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Study highlights trust deficiencies of cryptocurrencies

Are cryptocurrencies a viable form of money? Delving into this question, a study by the Bank for International Settlements (BIS) finds several shortcomings associated with these digital currencies, not least of which is the fragile foundation of trust in their value.

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The trust limitations of cryptocurrencies

A study that “looks beyond the hype” associated with cryptocurrencies points to the fragility of trust in the value of and operational backing for an instrument that aspires to be a new form of money.

by Chakravarthi Raghavan

GENEVA: In less than 10 years since their inception, cryptocurrencies have emerged from obscurity to attract intense interest on the part of businesses and consumers, as well as central banks and other authorities, but their decentralized creation has inherent limitations in maintenance of trust in value and involves vast energy use presaging an environmental disaster and the potential to bring the Internet to a halt.

These are some of the conclusions of the Bank for International Settlements (BIS) in its in-depth study of cryptocurrencies and whether they could play any role as money. Titled “Cryptocurrencies: looking beyond the hype”, the study is part of BIS’ *Annual Economic Report 2018* and was pre-released on 17 June ahead of the 24 June publication of the full report.

The study notes that cryptocurrencies garner attention because they promise to replace trust in longstanding institutions, such as commercial and central banks, with trust in a new, fully decentralized system founded on the blockchain and related distributed ledger technology (DLT).

However, the BIS study warns, cryptocurrencies are a poor substitute for the solid institutional backing of money, cannot scale with transaction demand, are prone to congestion, and come with poor efficiency and vast energy use that could presage an environmental disaster and bring the Internet to a halt.

Nevertheless, says the BIS, the underlying technology could have promise in other applications, such as the simplification of administrative processes in the settlement of financial transactions, though this still remains to be tested.

The BIS notes that many past episodes of monetary instability and failed currencies illustrate that the institutional arrangements through which money is supplied matter a great deal. The essence of good money has always been trust in the stability of its value. And for money to live up to its property to act as a coordination device facilitating transactions,

it needs to efficiently scale with the economy and be provided elastically to address fluctuating demand.

These considerations have led to specific institutional arrangements – the emergence of today’s independent and accountable central banks, after episodes of individual private banks performing this role.

As for cryptocurrencies, they entail economic limitations inherent in the decentralized creation of trust. For the trust to be maintained, honest network participants need to control the vast majority of computing power, and each and every user needs to verify the history of transactions. And the supply of the cryptocurrency needs to be predetermined by its protocol. Trust can evaporate at any time because of the fragility of the decentralized consensus through which transactions are recorded. Not only does this call into question the finality of individual payments, but it also means that a cryptocurrency can simply stop functioning, resulting in a complete loss of value.

Institutional monetary arrangements

Money, the BIS notes, plays a crucial role in facilitating economic exchange. Before its advent millennia ago, goods were primarily exchanged for the promise to return the favour in the future (traded IOUs). However, as societies grew larger and economic activity expanded, it became harder to keep a record of ever more complex IOUs, and default and settlement risks became concerns. Money and the institutions issuing it came into existence to address this growing complexity and the associated difficulty in maintaining trust.

Money has three fundamental and complementary roles as: (i) a unit of account; (ii) a medium of exchange; and (iii) a store of value, enabling users to transfer purchasing power over time. To fulfil these functions, money needs to have the same value in different places and to keep a stable value over time. However,

maintaining trust in the institutional arrangements through which money is supplied has been the biggest challenge.

Around the world, in different settings and at different times, money started to rely on issuance by centralized authorities. It evolved from the stamp of a sovereign certifying a coin's value in transactions, to bills of exchange intermediated by banks developed as a way for merchants to limit the costs and risks of travelling with large quantities of coinage.

However, historical experience also made clear an underlying trade-off: currencies that are supplied flexibly can also be debased easily. Sustained episodes of stable money are historically much more of an exception than the norm. "In fact, trust has failed so frequently that history is a graveyard of currencies."

History proves that money can be fragile, whether supplied through private means in a competitive manner, or by a sovereign as a monopolist supplier. Government-backed arrangements have not always worked well either. Avoiding abuse by the sovereign has thus been a key consideration in the design of monetary arrangements.

The quest for solid institutional underpinning for trust in money eventually culminated in the emergence of today's central banks. The tried, trusted and resilient way to provide confidence in money in modern times is the independent central bank with agreed goals: clear monetary policy and financial stability objectives; operational, instrument and administrative independence; and democratic accountability, so as to ensure broad-based political support and legitimacy.

Independent central banks have largely achieved the goal of safeguarding society's economic and political interest in a stable currency. In almost all modern-day economies, money is provided through a joint public-private venture between the central bank and private banks, with the central bank at the system's core. Electronic bank deposits are the main means of payment between ultimate users, while central bank reserves are the means of payment between banks.

In this two-tiered system, trust is generated through independent and accountable central banks, which back reserves through their asset holdings and operational rules. In turn, trust in bank deposits is generated through a variety

of means, including regulation, supervision and deposit insurance schemes, many ultimately emanating from the state.

As part of fulfilling their mandate to maintain a stable unit of account and means of payment, central banks take an active role in supervising, overseeing and in some cases providing the payments infrastructure for their currency. The central bank's role includes ensuring that the payment system operates smoothly and seeing to it that the supply of reserves responds appropriately to shifting demand, i.e., ensuring an elastic money supply.

Thanks to the active involvement of central banks, today's diverse payment systems have achieved safety, cost-effectiveness, scalability and trust that a payment, once made, is final. Payment systems are safe and cost-effective, handling high volumes and accommodating rapid growth with hardly any abuse and at low costs. In today's sophisticated economies, the volume of payments is huge, equal to many multiples of GDP.

Despite these large volumes, expanding use of the instrument does not lead to a proportional increase in costs. This is important since an essential feature of any successful money and payment system is how widely used it is by both buyers and sellers: the more others connect to a particular payment system, the greater one's own incentive to use it.

Users not only need to have trust in money itself, they also need to trust that a payment will take place promptly and smoothly: "finality" in certainty of payment, and the related ability to contest transactions that may have been incorrectly executed. Finality requires that the system be largely free of fraud and operational risks, at the level of both individual transactions and the system as a whole. Strong oversight and central bank accountability both help to support finality and hence trust.

While most modern-day transactions occur through means ultimately supported by central banks, over time a wide range of public and private payment means has emerged. Money is typically based on one of two basic technologies: so-called "tokens" or accounts.

Token-based money – banknotes or physical coins – can be exchanged in peer-to-peer settings, but such exchange relies critically on the payee's ability to verify the validity of the payment object – with cash, the worry is counterfeiting.

By contrast, systems based on account money depend fundamentally on the ability to verify the identity of the account holder.

The emergence of cryptocurrencies

Cryptocurrencies aspire to be a new form of currency and promise to maintain trust in the stability of their value through the use of technology. They consist of three elements: first, a set of rules (the "protocol"), computer code specifying how participants can transact; second, a ledger storing the history of transactions; and third, a decentralized network of participants that update, store and read the ledger of transactions following the rules of the protocol. With these elements, advocates claim, a cryptocurrency is not subject to the potentially misguided incentives of banks and sovereigns.

Cryptocurrencies are digital, aspiring to be a convenient means of payment and relying on cryptography to prevent counterfeiting and fraudulent transactions. Although created privately, they are no one's liability, i.e., they cannot be redeemed, and their value derives only from the expectation that they will continue to be accepted by others. And, last, they allow for digital peer-to-peer exchange.

Compared with other private digital moneys such as bank deposits, the distinguishing feature of cryptocurrencies is digital peer-to-peer exchange. Cryptocurrency transfers can in principle take place in a decentralized setting without the need for a central counterparty to execute the exchange.

The technological challenge in digital peer-to-peer exchange is the so-called "double-spending problem." Any digital form of money is easily replicable and can thus be fraudulently spent more than once. Digital information can be reproduced more easily than physical banknotes. For digital money, solving the double-spending problem requires, at a minimum, that someone keep a record of all transactions.

