ca098>

The new CPTPP is much like the old TPP

The new CPTPP that replaces the TPP trade agreement is like old wine in a new bottle – without the US but retaining most of the TPP's controversial elements.

by Martin Khor

The Trans-Pacific Partnership (TPP) agreement seemed to have died when President Donald Trump pulled the United States out of it early last year. But the remaining 11 members now appear to have rescued it almost intact, with a new agreement signed on 8 March in Chile.

The text of the treaty was released in February. Originally nicknamed the TPP11, it is now called the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP).

The old TPP had been pushed most adamantly by the US before Trump became president, with Japan as the next big advocate. They succeeded in getting controversial chapters and provisions on investment, government procurement, state-owned enterprises (SOEs), intellectual property (IP) and electronic commerce into the TPP text.

For the developing countries in the TPP, such as Malaysia, Vietnam, Singapore, Brunei, Peru and Chile, the attraction was to get more open markets for their exports, especially to the US, which has the biggest market in the world. With the US now out, the main benefits for them in the CPTPP would be lost.

The developing countries generally dislike the other aspects, especially government procurement, SOEs and IP, as these intrude into their domestic arena and seriously restrict what policies they can retain or introduce. But they were willing to swallow these in exchange for more exports to the US and other TPP countries.

With the US now out of the picture, the cost-benefit balance has shifted. The benefits have declined, but the costs remain as long as the controversial issues are retained.

Problematic provisions

The CPTPP text released in February shows that 22 provisions (out of over 1,000 provisions in total) of the TPP have been “suspended”, rather than removed.

This is in anticipation of a possible US return. The chances of that are quite good, as Trump announced in January that the US may reconsider its decision to withdraw.

If the US rejoins, the suspended provisions would make a comeback and the CPTPP would in effect become the TPP again.

The suspensions are mainly in the IP chapter. Some of the extreme IP clauses which the US had insisted on (but which many others were unhappy over) will not come into effect in the CPTPP.

Suspended are some provisions that would adversely affect access to medicines, including obliging the TPP countries to allow patents for a second use of a medicine and new methods for using the medicine, and to allow an extension of the patent term if there are delays in granting a patent for a new medicine.

But some other TPP provisions on IP remain. In particular, countries must join an international treaty known as UPOV (International Union for the Protection of New Varieties of Plants), under which farmers will not be able to save and exchange seeds that are protected, but have to buy new seeds for new planting of crops.

Most other suspensions are of minor importance, and much of the original TPP remains. The most problematic issues retained in the CPTPP include:

- Investment liberalization: Countries have to open up to other CPTPP members' companies and investors to enter and invest in their territory. These investors could take over the business of some domestic producers and service providers.
- Investor protection: Foreign investors can bring host-country governments to an international tribunal for loss of present and future profits or value of assets if the government introduces new economic, social or environmental policies that affect their business or even their business expectations.
- Government procurement: Most developing-country governments give

preferential treatment to local companies when granting projects and purchasing materials and services. This boost to the local firms and the economy would be eroded when foreign firms have to be given equal treatment in government procurement under the CPTPP.

- SOEs: In many countries, SOEs play multiple significant economic and social roles. Under the CPTPP, these roles will be much constrained by new rules that prohibit or make it more difficult for SOEs to obtain financing or preferential treatment from the government, and prevent SOEs from giving preferential treatment (for example, in their procurement) to local firms. The aim is to enable foreign companies to better compete with the SOEs.

- Intellectual property: Despite some IP provisions being suspended, the CPTPP has remaining clauses that can have negative effects such as higher costs for medicines, educational materials and farm inputs.

Reassessment

Policy makers should have done new cost-benefit analyses of the CPTPP, especially since the main TPP benefit of US market opening is now lost in the CPTPP.

Would it really be worthwhile losing so much policy space (i.e., the ability and freedom of a country to formulate its own policies in accordance with its own priorities and national goals) in order to gain new but limited export opportunities?

This question is made more pertinent because of two factors. Firstly, the new opportunities are limited because of the absence of the biggest player, the US. Secondly, any extra exports would be offset by inflow of new imports, so that the gains may be meagre, or even negative if the extra imports exceed the extra exports.

But then, some decisions including whether to join a trade agreement are made without careful study. Or if such a study is done, its conclusions may be overridden by other factors, such as geopolitics or something unknown to the public. □

Martin Khor is Executive Director of the South Centre, an intergovernmental think-tank of developing countries, and former Director of the Third World Network. This article was first published in The Star (Malaysia) (26 February 2018).

Intellectual property regime undermines equity, progress

Strict intellectual property laws are stifling innovation and access to knowledge even as they maximize profits for a select few monopolies.

by Jomo Kwame Sundaram

Over the last few decades, people in the developing world have been rejecting the intellectual property (IP) regime as it has been increasingly imposed on them following the establishment of the World Trade Organization (WTO) including its regime on trade-related aspects of intellectual property rights (TRIPS). IP rights (IPRs) have been further enforced through ostensible free trade agreements (FTAs) and investment treaties among two (bilateral) or more (plurilateral) partners.

Despite their ostensible rationale, the IP standards rich-country governments insist on have never been intended to maximize scientific progress and technological innovation. Rather, the IPR regime serves to maximize the profits of influential pharmaceutical and other companies by conferring them with exclusive monopoly rights.