Prior to cryptocurrencies, the only solution was to have a centralized agent do this and verify all transactions. Cryptocurrencies overcome the double-spending problem via decentralized record-keeping through what is known as a "distributed ledger". The ledger starts with an initial distribution of cryptocurrency and records the history

of all subsequent transactions. An up-to-date copy of the entire ledger is stored by each user, making it “distributed”. With a distributed ledger, peer-to-peer exchange of digital money is feasible: each user can directly verify in their copy of the ledger whether a transfer took place and that there was no attempt to double-spend.

While all cryptocurrencies rely on a distributed ledger, they differ in terms of how the ledger is updated. One can distinguish two broad classes, with substantial differences in their operational setup.

One class, based on “permissioned” DLT, is similar to conventional payment mechanisms. In this class, to prevent abuse, the ledger can only be updated by trusted participants, or what is known as “trusted nodes”, in the cryptocurrency. These nodes are chosen and subject to oversight by a central authority of the ledger, e.g., the firm that developed the cryptocurrency.

Thus, while cryptocurrencies based on permissioned systems differ from conventional money in terms of how transaction records are stored (decentralized versus centralized), they share with it the reliance on specific institutions as the ultimate source of trust.

In a much more radical departure from the prevailing institution-based setup, a second class of cryptocurrencies promises to generate trust in a fully decentralized setting using “permissionless” DLT. The ledger recording transactions can only be changed by a consensus of the participants in the currency: while anybody can participate, nobody has a special key to change the ledger.

The concept of permissionless cryptocurrencies, laid out for bitcoin, is based on a specific type of distributed ledger, the “blockchain”, updated in groups of transactions called blocks. Blocks are then chained sequentially via the use of cryptography to form the blockchain. This concept has been adapted to countless other cryptocurrencies.

Blockchain-based permissionless cryptocurrencies have two groups of participants: “miners” who act as bookkeepers, and “users” who want to transact in the cryptocurrency. At face value, the idea underlying these cryptocurrencies is simple: instead of a bank centrally recording transactions underlying this setup, the key feature of these

cryptocurrencies is the implementation of a set of rules (the protocol) that aim to align the incentives of all participants so as to create a reliable payment technology without a central trusted agent.

The protocol determines the supply of the asset in order to counter debasement – for example, in the case of bitcoin, it states that no more than 21 million bitcoins can exist. In addition, the protocol is designed to ensure that all participants follow the rules out of self-interest, i.e., that they yield a self-sustaining equilibrium.

The rules entail a cost to updating the ledger, requiring in most cases a “proof-of-work”, mathematical evidence that a certain amount of computational work has been done, in turn calling for costly equipment and electricity use. It is often referred to as “mining”. In return for their efforts, miners receive fees from the users – and, if specified by the protocol, newly minted cryptocurrency.

Second, all miners and users of a cryptocurrency verify all ledger updates, which induces miners to include only valid transactions. If a ledger update includes an invalid transaction, it is rejected by the network and the miner’s rewards are voided. The verification of all new ledger updates by the network of miners and users is thus essential to incentivize miners to add only valid transactions.

Third, the protocol specifies rules to achieve a consensus on the order of updates to the ledger.

With these key ingredients, it is costly – though not impossible – for any individual to forge a cryptocurrency.

Trust and efficiency

Cryptocurrencies such as bitcoin promise to deliver not only a convenient payment means based on digital technology, but also a novel model of trust. Yet delivering on this promise hinges on a set of assumptions: that honest miners control the vast majority of computing power, that users verify the history of all transactions and that the supply of the currency is predetermined by a protocol.

These assumptions give rise to two basic questions regarding the usefulness of cryptocurrencies. First, does this cumbersome way of trying to achieve trust come at the expense of efficiency? Second, can trust truly and always be achieved?

A key potential limitation in terms

of efficiency is the enormous cost of generating decentralized trust. Individual facilities operated by miners can host computing power equivalent to that of millions of personal computers. At the time of writing (25 May), the BIS estimated that the total electricity use of bitcoin mining equalled that of mid-sized economies such as Switzerland; and other cryptocurrencies also use ample electricity. Put in the simplest terms, the quest for decentralized trust has quickly become an environmental disaster.

But the underlying economic problems go well beyond the energy issue and relate to the signature property of money: to promote “network externalities” among users and thereby serve as a coordination device for economic activity. The shortcomings of cryptocurrencies in this respect lie in three areas: scalability, stability of value and trust in the finality of payments.

First, cryptocurrencies simply do not scale like sovereign moneys. At the most basic level of decentralized trust, cryptocurrencies require each and every user to download and verify the history of all transactions ever made, including amount paid, payer, payee and other details. With every transaction adding a few hundred bytes, the ledger grows substantially over time. For example, in mid-May, the bitcoin blockchain was growing at around 50 GB per year and stood at roughly 170 GB. Thus, to keep the ledger size and the time needed to verify all transactions (which increases with block size) manageable, cryptocurrencies have hard limits on the throughput of transactions.

To process the number of digital retail transactions currently handled by selected national retail payment systems, even under optimistic assumptions, the size of the ledger would swell well beyond the storage capacity of a typical smartphone in a matter of days, beyond that of a typical personal computer in a matter of weeks and beyond that of servers in a matter of months.

But the issue goes well beyond storage capacity and extends to processing capacity: only supercomputers could keep up with verification of the incoming transactions. The associated communication volumes could bring the Internet to a halt, as millions of users exchange files on the order of magnitude of a terabyte.

Another aspect of the scalability issue is that updating the ledger is subject

to congestion. Transactions have at times remained in a queue for several hours, interrupting the payment process. This limits cryptocurrencies' usefulness for day-to-day transactions such as paying for a coffee or a conference fee, not to mention for wholesale payments.

Thus, the more people use a cryptocurrency, the more cumbersome payments become. This negates an essential property of present-day money: the more people use it, the stronger the incentive to use it.

The second key issue with cryptocurrencies is their unstable value, due to the absence of a central issuer with a mandate to guarantee the currency's stability, a role in which well-run central banks succeed in stabilizing the domestic value of their sovereign currency by adjusting the supply of the means of payment in line with transaction demand.

This contrasts with a cryptocurrency, where generating some confidence in its value requires that supply be predetermined by a protocol, preventing it from being supplied elastically. Therefore, any fluctuation in demand translates into changes in valuation.

This outcome is not coincidental. Keeping the supply of the means of payment in line with transaction demand requires a central authority, typically the central bank, which can expand or contract its balance sheet. The authority needs to be willing at times to trade against the market, even if this means taking risk onto its balance sheet and absorbing a loss.

In a decentralized network of cryptocurrency users, there is no central agent with the obligation or the incentives to stabilize the value of the currency: whenever demand for the cryptocurrency decreases, so does its price.

Further contributing to unstable valuations is the speed at which new cryptocurrencies – all tending to be very closely substitutable with one another – come into existence, with several thousand now estimated to be in existence. As in past private banking experiences, the outcome of such liberal issuance of new moneys is rarely stability.

The third issue concerns the fragile foundation of the trust in cryptocurrencies. This relates to uncertainty about the finality of individual payments, as well as trust in the value of individual cryptocurrencies.

In mainstream payment systems, once an individual payment makes its way through the national payment system and ultimately through the central bank books, it cannot be revoked. In contrast, permissionless cryptocurrencies cannot guarantee the finality of individual payments. The lack of payment finality is exacerbated by the fact that cryptocurrencies can be manipulated by miners controlling substantial computing power, a real possibility given the concentration of mining for many cryptocurrencies. Finality will always remain uncertain.

Not only is the trust in individual payments uncertain, but the underpinning of trust in each cryptocurrency is also fragile. This is due to “forking”, a process whereby a subset of cryptocurrency holders coordinate on using a new version of the ledger and protocol, while others stick to the original one. In this way, a cryptocurrency can split into two subnetworks of users.

An episode on 11 March 2013 is noteworthy because – counter to the idea of achieving trust by decentralized means – it was undone by centralized coordination of the miners. On that day, an erroneous software update led to incompatibilities between one part of the bitcoin network mining on the legacy protocol and another part mining using an updated one. For several hours, two separate blockchains grew; once news of this fork spread, the price of bitcoin tumbled by almost a third. The fork was ultimately rolled back by a coordinated effort whereby miners temporarily departed from protocol and ignored the longest chain. But many transactions were voided hours after users had believed them to be final.

An even more worrying aspect underlying such episodes is that forking may only be symptomatic of a fundamental shortcoming: the fragility of the decentralized consensus involved in updating the ledger and, with it, of the underlying trust in the cryptocurrency.

Overall, decentralized cryptocurrencies suffer from a range of shortcomings. The main inefficiencies arise from the extreme degree of decentralization: creating the required trust in such a setting wastes huge amounts of computing power, decentralized storage of a transaction ledger is inefficient and the decentralized consensus is vulnerable.

Some of these issues might be ad-

dressed by novel protocols and other advances. But others seem inherently linked to the fragility and limited scalability of such decentralized systems. Ultimately, this points to the lack of an adequate institutional arrangement at the national level as the fundamental shortcoming.

While cryptocurrencies do not work as money, the underlying technology may have promise in other fields. A notable example is in low-volume cross-border payment services. More generally, compared with mainstream centralized technological solutions, DLT can be efficient in niche settings where the benefits of decentralized access exceed the higher operating cost of maintaining multiple copies of the ledger.

Permissioned cryptopayment systems may also have promise with respect to small-value cross-border transfers, which are important for countries with a large share of their workforce living abroad. Global remittance flows total more than \$540 billion annually. While cryptopayment systems are one option to address these needs, other technologies are also being considered, and it is not clear which will emerge as the most efficient one.

More important use cases are likely to combine cryptopayments with sophisticated self-executing codes and data permission systems.

Policy implications

The rise of cryptocurrencies and related technology brings to the fore a number of policy questions. Authorities are looking for ways to ensure the integrity of markets and payment systems, to protect consumers and investors, and to safeguard overall financial stability.

An important challenge is to combat illicit usage of funds. At the same time, authorities want to preserve long-run incentives for innovation and, in particular, maintain the principle of “same risk, same regulation.”

These are largely recurrent objectives, but cryptocurrencies raise new challenges and potentially call for new tools and approaches. A related question is whether central banks should issue their own central bank digital currency (CBDC) (see below).

A first key regulatory challenge is anti-money laundering (AML) and combating the financing of terrorism (CFT).

Because cryptocurrencies are anonymous, it is hard to quantify the extent to which they are being used to avoid capital controls or taxes, or to engage in illegal transactions more generally.

A second challenge encompasses securities rules and other regulations ensuring consumer and investor protection. Fraud issues also plague initial coin offerings (ICOs). An ICO involves the auctioning of an initial set of cryptocurrency coins to the public, with the proceeds sometimes granting participation rights in a startup business venture. Many of these projects have turned out to be fraudulent Ponzi schemes.

A third, longer-term challenge concerns the stability of the financial system. It remains to be seen whether widespread use of cryptocurrencies and related self-executing financial products will give rise to new financial vulnerabilities and systemic risks.

Close monitoring of developments will be required. And, given their novel risk profiles, these technologies call for enhanced capabilities of regulators and supervisory agencies. In some cases, such as the execution of large-value, high-volume payments, the regulatory perimeter may need to expand to include entities using new technologies, to avoid the build-up of systemic risks.

The need for strengthened or new regulations and monitoring of cryptocurrencies and related crypto-assets is widely recognized among regulators across the globe. In particular, a recent communique of the G20 Finance Ministers and Central Bank Governors highlights issues of consumer and investor protection, market integrity, tax evasion and AML/CFT, and calls for continuous monitoring by the international standard-setting bodies. It also calls for the Financial Action Task Force to advance global implementation of applicable standards.

However, the design and effective implementation of strengthened standards are challenging. Legal and regulatory definitions do not always align with the new realities. The technologies are used for multiple economic activities, which in many cases are regulated by different oversight bodies.

Operationally, the main complicating factor is that permissionless cryptocurrencies do not fit easily into existing frameworks. In particular, they

lack a legal entity or person that can be brought into the regulatory perimeter. Their legal domicile – to the extent they have one – might be offshore or impossible to establish clearly. As a result, they can be regulated only indirectly.

To implement a regulatory approach, three considerations are relevant. First, the rise of cryptocurrencies and crypto-assets calls for a redrawing of regulatory boundaries. Second, the interoperability of cryptocurrencies with regulated financial entities could be addressed. Third, regulation can target institutions offering services specific to cryptocurrencies. To avoid leakages, the regulation would ideally be broadly similar and consistently implemented across jurisdictions.

Should central banks issue digital currencies?

A related medium-term policy question concerns the issuance of CBDCs, including who should have access to them. CBDCs would function much like cash: the central bank would issue a CBDC initially, but once issued it would circulate between banks, non-financial firms and consumers without further central bank involvement.

Such a CBDC might be exchanged between private sector participants bilaterally using distributed ledgers without requiring the central bank to keep track and adjust balances. It would be based on a permissioned distributed ledger, with the central bank determining who

acts as a trusted node.

While the distinction between a general purpose CBDC and existing digital central bank liabilities – reserve balances of commercial banks – may appear technical, it is actually fundamental in terms of its repercussions for the financial system.

A general purpose CBDC – issued to consumers and firms – could profoundly affect three core central banking areas: payments, financial stability and monetary policy.

A recent joint report by the Committee on Payments and Market Infrastructures and the Markets Committee highlights the underlying considerations. It concludes that the strengths and weaknesses of a general purpose CBDC would depend on specific design features.

The report further notes that, while no leading contenders have yet emerged, such an instrument would come with substantial financial vulnerabilities, while the benefits are less clear. At the moment, central banks are closely monitoring the technologies while taking a cautious approach to implementation.

Some are evaluating the pros and cons of issuing narrowly targeted CBDCs, restricted to wholesale transactions among financial institutions. These would not challenge the current two-tier system but would instead be intended to enhance the operational efficiency of existing arrangements. So far, however, experiments with such wholesale CBDCs have not produced a strong case for immediate issuance. (SUNS8704) □

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Investment treaty-making sees turning point

More international investment agreements were terminated in 2017 than were concluded, marking the first time this has happened, according to a UN investment monitor.

by Kanaga Raja

GENEVA: Investment treaty-making has reached a turning point, as for the first time, the number of effective treaty terminations has outpaced the number of new IIA (international investment agreement) conclusions, according to the UN Conference on Trade and Development (UNCTAD).

In a chapter in its recently released *World Investment Report 2018 (WIR-2018)* highlighting recent developments in the international investment regime, UNCTAD also said that the year 2017 concluded with the lowest number of new IIAs since 1983, signalling a period of reflection on, and review of, international investment policies.

In 2017, countries concluded 18 new IIAs: nine bilateral investment treaties (BITs) and nine treaties with investment provisions (TIPs). This brought the size of the IIA universe to 3,322 agreements (2,946 BITs and 376 TIPs), of which 2,638 were in force at year-end.

The most active economy was Turkey, concluding four treaties, followed by Hong Kong-China with two. Forty-five economies were parties to one new treaty each.

Of the 18 new IIAs, three were regional agreements [the ASEAN-Hong Kong, China Investment Agreement, the Intra-MERCOSUR Investment Facilitation Protocol and the Pacific Agreement on Closer Economic Relations (PACER) Plus Agreement between Australia, New Zealand and 12 Pacific island states].

In addition, 15 IIAs entered into force. Between January and March 2018, three additional IIAs were signed.

At the same time, said UNCTAD, at least 22 terminations entered into effect ("effective termination").