In their paper "Innovation, Intellectual Property and Development", Dean Baker, Arjun Jayadev and Joseph Stiglitz have shown that the economic institutions and laws protecting knowledge in developed OECD economies not only poorly govern economic activity, but are also especially ill-suited to developing countries' needs.

From an economic perspective, knowledge is considered a global public good, as the marginal cost of anyone using it is zero. Growth of knowledge can presumably improve wellbeing.

Despite lack of evidence, the IP advocacy argument has been that market forces "under-supply" knowledge owing to the poor incentives for research and innovation. The usual claim is that this "market failure" is best corrected by providing a private monopoly through property rights for new knowledge, e.g., through enforceable patent rights. Private IP protection is presumed to be the only way to reward and thus encourage research and innovation.

Baker, Jayadev and Stiglitz argue that the IP regime has been much more problematic than expected, even in rich countries. They show how the 2013 US Supreme Court decision that naturally occurring genes cannot be patented has shown that the IP regime impedes, rather than stimulates, research by limiting ac-

cess to knowledge. Following the ruling, innovation accelerated, leading to better diagnostic tests (e.g., for genes related to breast cancer) at much lower cost.

Alternatives

Baker, Jayadev and Stiglitz focus on three alternatives to motivate and finance research in the US context. The first is through centralized mechanisms to directly support research.

The second is by decentralizing direct funding, e.g., via tax credits; government bodies or research foundations or institutions can reward successful innovations or findings.

The patent system rewards legal ownership of innovation, but effectively impedes the use of that knowledge by others, thus reducing its potential benefits. Having a creative commons, e.g., open-source software, would maximize the flow of knowledge.

The trio recommend that developing economies use all these approaches to promote learning and innovation.

They view the gap between developing and developed countries as involving a gap in knowledge comparable to the gap in resources. Hence, to improve economic welfare in the world, they urge diffusion of knowledge from developed to developing countries, as conventional social scientists have urged as part of modernization theory for more than half a century.

Often dense "patent thickets", requiring many patents, are increasingly stifling innovation. Payments to lawyers and patent investigators typically exceed those to scientific researchers in such cases, with research often oriented to extending, broadening and leveraging monopoly rights due to patents.

One perverse consequence has been patent "trolling" by speculators who buy up patents which they think have a chance of being necessary for any product or process innovation. Thus becoming gatekeepers like the mythical trolls, they effectively block innovation unless their price is met.

Ironically, while the case for more openness in sharing knowledge is compelling, neoliberals – who typically claim

the moral high ground in opposing monopolies and related market distortions – have effectively served to extend and strengthen property rights and attendant monopolies.

Powerful corporate and developed-economy-government lobbies have influenced the IP regime, e.g., by opposing competing rights associated with nature, biodiversity or even traditional knowledge. Hence, recent ostensible FTAs have extended IPRs to cover "biologics", i.e., naturally occurring substances, such as insulin for those suffering from diabetes, which is derived from mammals.

Thus, over the last few decades, the evolving IP regime has erected more and more barriers to widespread use of new knowledge.

The current IP regime serves to maximize profits for a few monopolies, e.g., "Big Pharma", rather than the progress and welfare of the many.

Widespread strictly enforced IP protection is historically new. IP protections came very late to the early industrializing economies, typically delayed to enable rapid "catch-up" industrialization and technological change.

The "weightless economy" of data, information and knowledge is accounting for a growing share of economic value in the world. Baker, Jayadev and Stiglitz argue that existing rules governing global knowledge serve as fetters that must be broken to reflect these realities. (IPS) □

Jomo Kwame Sundaram, a former economics professor and United Nations Assistant Secretary-General for Economic Development, received the Wassily Leontief Prize for Advancing the Frontiers of Economic Thought in 2007.

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Playing with financial fire: A South perspective on the international financial system

Andrew Cornford reviews an important book on the deepening integration of developing economies into global financial markets, examining the challenges posed by such financial liberalization and the shortcomings of the associated policy responses, especially on the prudential regulation front.

Yilmaz Akyüz, *Playing with Fire: Deepened Financial Integration and Changing Vulnerabilities of the Global South*, Oxford: Oxford University Press, 2017.

Playing with Fire (PWF) is a continuation of the analysis of the integration of emerging and developing economies (EDEs) into the international financial system which Yilmaz Akyüz has carried out in his roles as senior economist for many years responsible for the UN Conference on Trade and Development (UNCTAD)'s *Trade and Development Report* and as Chief Economist at the South Centre. The treatment covers cross-border financial flows, increased commercial presence of foreign financial institutions in EDEs and their increased participation in their local financial markets, as well as policy and regulatory issues. PWF deploys data on major cross-border financial flows on a gross as well as a net basis. This innovative approach facilitates identification of financial stability issues posed by the increased participation of EDEs in international financial markets.

The reflections which follow do not cover all the subjects raised in PWF's wide-ranging analysis. They concentrate on the discussion of the overall context of financial integration of EDEs, the progress of this integration, the continuing exposures to financial instability, and PWF's conclusions regarding policy and regulation.