Particularly active in terminating treaties was India with 17, while Ecuador sent 16 notices of termination in 2017. Among intra-European Union (EU) BITs, at least two terminations took effect in 2017.

For the first time, the number of effectively terminated IIAs (22) exceeded

the number of newly concluded treaties (18) and the number of new treaties entering into force (15).

However, the low number of IIAs concluded in 2017 does not necessarily translate into fewer treaty relationships among countries, said UNCTAD. Unlike BITs, a single regional IIA creates many treaty relationships, depending on the number of contracting parties.

Moreover, effective treaty termination must also be seen in light of survival clauses, according to which treaty application is extended for a further period after termination (some for five years, but most commonly for 10, 15 or even 20 years).

And the stock of IIAs remains very large, comprising more than 3,300 treaties, most of them belonging to the "first generation" of IIAs that are in need of reform.

According to UNCTAD, the nine TIPs concluded in 2017 can be grouped into four categories:

(a) Four agreements with obligations commonly found in BITs, including substantive standards of investment protection: Argentina-Chile Free Trade Agreement; ASEAN-Hong Kong, China Investment Agreement; China-Hong Kong, China Investment Agreement; Pacific Agreement on Closer Economic Relations (PACER) Plus.

(b) One agreement with investment provisions emphasizing investment promotion and facilitation as well as a number of investment protection provisions, but no investor-state dispute settlement (ISDS) clause: Intra-MERCOSUR Investment Facilitation Protocol.

(c) One agreement with limited investment provisions [e.g., national treatment and most favoured nation (MFN) treatment with regard to the right of establishment of companies] or provisions on free movement of capital relating to direct investments: Armenia-EU Comprehensive and Enhanced Partnership Agreement.

(d) Three agreements that establish

a process for negotiation or an institutional framework to promote and cooperate on investment but do not contain substantive investment protection provisions: Paraguay-United States Trade and Investment Framework Agreement; Chile-Indonesia Comprehensive Economic Partnership Agreement; China-Georgia Free Trade Agreement.

UNCTAD also said that the year 2017 maintained momentum in negotiations for mega-regional agreements, particularly in Africa and Asia. In addition, a number of country groups are developing non-binding guiding principles for investment policymaking.

Trends in ISDS

The *WIR-2018* also found that the number of new ISDS claims remains high.

In 2017, investors initiated at least 65 ISDS cases pursuant to IIAs. As of 1 January 2018, the total number of publicly known ISDS claims had reached 855.

(On the basis of newly revealed information, the number of known cases for 2016 was adjusted to 75, and for 2015 to 80.)

As some arbitrations can be kept fully confidential, the actual number of disputes filed in 2017 and previous years is likely to be higher, said UNCTAD.

The new ISDS cases in 2017 were initiated against 48 countries. Croatia was the most frequent respondent with four cases, followed by India and Spain with three cases each. Four economies – Bahrain, Benin, Iraq and Kuwait – faced their first (known) ISDS claims. As in previous years, said UNCTAD, the majority of new cases were brought against developing countries and transition economies.

So far, 113 countries have been respondents to one or more known ISDS claims.

Developed-country investors brought most of the 65 known cases in 2017. Investors from the Netherlands and the United States initiated the most cases with eight cases each, followed by investors from the United Kingdom with six.

Investors from Turkey were the most active claimants from developing countries, with four cases filed in 2017.

Intra-EU disputes accounted for about one-fifth of all investment arbitrations initiated in 2017, down from one-quarter in the preceding year. The overall number of arbitrations initiated by an

investor from one EU member state against another totalled 168 by the end of 2017, i.e., 20% of the total number of cases globally.

UNCTAD noted that a recent judgment of the EU Court of Justice found that the arbitration clause contained in the Netherlands-Slovakia BIT (1991) was incompatible with EU law. This decision may have important implications for intra-EU BITs and future intra-EU disputes, said UNCTAD.

About 80% of investment arbitrations in 2017 were brought under BITs. The remaining arbitrations were based on TIPs, or on BITs and TIPs in combination. The majority of the IIAs invoked in 2017 date back to the 1980s and 1990s.

The IIAs most frequently invoked in 2017 were the Energy Charter Treaty (with six cases), the Austria-Croatia BIT (three cases) and the North American Free Trade Agreement (NAFTA) (two cases).

Looking at the overall trend, about 20% of all known cases have invoked the Energy Charter Treaty (113 cases) or NAFTA (61 cases).

In respect of the economic sectors involved, about 70% of the cases filed in 2017 related to activities in the services sector, including: financial and insurance services (11 cases); construction (nine cases); supply of electricity, gas, steam and air (seven cases); information and communication (six cases); and transportation and storage (four cases). Primary industries and manufacturing each accounted for 15% of new cases. This is broadly in line with the overall distribution of the 855 known ISDS cases filed to date, said UNCTAD.

Investors in 2017 most frequently challenged the following types of state conduct:

- Domestic legal proceedings and decisions (at least seven cases);
- Termination of contracts or concessions, and revocation or non-renewal of licences (at least seven cases);
- Placement under administration and other actions allegedly resulting in bankruptcy or liquidation (at least six cases);
- Alleged takeover, seizure or nationalization of investments (at least five cases);
- Legislation prescribing changes in the currency of loans and mortgages (at least four cases);
- Tax-related measures such as allegedly unlawful tax assessments or the

denial of tax exemptions (at least four cases);

- Legislative reforms in the renewable energy sector (at least two cases).

Other conduct that was challenged included alleged harassment by state authorities, unfair or discriminatory treatment, fraudulent misrepresentation and anti-money laundering regulations.

Where information regarding the amounts sought by investors has been disclosed (in about one-quarter of the new cases), the amounts claimed range from \$15 million (*Arin Capital and Khudyan v. Armenia*) to \$1.5 billion (*MAKAE v. Saudi Arabia*).

In 2017, ISDS tribunals rendered at least 62 substantive decisions, 34 of which are in the public domain (at the time of writing), said UNCTAD.

Of these public decisions, more than half of the decisions on jurisdictional issues were decided in favour of the state, whereas those on the merits were mostly decided in favour of the investor. More specifically:

- Thirteen decisions (including rulings on preliminary objections) principally addressed jurisdictional issues, with five upholding the tribunal's jurisdiction and eight denying jurisdiction.

- Eighteen decisions on the merits were rendered in 2017, with 12 accepting at least some investor claims and six dismissing all of the claims. In the decisions holding the state liable, tribunals most frequently found breaches of the expropriation and the fair and equitable treatment (FET) provisions. In one decision, the tribunal found that the state had breached the IIA but decided that no compensation was due.

- Three publicly known decisions were rendered in ICSID (International Centre for Settlement of Investment Disputes) annulment proceedings. ICSID ad hoc committees rejected two applications for annulment and partially annulled one award.

According to the *WIR-2018*, by the end of 2017, some 548 ISDS proceedings had been concluded.

About one-third of all concluded cases were decided in favour of the state (claims were dismissed either on jurisdictional grounds or on the merits), and about one-quarter were decided in favour of the investor, with monetary compensation awarded. A quarter of cases were settled; in most cases, the specific terms of settlements remain confidential. In the remaining proceedings,

cases were either discontinued or the tribunal found a treaty breach but did not award monetary compensation.

Of the cases that were resolved in favour of the state, about half were dismissed for lack of jurisdiction.

Looking at the totality of decisions on the merits (i.e., where a tribunal determined whether the challenged measure breached any of the IIA's substantive obligations), about 60% were decided in favour of the investor and 40% in favour of the state.

On average, said UNCTAD, successful claimants were awarded about 40% of the amounts they claimed. In cases decided in favour of the investor, the average amount claimed was \$1.3 billion and the median \$118 million. The average amount awarded was \$504 million and the median \$20 million. These amounts do not include interest or legal costs, and some of the awarded sums may have been subject to set-aside or annulment proceedings.

The combined \$114 billion claimed and \$50 billion awarded in three cases related to the Yukos company (brought by Hulley Enterprises, Veteran Petroleum and Yukos Universal against the Russian Federation) were the highest in the history of investment treaty arbitration. These arbitration awards have been set aside by The Hague District Court; its judgment was appealed and the appeal is currently pending.

Excluding these values from the calculations above, the average amount claimed falls to \$454 million and the amount awarded to \$125 million, i.e., about 28% of the amount claimed, said UNCTAD.

The *WIR-2018* also found that about 500 people have been appointed as arbitrators in known ISDS cases (original proceedings). About half have served on more than one known case. A small number of people (13) have been appointed to more than 30 cases each, with three having received the most appointments. All but one are citizens of European or North American countries.

IIA reform

UNCTAD also said that IIA reform is well under way across all regions. Most of today's new IIAs include sustainable development-oriented reform elements. Highlights of modern treaty-making include a sustainable development orientation, preservation of regulatory space

and improvements to or omissions of ISDS.

For example, in contrast to the IIAs signed in 2000, the 2017 IIAs include a larger number of provisions explicitly referring to sustainable development issues (including by preserving the right to regulate for sustainable development-oriented policy objectives).

Of the 13 agreements concluded in 2017 for which texts are available, 12 have general exceptions – for example, for the protection of human, animal or plant life or health, or the conservation of exhaustible natural resources.

All but one also explicitly recognize that the parties should not relax health, safety or environmental standards to at-

tract investment; and 11 refer to the protection of health and safety, labour rights, the environment or sustainable development in their preambles.

UNCTAD also noted that some of the IIAs concluded in 2017 contain innovative features that have rarely been encountered in earlier IIAs. These include conditioning treaty coverage on investors' contribution to sustainable development; reducing the role of investor expectations in fair and equitable treatment (FET); fostering responsible investment; building capacity for investment facilitation; and facilitating counterclaims by the respondent party against the claimant investor. (SUNS8702) □

will lead to building productive capacity and structural transformation for LDC economies will fundamentally be public policies domestically embraced and initiated by the governments.

Challenges faced by LDCs

According to the UNCTAD compendium, there are currently 47 LDCs. They host just over 1 billion people, approximately 13% of the world's population, but account for only 1.2% of global gross domestic product (GDP).

Almost half of the population of LDCs still live in extreme poverty. At the same time LDCs have the world's fastest population growth rate. The basic causes of persistent and widespread poverty in LDCs are low productivity, and high levels of unemployment and underemployment.

Most LDCs face considerable challenges posed by demographic developments, rising inequality and persistent poverty, combined with accelerated urbanization. The population living in the present LDCs is projected to almost double to 1.9 billion by 2050. With a soaring youth population, an additional 630 million people (equivalent to about one-third of the estimated LDC population in 2050) will have entered the labour market by 2050. Moreover, it is the most vulnerable countries among LDCs that are the most affected by these demographic trends.

Insufficient paid employment creation has the potential to become a source of significant social and political tension and can weaken domestic demand growth.

In sharp contrast with demographic developments, the rate of capital accumulation and technological progress in LDCs is generally slow. As a result, most workers, who on average receive only low levels of education and training, must earn a living by using their raw labour, and basic tools and equipment. They also face challenges related to poor infrastructure provision.

The compendium noted that in most LDCs the growing labour force has mostly found employment in agriculture, largely in connection with the cultivation of additional land. However, with further population growth, more and more young people are seeking work opportunities outside of agriculture.

Nascent manufacturing activities and services offer new opportunities for productive employment, mostly in urban centres, but these employment opportu-

UNCTAD releases policy tool to help LDCs meet SDGs

A new UNCTAD publication sets out possible policy options for the world's least developed countries to attain the Sustainable Development Goals.

by Kanaga Raja

GENEVA: The United Nations Conference on Trade and Development (UNCTAD) has released a policy compendium aimed at assisting the least developed countries (LDCs) in achieving the Sustainable Development Goals (SDGs).

The compendium of policy options, titled *Achieving the Sustainable Development Goals in the Least Developed Countries*, was launched on 6 June by Amina J. Mohammed, Deputy Secretary-General of the United Nations, on the sidelines of the sixty-fifth session of UNCTAD's Trade and Development Board (TDB) meeting here.

According to UNCTAD, the compendium synthesizes nearly 15 years of UNCTAD research and policy options in a single resource. It identifies possible types of instruments in various policy areas that may foster development progress, enhance growth and support poverty eradication and economic structural transformation in the LDCs.

The UNCTAD policy compendium offers a wide range of ways for policymakers and international development partners to fashion targeted solutions for the social, economic and environmental challenges facing the LDCs.

"UNCTAD is, as it always has been, in the forefront of crafting vital policy

options needed for the structural transformation of the world's poorest and most fragile economies," said Mohammed. "Without concrete proposals to bring about this transformation, the development prospects of millions of people remain in jeopardy."

"I welcome this UNCTAD compendium as a powerful resource for countries working to achieve the targets of the Sustainable Development Goals, and for their development partners worldwide," Mohammed added.

"UNCTAD has always been ahead of the curve, producing cutting-edge policy options with a special focus on the LDCs, based on sound analytical research. This compendium, rich in options for action and trendsetting in its approach to LDC challenges, is such an example of frontier research," said UNCTAD Secretary-General Mukhisa Kituyi.

"We at UNCTAD have always believed that the battle for success in realizing Agenda 2030 [which encompasses the SDGs] will be won or lost in the LDCs," Kituyi said at a 6 June media briefing, pointing out that of the 169 SDG targets, 18 explicitly refer to the LDCs.

While donors and international partners have a role to play, said Kituyi, at the end of the day policy approaches that

nities are not expanding fast enough to meet the growing demand for jobs.

As a result, poverty in LDCs has two faces. One is low-productivity, small-scale agriculture and the other is low-productivity, urban, informal-sector activities in petty trade and services. This situation has led to large-scale emigration, said UNCTAD.

"If this situation persists, poverty reduction will be very slow, despite accelerated output growth. In addition, the link between output growth and employment creation needs to be strengthened."

It was only during the period of relatively fast output growth from 2001-08 that average annual LDC employment growth (at about 3.4%) exceeded the rate of population growth. Even during this period, however, employment growth was less than half of the growth rate of real GDP (7.2%).

It is therefore alarming that after 2014, GDP growth in LDCs has fallen to an average of less than 5%, while average annual growth of at least 7% is recommended by the Istanbul Programme of Action for the Least Developed Countries for the Decade 2011-2020 (IPoA), and targeted by the 2030 Agenda for Sustainable Development (SDG target 8.1).

Moreover, said the compendium, LDCs are characterized by chronic current account deficits and remain highly dependent on external finance. Even in times of record economic growth, during the first decade of this millennium, many LDCs continued to rely on external resources to finance a majority of their investments and part of their consumption.

The SDGs and LDC strategies

According to the compendium, accelerated economic development in LDCs is at the centre of efforts to achieve the SDGs. Not only is the incidence of poverty and malnutrition the greatest in this group of countries, but the selection and implementation of effective policies to overcome these problems are also the most challenging there.

Among the SDGs that are important reference points for the design of national development strategies for LDCs are:

- End poverty everywhere (SDG 1);
- End hunger, achieve food security and improved nutrition and promote sustainable agriculture (SDG 2);
- Ensure access to affordable, reliable, sustainable and modern energy for all (SDG 7);
- Promote sustained and sustain-

able economic growth, full and productive employment and decent work for all (SDG 8);

- Build resilient infrastructure, promote inclusive and sustainable industrialization and foster innovation (SDG 9);
- Reduce inequality within and among countries (SDG 10);
- Combat climate change (SDG 13); and
- Strengthen the means of implementation (SDG 17).