These policy conclusions are linked to the discussion of changes in financing linked to the liberalization and progressive opening up of EDEs' financial markets to non-residents. Of special importance here are continuing vulnerabilities to credit and foreign exchange risk. These have been modified by the changing distribution of the parties exposed to the risks and of the instruments which give rise to them.

There is also brief discussion of the current regulatory agenda for banks. Despite the changes in the character and incidence of credit and foreign exchange risk, the prudential regulation of banks' exposure to foreign exchange risk remains an important part of the picture and arguably merits more extended attention than it receives in PWF.

The first part of the commentary which follows focuses on PWF's treatment of the process of financial liberalization, the problems which it has created, and the shortcomings of policy responses and of the reform agenda. The second part of the commentary is a more detailed review of aspects of prudential regulation in the policy response, with special attention to its treatment of foreign exchange risks. This review reinforces the conclusion of PWF that, while the proposed regulatory reforms will render the financial system more robust, their role in the control of financial instability is subject to limitations. The more detailed examination here nonetheless highlights major features of foreign exchange risk and continuing

shortcomings of the existing and proposed regulatory rules for banks' exposures to it.

The GFC and policy response in AEs

Inevitably an important part of the backdrop of PWF's analysis is the global financial crisis (GFC) and the misguided policy response in advanced economies (AEs). After a brief period of reliance on expansionary macroeconomic policy which emphasized support of aggregate demand and employment, governments proved unwilling to grasp the nettle of dealing directly with the huge debt overhang due to the excessive leverage of the balance sheets of both banks and other enterprises accumulated during the boom preceding the GFC. They relied instead on measures which bailed out creditors while imposing austerity on debtors. Refusing to make use of the expansionary potential of fiscal policy, governments had recourse to unconventional monetary policies for macroeconomic management and to official financing with onerous conditions to avoid debtors' defaults.

This policy stance failed to provide the needed boost to growth, while increasing inequalities through its effects in boosting the value of financial assets largely held by the rich minority and on its own doing little to reduce financial fragility. Moreover EDEs, though benefiting from stronger fiscal positions than during previous crises since the 1980s, were still vulnerable to shifts in macroeconomic policies in AEs.

Waves of external financing and the structure of EDEs' liabilities

The boom of the new millennium in external financing of EDEs was the third since the 1970s: the first began in the 1970s and ended in 1982 with a debt crisis in Latin America; the second began in the early 1990s and culminated in crises in East Asia, Brazil, Russia, Turkey and Argentina; and that of the new millennium experienced a hiccup at the time of the collapse of Lehman Brothers in September 2008 (generally considered to have been the beginning of the GFC proper) but then resumed and had yet to reach a well-defined halt by 2013, the closing date of PWF's systematic coverage of developments.

The first of these booms was associated with a major increase in cross-border bank lending. The distribution of different categories of debtors' external liabilities was somewhat more varied during the second boom. What distinguished this phase was a widespread movement towards financial liberalization and the opening up of capital accounts which was not yet accompanied by correspondingly strengthened financial regulation.

The most recent boom has been associated with a much deeper integration of major EDEs into the global financial system. This integration has several manifestations: an increased share of direct and portfolio investment in external liabilities;

an increasingly important role for bond issues as opposed to international bank lending in the borrowing of both public and private sectors; a shift by international banks from cross-border to local lending with the latter often in local currencies; acceleration of external borrowing by the private sector in EDEs, much of which is still denominated in foreign currencies; and an increase in non-residents' holdings of sovereign debt issued in local financial markets and denominated in local currencies.

These shifts have accompanied corresponding shifts in the composition of different categories of liability in national balance sheets and increases in the proportions of these liabilities held by non-residents. The control of money markets and the management of foreign debt has been complicated by opacity regarding the identity of the ultimate holders of these liabilities and by blurring of the distinctions between different financial instruments. The identity of holders is viewed as likely to affect the volatility of holdings, and the blurring of distinctions between financial instruments makes more difficult overview of liquidity and currency denominations in the financial sector. The opacity has implications for the regulation of money markets and of foreign exchange exposure. It also magnifies the challenges for risk management at firm level, particularly at the level of banks.

Evolution of financial risk

New external financial liabilities during the first lending boom took principally the form of cross-border bank financing. Much of this financing was in the form of medium-term Eurocurrency lending, a relatively recent innovation which enabled the transformation for banks of short-term liabilities into longer-term loans through adjustments in the interest rate.

Various changes in the pattern of financing, many of them associated with the widespread application of innovations, preceded the crisis which followed the second lending boom. For example, the increased recourse to securitization of banks' assets began to lead to a blurring of the distinction between bank lending and financing through the capital markets. Moreover off-balance-sheet items such as interest-rate and currency derivatives and forward rate agreements as well as other contingent liabilities began to assume greater importance in banking operations. Off-balance-sheet items were associated with reduced transparency in banks' financial reports for both supervisors and investors, with the result that identification of financial risks in banks' operations became more difficult for both. Some of the cross-border shifts in financing and some of the pricing of financial instruments during the crisis following the second lending boom were not anticipated nor necessarily well understood. This was also the period when the attention of regulators began seriously to focus on macroprudential risks, i.e., those due to correlated financial failures and to insolvencies of institutions with systemic economic significance, both of which were capable of threatening payments mechanisms and other aspects of the broader financial system.