The compendium noted that LDCs have the highest shares of population living in extreme poverty. The fundamental goal of ending poverty, with the specific target to eradicate extreme poverty by 2030, must be the central reference of policymaking in LDCs, it said. Achieving this goal matters for improving welfare, sustaining livelihoods and enabling peace. It also will strengthen domestic growth and promote structural transformation in LDCs.

Thanks to substantial increases in social spending, poverty has been reduced almost everywhere since 2000, the year when the international community agreed on the Millennium Development Goals (MDGs). Yet, for sustained and sustainable poverty reduction, income transfers and other forms of public or charitable social spending must be subsidiary to measures that tackle the root causes of the problem, i.e., the lack of productive and decently paid jobs. This means that output growth and employment creation in LDCs must be accelerated considerably.

Enhancing agricultural production remains an indispensable element of the development strategy of LDCs. The scope for raising agricultural output and productivity is considerable and leveraging this will help to ensure food security, raise agricultural exports and increase the quantity and quality of raw materials available for domestic manufacturing.

UNCTAD said a rapid expansion of non-agricultural activities must also be considered as the central pillar of sustainable development strategies.

Energy provision is one of the priority areas of the IPoA, as inadequate access to energy seriously constrains economic growth and sustainable development in the majority of LDCs. Sixty-two percent of people in LDCs lack access to electricity and even more do not have access to modern fuels for cooking and heating.

While energy deficiency is most pro-

nounced in rural areas, it is also an obstacle to the expansion of economic activities in the manufacturing and service sectors and to greater participation in international trade.

The energy sector contributes directly to GDP by generating value added, jobs and, in some LDCs, exports. Energy is also indispensable for the adoption of technological innovations and productivity growth in other sectors.

Achieving SDG 7 will require increased power generation, extended distribution infrastructure and upgraded technology to enable the supply of modern and sustainable energy, including an increased share of electricity generated from renewable energy sources.

According to UNCTAD, achieving virtually all the SDGs requires economic growth at a pace that is significantly faster than in the past. From 2010 to 2016, average annual GDP growth in LDCs was 4.8%, considerably below the explicit SDG target of 7%. Accordingly, average annual growth per capita in LDCs fell from 5% in 2002-08 to 2.6% in 2012-17, a pace far too slow to reach the ambitious SDG targets, let alone catch up with more advanced economies.

"Therefore, sound national development strategies must be strongly geared towards a sustained acceleration of output growth, combining productivity increases with the creation of productive employment opportunities and an expansion of supply capacities with demand growth."

As in the case of energy, improvements in water, transport and telecommunications infrastructure can directly improve living conditions. Such improvements are also a prerequisite for the viability and profitability of productive activities in practically all sectors of the economy.

Diversification of the production structure, technological upgrading and productivity growth also depend on innovation in the design of products and the application of new production techniques in LDC economies.

"Policies aimed at accelerating the progresses [sic] towards a higher share of the manufacturing industry in income and employment generation must therefore be complemented by measures to ensure that benefits accrue to all groups of society and that the modes of production and consumption are environmentally sustainable and climate friendly."

According to the compendium, despite considerable progress in combat-

ting poverty in low- and middle-income countries since the early 1990s, disparities in household income between the highest and the lowest income groups have widened. However, in Africa, the continent with the largest number of LDCs, these disparities have shrunk. Still, inequality in Africa is higher than the global average.

Similar to reducing poverty, reducing income inequality within each country is both an objective and a means to strengthen the domestic forces of growth.

Average real per capita income in LDCs is only about 2% of that in developed countries and about 21% of the average per capita income in the other developing countries, excluding China. The gaps have narrowed somewhat since 2005, mainly due to growth in the Asian LDCs.

"Significant further reductions will only be possible if LDCs can move to a substantially higher growth path and increase the net earnings from their participation in international trade," said UNCTAD.

It also said the challenges posed by climate change are especially pressing for LDCs and small island developing states (SIDS). Like other developing countries, these economies are obliged to integrate responses to climate change into their national development strategies, but they are more heavily affected than others by the impacts of climate change.

"The principle of common but differentiated responsibility for combatting climate change is of particular relevance for these countries," said UNCTAD.

"Whereas developed countries must undertake major efforts for climate change mitigation, the challenge for LDCs is primarily to take effective measures to strengthen their resilience against the inevitable impacts of climate change."

The 2030 Agenda for Sustainable Development clearly recognizes the responsibility of developed countries for taking the lead in climate change mitigation and for strengthening the capacity of LDCs, landlocked developing countries (LLDCs) and SIDS to adapt to the economic and social effects of climate change.

The SDGs are extremely ambitious, especially at a time when climate change poses additional challenges. Achieving them requires economic progress at a pace similar to the performance of the

(continued on page 16)

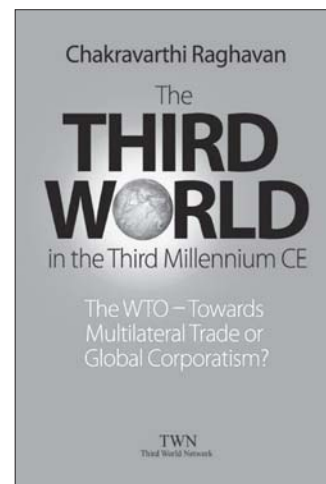
The Third World in the Third Millennium CE

The WTO – Towards Multilateral Trade or Global Corporatism?

By Chakravarthi Raghavan

THE second volume of *The Third World in the Third Millennium CE* looks at how the countries of the South have fared amidst the evolution of the multilateral trading system over the years. Even at the General Agreement on Tariffs and Trade (GATT) gave way to the World Trade Organization (WTO) as the institution governing international trade, this book reveals, the Third World nations have continued to see their developmental concerns sidelined in favour of the commercial interests of the industrial countries.

From the landmark Uruguay Round of talks which resulted in the WTO's establishment to the ongoing Doha Round and its tortuous progress, the scenario facing the developing countries on the multilateral trade front has been one of broken promises, onerous obligations and manipulative manoeuvrings. In such a context, the need is for the countries of the Third World to push back by working together to bring about a more equitable trade order. All this is painstakingly documented by Chakravarthi Raghavan in the articles collected in this volume, which capture the complex and contentious dynamics of the trading system as seen through the eyes of a leading international affairs commentator.



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IMF needs different mindset than its modified neoliberalism

Urging a shift in the International Monetary Fund's approach from its current "modified neoliberalism", a UN human rights expert has called on the Fund to more seriously promote social protection in its policies and programmes.

by Kanaga Raja

GENEVA: If the International Monetary Fund (IMF) is to respond effectively in the years ahead to the challenges in a world in which both globalization and liberal democracy are increasingly under attack, it will need a different mindset from the modified neoliberalism that currently sets the parameters of its thinking.

This is the assessment of Philip Alston, the UN Special Rapporteur on extreme poverty and human rights, in his latest report to the UN Human Rights Council, which convened its thirty-eighth regular session on 18 June-6 July.

In his report, which focuses on the IMF and its impact on social protection, Alston said that the IMF is the single most influential international actor in relation not only to fiscal policy but also to social protection, even if both it and its critics might prefer that this were not the case.

He noted that the majority of low-income developing countries are already included in IMF programmes or are likely to be so in the near future, yet fewer than one in five of the poorest 20% of people in those countries is covered by any form of social protection. And any assistance they receive will only cover a mere 13% of their consumption needs. Even in lower-middle-income countries, fewer than half of those living in poverty receive such assistance.

No international institution exerts greater influence than the IMF over issues such as distribution, including social protection, said the rights expert. But for many years, it took the position that these issues were not its concern; it could take account only of macroeconomic issues narrowly defined. Other institutions were left to pick up the pieces in the social area, but could only do so within the confines of the fiscal space, if any, left open after IMF prescriptions had been adopted.

The IMF has long been criticized for its disregard of "social issues" and its impact thereon, Alston pointed out.

In 1987, when a groundbreaking and devastatingly critical report entitled *Ad-*

justment with a Human Face was published by the United Nations Children's Fund (UNICEF), the IMF subscribed to the original Washington Consensus, which prioritized "prudent macroeconomic policies, outward orientation and free-market capitalism".