By the opening of the new millennium, cross-border international financial integration was more deeply rooted and more pervasive. This reflected pressures from financial markets themselves in which lenders and investors generally preferred more open financial markets and greater freedom for their operations. It was also due to pervasive regulatory and intellectual capture of policy makers and analysts concerning the virtues of liberalized financial markets as vehicles for re-

source allocation and macrofinancial management. In a few EDEs a role was also played by conditions attached to lending programmes of multilateral financial institutions.

PWF's major findings concerning changes in the structure of external financing

The challenges for policy of new levels of financial integration have resulted not only from the sheer scale of international financing but also from the instruments and actors involved. Neither can be described in isolation from the other. The focus in PWF on gross rather than net assets and liabilities enables fuller analysis of the component determinants of fluctuations in financial flows and debt stocks. This focus facilitates the disaggregation of assets and liabilities by different liquidity and maturity characteristics and by the different economic actors who contribute to observed financial outcomes. By contrast, the more traditional focus on net financial flows to EDEs conceals features important to understanding recent developments such as the continuous rises in both gross and net liabilities. It also results in insufficient attention to the effects of increases in the presence of foreign economic actors in the local markets for debt and equity in EDEs and of foreign direct investors in the markets for goods and services. These, PWF convincingly argues, can be adequately identified only through disaggregated analysis.

Study of financial flows to EDEs in the form deployed in PWF highlights several important features of the increased integration in cross-border finance. The expanded participation of foreign actors has resulted in a situation where local equity and bond markets are now more internationalized as measured by the holdings of foreign actors than are these markets in some AEs. The distribution of external liabilities shows several shifts. The share of debt securities has risen relative to that of bank loans; the liabilities of the private sector have increased faster than those of the public sector; and sovereign external liabilities in local currencies have expanded in relation to those denominated in reserve currencies. On the asset side, EDEs' official reserves have increased not only absolutely but also in relation to privately held foreign assets as a result of not only surpluses on the current account but also capital inflows. The increase in reserves reflects self-insurance against the procyclical behaviour of international financial markets to which the EDEs are now more exposed.

The blurring of the distinctions between domestic and external debt which has resulted from the new patterns of financing has complicated analysis of countries' financial vulnerability to changes in external conditions, and can also affect the accuracy of debt statistics. Lack of clarity as to the identity of holders complicates differentiation in terms of governing law.¹ Thus paradoxically debt owed by governments to their own nationals can be part of external debt denominated in foreign currency, and debt owed to foreigners can be subject to local jurisdiction and denominated in local currency.

These features of financial integration have implications for financial stability. The increased dependence of EDEs' domestic bond markets on foreign investors and on domestic investors that take positions in international markets can result in significantly less control over domestic interest rates. The internationalization of EDEs' bond markets has created the potential for destabilizing feedbacks between a country's bond and currency markets. A stop in capital inflows leading to a depreciation of the currency can trigger an exit from local bond markets, pushing bond prices downwards and thus in-

terest rates upwards. The exit and the depreciation can then snowball as unhedged corporate debtors buy dollars to cover their obligations. Since the onset of the GFC, there have been episodes of simultaneous declines in both bonds and currencies in response to stress in international financial markets. Similar feedbacks have also been witnessed between prices in EDEs' equity markets and the levels of their currencies. Foreign direct investment can also be procyclical.

Flaws in current policy responses

The orthodox response to the challenges to financial stability due to the changes in the structure of external financing has emphasized a number of policy options, all of which have limitations pointed to by PWF:

1. Flexible exchange rates to absorb shocks to capital flows. While these can help for small moves in exchange rates, they are less effective as a means of coping with sustained surges, which, in the case of resulting currency appreciations, can undermine industry and exports, and in the case of depreciations can force economic contraction and financial meltdown.

2. Substantial foreign exchange reserves. These typically have a cost owing to the low returns on reserve holdings and are vulnerable to the susceptibility of the borrowed part of the reserves to withdrawal along with the other outflows.

3. Temporary capital controls. These are now sanctioned in orthodox policy circles. However, the sanctioned versions of controls are to be market-friendly and deployed only as a last resort. This position does not acknowledge the role of such controls in the avoidance of potentially fragile and unstable financial positions and in the protection of development policies in place. According to the new orthodoxy, capital controls are to be only a temporary exception to moving towards cross-border financial liberalization.

4. Strengthened prudential regulation for financial institutions as a defence against the destabilizing effects which capital flows can have on domestic financial markets. Since the GFC, this has been an important part of the policy agenda in the form of higher and more stringent capital charges, better provision for loan losses, extended rules for liquidity management, and wide-ranging rules for risk control and corporate governance in banks. The value of such measures is generally acknowledged. However, reliance on them on its own will principally limit or mitigate the effects of crises. The regulatory agenda is still limited to particular categories of institution and has been shown historically to be vulnerable to erosion of the rules due to the lobbying power of financial sectors and to innovation aimed at bypassing regulations. A consequence of global financial integration has been that financial innovations initially introduced in AEs have spread to EDEs, complicating regulation and risk management in the latter. Crucially regulation has a largely responsive character, being designed to provide protection against shocks – particularly macroeconomic shocks – but lacking control over the generation of the shocks.