The "imposition" of structural adjustment policies on many countries in Africa, Asia and Latin America was said by human rights groups and others to have further immiserated the living conditions of the poor.

Such criticism, combined with political pushback, led to an "augmented Washington consensus" with a new emphasis on social safety nets and "pro-poor growth".

The advice subsequently proffered by the IMF during the 1997 Asian financial crisis was widely faulted by governments and commentators, and as the Asian recession abated and the developing-country debt crisis was resolved, the IMF receded into the background and underwent significant staff cutbacks.

But the global financial crisis of 2007-08 returned it to the centre of international economic governance. At their 2009 summit, the Group of 20 major economies committed \$750 billion to expand IMF operations, leading its Managing Director to proclaim with justification that "the IMF is back".

Earlier criticism, combined with the nature and scale of the new global crisis, prompted an internal reassessment at the IMF, including revisiting parts of the "neoliberal agenda". This included developing the theory of "macro-criticality" to justify the possible inclusion of an expanded range of issues, such as social protection, in its analyses and prescriptions.

Many of the critics, however, are not convinced that the basic policy paradigm has changed. Some have characterized the changes at the IMF as "a smokescreen designed to deflect criticism" and part of its "escalating commitment to hypocrisy", and have pointed to evidence that "structural conditionality remains alive and well", suggesting a return to the

"old" IMF.

At the outset, however, it should be noted that the IMF, for all its homogeneity and hierarchy, is not a monolithic institution without any internal diversity of views or differences in operational practice. As with any complex international organization, its approach is evolving. The current Managing Director (Christine Lagarde), like her predecessor, has championed major changes, including a newfound focus on issues such as inequality, gender equality, governance, climate change and social protection.

Much of the new discourse, and the research underpinning it, is welcome from a human rights perspective, but the real test is whether it will be fully translated into operational reality, which is where new ideas meet entrenched institutional culture, vested interests and ideology, said Alston.

Macro-critical issues

Before focusing on how the potentially very flexible notion of macro-criticality has been approached in practice in relation to social protection, said Alston, it is instructive to consider the macro-criticality of human rights, military expenditure, corruption, inequality and gender equality.

The present analysis shows that the sole taboo at the IMF seems to be human rights, although IMF analyses do in fact note the relevance of political conflict, violence and social unrest. The Special Rapporteur's report noted that the IMF has not adopted an official legal opinion in relation to human rights.

The IMF first addressed corruption in-depth in a 1997 guidance note on "governance issues". Increased attention to the issue at the IMF and the World Bank at that time reflected a realization on the part of the proponents of the Washington Consensus that corruption had undermined the institutions that had been key to successful policy reform and economic development.

Recent examples of countries where the IMF considered corruption to be "macro-critical" are Mozambique, where enormous loans made to state-owned enterprises were concealed, the Congo, where authorities recently announced plans to arrest corrupt officials in order to meet IMF loan conditions, and Ukraine.

But in other states experiencing major corruption scandals, the IMF has confined itself to general observations about the desirability of something being done. "Such timidity contrasts with its strong measures to combat money laundering

and the financing of terrorism, in relation to which it has provided technical assistance to 120 countries.”

The IMF is currently in the midst of a major review designed to make its corruption policy more effective. Challenges include the risk of becoming involved in politically charged debates and of not being perceived as “even-handed”, how to determine macro-criticality and what information sources to rely upon, and the need for specialized staff with appropriate expertise.

“While none of those issues is straightforward, failure to take a strong line on an issue such as large-scale or systemic corruption, which has major macroeconomic ramifications, leaves a large dent in the credibility of the IMF,” Alston emphasized.

A stronger anti-corruption policy would also enable the IMF to contribute to the realization of target 16.5 of the Sustainable Development Goals.

An even more sensitive topic than corruption at the IMF is military expenditure. Despite the clear links between reining in military spending on the one hand, and promoting fiscal consolidation while creating fiscal space for social protection on the other, there is an almost complete absence of the subject from IMF macroeconomic analyses.

“This represents a major strike against its claims to be above politics and to go wherever the economic facts lead it,” said the Special Rapporteur.

It is true that isolated examples of IMF engagement with military spending can be found, and relevant military spending data are made available through its Government Financial Statistics Yearbook. But, in general, said the rights expert, governments still seem to believe that “national security, and judgments regarding the appropriate level of military expenditures required to assure that security, [are] a sovereign prerogative of national governments and ... not in the domain of the work of the Fund”.

But such views are surely “macro-incompatible”, especially after a decade in which military expenditures have risen 64% in Asia and Oceania, 48% in Africa, 19% in the Middle East and 6% in Europe. In the years ahead, even more dramatic increases look likely. While the issue is a potential minefield for the IMF, its impact on the overall macroeconomic equation is so great that it can hardly be ignored.

“It is the proverbial elephant in the

room, and it behoves the IMF to engage with it and to explore what options might be feasible to draw the attention of Governments and others to the macroeconomic significance of military spending,” the Special Rapporteur pointed out.

According to the report, the work of the IMF on social protection is closely linked to its work on tackling growing inequality and promoting gender equality.

Oxfam has praised the IMF for becoming a global leader in highlighting the economic inequality crisis in recent years. Indeed, comments by the Managing Director have attracted much attention, and IMF research has shown that “lower net inequality is robustly correlated with faster and more durable growth” and “redistribution appears generally benign in terms of its impact on growth.”

Those findings challenge the orthodox views about an inevitable trade-off between redistribution and growth, and have implications for IMF policy advice. But considerable tensions remain between that theory and IMF practice, which is still more likely to be preoccupied with efficiency and targeting than redistribution aimed at lowering inequality. While change might be afoot, it has not yet consistently made its way into policy advice.

Alston also noted that until around 2013, “gender” had not been a term that could easily be found in IMF documents. Initially, the IMF had focused on female labour force participation and income inequality. In 2015, gender was included as a structural issue that staff could consider in Article IV surveillance, and gender pilot studies were then undertaken in Article IV reports. More recently, a number of IMF loans, including to Egypt and Jordan, have included “gender conditionalities”.

“These are very important steps forward, but much remains to be done,” said Alston.

Observers have criticized the IMF for focusing too much on labour-market participation and micro-level gender budgeting decisions. An example of the IMF ignoring gender in the broader macroeconomic context is the constitutional amendment passed by the government of Brazil in 2016 capping public spending for 20 years, which has been characterized as “the mother of all austerity plans”. The IMF very publicly supported the initiative. Brazilian researchers claim

that, subsequent to the amendment, “expenditures specifically benefiting women were reduced by 58%”.

Unsurprisingly, Oxfam has called on the IMF to focus on the gender impact of its core macroeconomic advice, as well as on the creation of fiscal space to support quality public care services and the discontinuation of “policy advice that is shown to have negative impacts on gender equality”.

In dealing with an issue like gender equality, the IMF also needs to overcome its aversion to ever mentioning human rights.

The IMF and social protection

The Special Rapporteur noted that in the aftermath of the global financial crisis and in response to the increasing backlash against neoliberalism, the IMF has gradually moved over the past few years to accept the macro-criticality of some elements of social protection.

Five recommendations emerging from a 2017 report of the Independent Evaluation Office of those initiatives were subsequently supported by the Executive Board. Given the inconsistent and contingent past practice at the IMF and the uncertainty of its staff about its role, the report’s key message was the need for a clear strategic framework to guide IMF involvement in social protection.

In January 2018, a management implementation plan announced the preparation of a paper to be discussed by the Executive Board in February 2019 that would address a definition of social protection, the macro-criticality of social protection, the affordability and efficiency of social protection systems, potential forms of IMF engagement with social protection, the position of the IMF on universal access to and targeting of social programmes and collaboration with other institutions.

The strategic framework would also provide guidance on effective programme design, covering both the General Resources Account Arrangements and concessional lending.