PWF expresses scepticism concerning the adequacy and effectiveness of global institutions and mechanisms for prevention and management of financial crises with international origins and consequences. PWF acknowledges that many of the proposals for actions under this heading are potentially helpful. Moreover, such proposals have made periodic appearances on the international policy agenda, particularly in the aftermath of crises. However, they have not been implemented owing to the opposition of major AEs.

PWF provides the following lucid characterization of an alternative policy framework: "One of the key lessons of the history of economic development is that successful policies are associated not with autarky or full integration into the global economy, but strategic and selective integration suitable to the stage of economic and financial development reached, seeking to use the opportunities that a broader economic space may offer, while minimizing the potential risks it may entail." It is important to be clear what this framework – with which this commentator agrees – implies and what it does not. Piece-meal, meliorist reforms are not rejected. But their strengths and weaknesses need to be carefully assessed. Many of them (such as improved arrangements for external debt workouts, and more balanced governance of, and more even-handed surveillance by, multilateral financial institutions) are endorsed in PWF. However, their introduction should not be associated with the illusion that they are capable of furnishing the systemic reform which the international financial system requires, especially in the assistance it should provide to EDEs.

On the subject of regulation, PWF's treatment seems summary in view of its pervasive effects at the level of both institutions and transactions. PWF is correct in treating regulatory reform as part of the meliorist programme which on its own is insufficient for avoiding the instabilities to which the international financial system is subject. However, PWF's listing of subjects under the regulatory agenda merely refers without elaboration to various regulatory requirements for better managing risks which constitute potential threats to microeconomic and macroeconomic financial stability.

In its discussion of different categories of external assets and liabilities, PWF covers at length the associated foreign exchange exposures. Perhaps most originally it draws attention to the way in which the opening of domestic financial markets to foreign participation undertaken by several countries has extended the set of foreign exchange risks to which domestic and foreign economic actors are subject as well as the channels of transmission between such risks and the domestic prices of financial assets (which were mentioned earlier for bond and equity markets). Both government policy towards exchange reserves and risk management of private financial and non-financial institutions have become in consequence more complex since they must allow for a greater range of outcomes for the prices of currencies and other assets in conditions in which these prices can be difficult to forecast.

To the best of this commentator's knowledge, the increased potential exposure due to the opening up of EDEs' financial markets to foreign participation has not been treated to similarly comprehensive description elsewhere. But PWF's discussion of its implications for regulation and risk management nonetheless lacks the detail which the subject merits. These implications go beyond the treatment of foreign exchange risk in prudential rules for financial institutions and also involve government policies towards the management of foreign exchange reserves and risk management in non-financial firms. Nevertheless such prudential rules still cover an important part of an economy's exposure to foreign exchange risk.

The existing and proposed regulatory treatment of banks' exposure to foreign exchange risk is currently incomplete – even before account is taken of the expanded risks due to increased global financial integration to which PWF draws attention. Moreover, PWF's discussion poses questions concerning the need for further extension of this prudential agenda. What follows focusses on regulation and management of the foreign exchange risk of banks and, as already mentioned,

underlines the shortcomings of overreliance on reform of prudential measures in the policy response to financial instability.

Existing rules and procedures for the management of foreign exchange risk

This section begins with an account of the rules in the global regulatory agenda in order to show where these rules are incomplete or inadequate. Suggestions then follow for extension of these rules.²

Foreign exchange risk manifests itself in the balance sheets and payments obligations associated with the liabilities not only of banks and other financial institutions but also of the borrowers to which banks are exposed through their lending. Depreciation of a country's currency – due, for example, to capital outflows – exposes both its banks and its non-banks to foreign exchange risk through its effects on liabilities in relation to assets, when there is no matching of assets and liabilities denominated in foreign exchange.

Large capital inflows in a regime of flexible exchange rates can also pose problems for policy since the resulting appreciation of the country's currency can have adverse effects for both industry and other sectors. But the focus of the discussion which follows will be outflows and currency depreciation since these are the most frequently discussed concerns in the literature.

For banks the impact of foreign exchange risk is reflected in both its banking book and its trading book. The banking book contains assets and liabilities associated with commercial banking operations or intended to be held to maturity as a source of income. Balance-sheet items in the trading book, on the other hand, are held with the intention of reselling them in the shorter term to take advantage of changes in asset prices and interest rates.

The distinction between trading and banking books underlies the approach of the Basel capital framework for banks to foreign exchange risk. Exposures to such risk associated with positions in the trading book attract capital requirements set in accordance with the separate rules of the framework for market risk of such exposures (BCBS, 2006: 179-182 and 191-202). Exposures to foreign exchange risk (or its absence) associated with standard commercial banking operations would normally be classified as belonging to the banking book and translated into their equivalents in domestic currency on the basis of applicable accounting rules (which may of course vary between jurisdictions). Capital requirements corresponding to these exposures are then calculated in the standard way for credit and operational risk.

More detailed attention is given to short-term foreign exchange risk in the liquidity framework of Basel III (BCBS, 2010: paras. 172-176). The inclusion of a metric on this subject “is meant to allow the bank and supervisor to track potential currency mismatch issues [between assets and liabilities in the balance sheet] that could arise in a time of stress”. The Foreign Currency Liquidity Coverage Ratio (LCR) – the metric specified – is the ratio of the stock of high-quality liquid assets in each significant currency to the total net cash outflows over a 30-day time period in each significant currency. According to the metric, the amount of estimated total net foreign exchange outflows should be net of foreign exchange hedges.

The metric has no internationally defined minimum threshold. Setting standards for the metric is to be the task of different jurisdictions' supervisors based on their views as to

what constitutes stress. These views should follow from an evaluation of “banks' ability to raise funds in foreign currency markets and the ability to transfer a liquidity surplus from one currency to another and across jurisdictions and legal entities”.

How do such rules fit into what is known about actual bank practices regarding exposure to currency risk?

Large cross-border banks typically act as dealers in foreign exchange and have units which run this part of a bank's operations. The individuals responsible may take speculative positions in different currencies within limits set by the bank. The risk of speculative positions will generally be treated as part of the management of market risk in accordance with Basel III (BCBS, 2006: 179-182 and 191-202).

Funding for the commercial banking operations of such banks, on the other hand, will be conducted in accordance with internal rules designed to avoid large open currency positions and to ensure close matching of positions in different currencies. With the implementation of Basel III, these rules can be expected to include application of the metric of its Foreign Currency Liquidity Coverage Ratio as set by national supervisors.

Various arrangements are used by the banks of AEs to minimize exposure to short-term currency risk. The best known of the arrangements for controlling short-term currency risk is the Continuous Linked Settlement (CLS) Bank. However, less is known about the use of these arrangements by EDE banks.

Surveys of foreign exchange settlement have been periodically conducted by central banks for the Committee on Payment and Settlement Systems of the Bank for International Settlements (BIS) (since renamed the Committee on Payments and Market Infrastructures). In the surveys, banks and financial institutions are not classified by the country of their parents but it is reasonable to assume that the great majority are located in AEs.

Settlement through the CLS Bank is payment-versus-payment (PVP), i.e., the bought currency is paid out only when the sold currency is received, an arrangement which virtually eliminates principal risk. The CLS Bank holds accounts at the central banks of the countries whose currencies are eligible for its operations. At the time of a 2006 survey, 69% of the total value of foreign exchange obligations of the institutions included (obligations between CLS institutions and between CLS institutions and third parties) were settled by this method (Committee on Payment and Settlement Systems, 2008: 4-5). The importance of the CLS Bank, which is owned by 69 large financial groups with about 170 financial entities as participants in its settlement system, has increased since 2006 (Scott and Gelpert, 2012: 700-702).

The other most widely used settlement method is traditional correspondent banking. Under this method, each counterparty to a foreign exchange transaction transfers to the other the currency it is selling, generally using their respective correspondent banks in the currencies concerned. Since the currency transfers take place independently of one another, the method exposes the counterparties to principal and liquidity risk. Still other arrangements with lesser coverage by jurisdictions and institutions are also used to control short-term exchange settlement risk.

The proportion of short-term foreign exchange transactions of EDE banks settled through the arrangements described above is not known. It is reasonable to assume that cross-border banks with a presence in EDEs and the correspondent banks of local EDE banks use the CLS Bank and traditional

correspondent banking. Moreover, several EDEs have domestic payments systems through which resident banks, foreign as well as domestic, can settle mutual transactions denominated in foreign currency. But the absence of data impedes a comprehensive picture.

Longer-term foreign exchange exposures (other than in the trading book) are not covered by the arrangements for short-term foreign exchange transactions. While those responsible for funding strategies in the banks of AEs do take open positions which expose them to currency risk not associated with foreign exchange settlement, these positions are mostly accompanied by hedging strategies which reduce or control the risk. Such strategies are facilitated by the availability of hedging instruments in the financial markets to which economic actors have straightforward access (and which would reduce exposure according to the metric of the Basel liquidity framework). But the outcomes of such strategies are not covered by reporting systems like those for foreign exchange settlement.

Fragmentary information suggests that the taking of open currency positions as part of the funding of banks in EDEs and other developing countries is fairly common, especially in countries where domestic rates of inflation higher than the rates of depreciation of the currency favour the value of assets in relation to that of liabilities. Attention is drawn to such cases by two analysts of bank credit with extensive experience of Asia (Golin and Delhaise, 2013: 672-674 and 713). While such positions will be brought under tighter control when supervisors introduce as part of their monitoring the Foreign Currency Liquidity Coverage Ratio of the Basel III liquidity framework, they are still likely to feature in banking operations in many EDEs.

Open currency positions at enterprise level help to explain the continuing concern with exposure to currency risk in EDEs and other developing countries which are faced with large capital movements and unstable exchange rates. Even after the introduction by supervisors of the metric of the Basel III liquidity framework, greater vulnerability to foreign exchange risk in EDEs than in AEs is likely to prove a problem which merits more attention and monitoring in reports on the implementation of the international reform agenda.

The reasons for the persistence of greater vulnerability in EDEs are implicit in the remarks in the Basel III liquidity framework about the variation in the levels of the Foreign Currency Liquidity Coverage Ratio appropriate for different jurisdictions. Such variation will reflect differences in banks' access to foreign currency financing and their ability to transfer liquidity surpluses between currencies and jurisdictions. Banks in EDEs will generally be less well placed to manage their exposure to currency risk under both of these headings. Moreover, the capacity of their central banks to provide foreign currencies to their countries' banks in periods of stress as an alternative to financial markets is also likely to be limited since during such periods the central banks may experience pressure on their foreign exchange reserves and their own access to borrowing foreign currencies.

One can envisage various steps to extend regulatory coverage of foreign exchange risk which would be likely to be especially pertinent for EDEs. Policy guidelines on exposure to currency risk in the banking book could prescribe fuller analyses of mismatches of currency exposures than that of the Foreign Currency Liquidity Coverage Ratio of the Basel III liquidity framework. This could take the form of a more com-

prehensive currency gap analysis, combining maturity mismatches of assets and liabilities with their currency denomination, extending beyond the short period of the Basel III liquidity framework. The difficulty of such analysis in practice should not be underestimated, especially in the case of banks with multiple cross-border operations. However, such an analysis by a bank should itself serve as a vehicle for improving its management of currency risk.

Exposure to foreign exchange risk in the banking book could also be given more explicit treatment elsewhere in the Basel capital framework. Controlling such exposure (with a cross-reference to the liquidity framework) could be explicitly included in Pillar 2 of Basel III (the Supervisory Review Process) under comprehensive assessment of risks for the purpose of sound capital assessment, whose elements are specified as including the following: policies and procedures designed to ensure that the bank identifies, measures and reports all material risks; a process that specifies capital adequacy goals with respect to such risks; and a process of internal controls, reviews and audit to ensure the integrity of the overall management process (BCBS, 2006: paras. 731-742). Currently the comprehensive assessment of risk has headings for credit risk, operational risk, market risk, interest rate risk in the banking book, liquidity risk and other risks. The last of these headings could be expanded to include full, explicit coverage of foreign exchange risk not covered as part of market risk.

Indirect foreign exchange exposure and credit risk

How would a more fully developed approach to currency risk accommodate that to which a bank is exposed via the currency risk exposure of borrowers from it with loans in a foreign currency which has appreciated, thus making repayment obligations more onerous if the borrowers' corresponding revenues or incomes are in domestic currency?

The risk to a bank in such cases should be classified as credit rather than as currency risk since the risk to the bank is of borrowers' non-payment of their loan obligations due to the depreciation of its country's currency. One way of handling the indirect exposure of a bank to credit risk stemming from the currency risks incurred by its counterparties could be through a supervisors' advisory which could also be part of the comprehensive assessment of risks prescribed in Pillar 2 of Basel III. Such an advisory would be consistent with the statement of the Basel Committee on Banking Supervision that "While the Committee recognizes that not all risks can be measured precisely, a process should be developed to estimate risks" (BCBS, 2006: para. 732), which (in accordance with the advisory suggested here) would now include not only different categories of currency risk to the bank from its own balance sheet but also credit risk resulting from the currency denomination of the liabilities of a bank's borrowers.

A study by the Financial Stability Board, International Monetary Fund and World Bank (FSB, IMF and World Bank, 2011: 30) draws attention to the useful role which can be played by stress testing in alerting banks in EDEs under the heading of indirect currency risk. This recommendation presupposes a certain level of technical capacity of both banks and their supervisors. Arguably a bank's supervisors should recommend minimization or avoidance of substantial indirect foreign exchange exposures for banks lacking this technical capacity.

Implications of PWF for control of currency risk

Foreign exchange risk is a central part of PWF's arguments concerning risks to financial stability in EDEs due to coun-

tries' greater financial integration, partly on its own account and partly owing to its relation to other financial risks such as those due to interest rates. The previous section proposes an approach to controlling banks' currency risks which are not covered by the rules of the liquidity framework in the current regulatory agenda. But the question arises whether this approach, with its reliance on advisories for supervisors, would be sufficient for the purpose.

Financial regulators of AEs have not ignored the risks discussed at length in PWF. The 1986 Cross report produced by a study group established by the central banks of the Group of Ten countries (and named after its chairman from the New York Federal Reserve) acknowledged the multiple ways in which financial innovation "can contribute to systemic vulnerabilities" such as underpricing of new financial instruments which does not reflect their true risks, the lack of assured liquidity for securitized assets, and the opacity of such assets based on multiple linked transactions and off-balance-sheet positions (Study Group, 1986: 127).³ But in the observations of the Cross report on securities financing, the emphasis was on the Euro-markets whose operations were mostly located in AE financial centres or in selected offshore centres, not in EDEs.

It is the increases in the scale and the expanded sectoral character of the cross-border financial integration since the 1990s (i.e., since the Cross report) of EDEs' financial markets (including domestic markets) which are given prominence by PWF. These features have had the following consequences:

1. In half of a set of 16 EDEs in 2012, the equity market capitalization was higher than or close to that of AEs as a proportion of GDP. In many EDEs the share of foreign investors in equity markets (of which part admittedly reflected movements in prices) exceeded that in some AEs such as the United States and Japan.

2. As part of external debt, bond issues have been growing faster than international bank lending for borrowers from both the public and the private sectors. There has been a shift by international banks from cross-border lending to local lending by entities with a local commercial presence. This has been accompanied in many EDEs by a shift in government policy away from incurring international debt in foreign currency to borrowing in local currency, often through issues in local debt markets. This has raised the share of such debt denominated in local currency and increased the share of locally issued debt held by non-residents.

3. There has been a continuing build-up of external debt, which has accelerated since 2009. Borrowing by the private sector has grown more rapidly so that it now accounts for a higher proportion of both international bank loans and securities issues than the public sector. Local-currency borrowing has been growing faster than that denominated in dollars, and somewhat incomplete data point to an increase in several EDEs in the share of non-residents in holdings of government debt.

As PWF notes and was mentioned earlier, the changed pattern of financial integration of EDEs has added to the channels for the transmission to them of financial shocks due to global cycles. The new vulnerabilities are due to the internationalization of domestic bond, equity and property markets and to the role which may be played by the local presence of foreign banks. These vulnerabilities can give rise to foreign exchange risks and, as already mentioned, are large and pervasive enough to raise the question of whether the measures proposed above are sufficient for the management of the currency risks posed by the substantially increased openness of

financial markets now prevailing.

There does not appear to exist a magician's wand under the heading of prudential regulation for controlling risks due to these vulnerabilities. Moreover, both the character and extent of the vulnerabilities and the information available to regulators concerning the risks are likely to vary among countries. There do not appear to be appropriate policy responses involving measures radically different from those already listed. However, these measures are susceptible to design which will enable them to target currency risk more effectively. For example, special liquidity requirements, supplementing those of Basel III, could be imposed with the objective of increasing banks' ability to deal with increased foreign exchange risks due to changes in sectoral developments. Such requirements, which are included in the policy toolkit of the Bank of England, are designed to discourage excessive reliance on particular sources of funding and overexposures to particular asset classes (which could provide protection against foreign exchange risks due to indirect exposures, provided that the bank has the necessary information). Countries have also made use of restrictions on the forms of banks' funding designed to increase sustainability beyond that targeted by Basel III's Liquidity Coverage Ratio.⁴

The scope of subjects eligible for inclusion in the supervisors' advisories suggested earlier could be extended to cover all identifiable foreign exchange risks including those resulting from indirect exposures due to the positions of banks' borrowers. But to be effective, such a measure presupposes adequate knowledge concerning such risks. This approach would be less effective unless the rules extend to financial institutions which engage in financing leading to foreign exchange risk but are not regulated as part of the banking sector, however defined in the jurisdiction in question.⁵

Concluding observations

As emphasized earlier, the extension and elaboration proposed above for the treatment of prudential rules for foreign exchange risk does not contradict the verdict of PWF that on their own, such rules are not adequate for controlling the risks to financial stability posed by global financial integration. In evaluation of their potential effectiveness, account should also be taken of political and administrative difficulties associated with adoption and implementation of the rules and standards of the global regulatory agenda. Agreement on the subjects of this agenda depends on a laborious process involving a large group of countries, and eventual incorporation in laws and in firms' practices takes considerable time. Eventual outcomes will almost inevitably entail compromises, meaning that some issues are addressed at best inadequately. Perhaps still more important here is a key point touched on earlier in discussion of the meliorist character of the agenda for reform of prudential regulation: the resulting rules can provide protection against and mitigation of shocks but do not tackle many of the risks associated with financial globalization at their source.

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Notes

- 1 The sort of problems to which differences in the coverage of cross-border financial statistics can give rise are illustrated by remarks concerning estimates of foreign currency credit (FCC) in a recent publication by the Bank for International

Settlements (BIS). Current FCC estimates refer to borrowing by a country's residents rather than by its nationals. Thus foreign currency debt incurred by offshore affiliates is not reallocated to the country in which the parent company is headquartered. This may underestimate FCC in EDEs where there is increasing use of foreign affiliates to issue debt securities and then to repatriate the funds raised back to their home country (BIS, 2017: 28-30).

neatly under the particular supervisory standards applicable to banks" (Study Group, 1986: 241).

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- 2 This account makes extensive use of my article, "FSB monitoring reports lack focus on EMDE problems", in *South-North Development Monitor (SUNS)*, No. 8038, 10 June 2015.
 - 3 The Cross report characterized financial innovation as follows: "Financial innovation in its broadest sense may encompass two different phenomena. It may take the form of new instruments ... or it may manifest itself in far-reaching changes in the relative importance of various channels of financial intermediation. In practice, of course, these two types of structural change will tend to be closely interrelated" (Study Group, 1986: 127).
 - 4 Macroprudential measures designed to strengthen banks' balance sheets beyond the levels of Basel III's Liquidity Coverage Ratio are described in Cornford (2014: section IV.C).
 - 5 The problems associated with near-banks in a similar context were recognized by the Cross study group: "But where ... near-banks are conducting similar business to banks ... a case can be made for reducing the risk posed by the potential failure of large non-bank financial firms by extending bank-like regulation and supervision to them, even though they do not themselves take deposits from the public and would not fit neatly under the particular supervisory standards applicable to banks" (Study Group, 1986: 241).
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