“The IMF has committed to consult with civil society on the development of its new social protection strategy, but that process has to date been relatively opaque and formalistic, reflecting the culture of control at the IMF and the relatively few civil society organizations that focus on scrutinizing its activities.”

The Special Rapporteur also pointed

out that the social safety net approach generally adopted by the IMF is often so minimal that it barely warrants the term “social protection”. In the words of the Independent Evaluation Office, the view of the IMF is that “[s]ocial safety nets are necessary to mitigate adverse short-term effects of fiscal adjustment, economic reforms, or external shocks on vulnerable population groups”.

In essence, social protection is a short-term fix to help the “most vulnerable” to overcome temporary economic hardship. Often, that group is not coterminous with the worst-off in society, but with those hit by the economic adjustments the IMF is promoting.

Furthermore, affordability is the overriding consideration, defined in almost circular terms that assume that responsible fiscal consolidation will be unable to provide a genuine floor to ensure the survival of those living in extreme poverty.

The interest of the IMF is in mitigation, not transformation, and social protection is embraced for largely pragmatic programmatic considerations, rather than for the principled reason that any macroeconomic framework should protect those who cannot protect themselves.

Since 2009, only 15% of IMF fiscal consolidation programmes for low-income countries have required the protection of vulnerable groups, and most of the relevant conditionalities “focused on improving the targeting ... of the social safety net.”

According to Alston, the IMF has also strongly opposed universal programmes in some situations.

In 2017, after years of pressure from the IMF, Mongolia agreed to restrict the scope of the previously universal “Child Money” programme offered to the poorest 60% of its children, which has since been raised again to 80%. That structural benchmark in the IMF loan has reportedly been strictly enforced.

Similarly, in January 2018, the IMF announced that Kyrgyzstan would “amend the law on universal child allowances to reintroduce targeting”. That policy change is said to have been adopted following the IMF review of the country’s Extended Credit Facility.

Nonetheless, said Alston, recent research on targeting in sub-Saharan Africa presents a compelling challenge to the logic of targeting, assuming the objective is to reduce poverty rather than to promote neoliberal orthodoxy.

He also said the past decade has seen increased international attention to social

protection and inter-institutional cooperation. The UN System Chief Executives Board for Coordination adopted the Social Protection Floor Initiative in 2009 as a key response to the global crisis, and member states endorsed it at the UN Conference on Sustainable Development, as did the Group of 20 and the International Labour Organization (ILO) (in its Recommendation No. 202). Also, in 2012, the Social Protection Inter-agency Cooperation Board, co-chaired by the World Bank and ILO, was set up to coordinate work in this area.

“However, social protection cooperation between the IMF and United Nations agencies, including ILO, has been marginal at best.”

In practice, the IMF and UNICEF have had a complicated relationship since the publication of *Adjustment with a Human Face*. Following the 2008 financial crisis, the two organizations sought closer cooperation by undertaking social protection pilot studies in 11 countries. The pilot studies reported some positive results in, for example, Burkina Faso, the Congo and Mozambique, but since that time, with the exception of Malawi, coordination has faltered.

There was little cooperation between the IMF and ILO until 2010, when the two executive heads agreed to collaborate on the Social Protection Floor Initiative, and on three pilot cases. Two failed, but in Mozambique, inter-agency cooperation succeeded until the relevant personnel changed in 2013, at which point cooperation ceased. Despite the commitment of the Managing Director of the IMF to the Initiative in 2012 and 2014, cooperation between ILO and the IMF has stalled.

In other areas, the IMF has also been reluctant to cooperate with other international organizations with regard to social protection. Between 2012 and 2017, IMF representatives rarely attended meetings of the Social Protection Inter-agency Cooperation Board. In 2018, the IMF announced that it would attend, but only “when the issues under discussion are particularly relevant to the Fund’s work”.

According to the Special Rapporteur, the lack of cooperation described above might be explained by different conceptions of social protection, by the longstanding determination of the IMF to remain independent of the UN, or the fact that the IMF is only committed to the Sustainable Development Goals in so far as they fall “within the scope of its mandate” and has expressed no particu-

lar interest in Goal 1.3.

Some conclusions and recommendations

Alston said that fiscal sustainability is important, but it can be made compatible with the gradual introduction of broad-based systems of social protection, which in turn ensure the social sustainability of the overall situation. Social protection reduces the economic drain of emergency care, expands employment capabilities, facilitates educational opportunities for the children of the poor and helps to break the cycle of dependency.

There are many social protection issues that should be dealt with by other organizations and should remain off the radar of the IMF, but unless it more consistently promotes the creation of fiscal space for social protection, there is little that other actors can or will do.

“Given the impact of IMF policies, it is indispensable that the internal review currently underway examines ways in which it could actually evaluate the impact of its interventions on the bottom income quintile.”

If the IMF is to respond effectively in the years ahead to the challenges in a world in which both globalization and liberal democracy are increasingly under attack, it will need a different mindset from the modified neoliberalism that currently sets the parameters of its thinking, even as it talks about gender, inequality and social protection, said the rights expert. Those concerns will not be truly integrated within its mission unless they are embraced as matters of principle and not just pragmatically driven side-shows.

The IMF insists that it does not insist on ever-more-precise targeting of social beneficiaries. That claim is difficult to support given the evidence available, said the Special Rapporteur. However, given that the scientific literature now highlights the failures of the proxy means tests used in most such targeting, it is essential that the IMF rethink its approach and acknowledge that excessively narrowly targeted social protection ensures that there will be, at best, weak political support for any resulting policies.

Institutions are also the sum of their parts and the elite and highly specialized nature of the IMF is reinforced by the composition of its staff. If it is to become less inward-looking, less obsessively self-referential and more genuinely engaged,

it needs diversity within.

First, Alston noted, half of around its 2,400 staff members are economists, almost all of whom have been trained in the sub-field of macroeconomics. Between 1980 and 2000, 74% of all senior staff appointees had been educated in the United States or the United Kingdom, and 40% had been trained at 10 elite universities in those two countries. Much criticism since the Great Recession has focused on the increasing belief of economists from these leading universities that their profession is an almost natural science based exclusively on mathematical models.

Second, cultural diversity is also limited. As at 2017, among “B-level” staff (from division chiefs to department directors), 5.4% are from sub-Saharan Africa, 4.8% from East Asia and 6% from the Middle East and North Africa.

Third, only 25.2% of “B-level” economists are women, including three of the 32 senior officials, and three of 24 Executive Directors, despite a commitment to enhance gender diversity at the IMF. While macroeconomics as a whole is a field dominated by men, research suggests that this has significant effects on policy preferences, with female economists favouring government-backed redistribution policies more than males.

Extreme poverty is abject, violates basic rights and is a political choice. The IMF needs to move beyond seeing it as just another abstract item on a balance sheet. At present, the professional mindset of IMF staff sees its role as essentially technical, scientific and apolitical.

The imagery often invoked by IMF staff is telling. In critical situations, they see themselves as emergency-room doctors, implying the routine application of prescribed surgical interventions, with no time to consider alternative medical approaches. In surveillance mode, they see themselves as police, also implying that there are rigid rules to be followed.

“What is missing is an underlying ethical framework. Fiscal consolidation, for example, is not neutral; it can be elite-reinforcing, or it can be pro-poor, or much in-between. The choices that are made reflect values, and the means of fiscal consolidation should not become ends in themselves.”

IMF personnel often use the term “equity”, but it has no defined meaning and rarely serves to focus policies on the situation of those living in poverty. They also speak often of “the vulnerable”, but this too is an amorphous and open-ended concept that is rarely given fixed policy content.

Proactive steps are essential. IMF staff often complained to the Special Rapporteur that social protection only becomes a “hot” issue in times of fiscal crisis, by which time it has become unaffordable. But the IMF itself makes all too little effort to raise the issue in the (relatively) good times. A gradual and proactive approach to embedding social protection is required, by both the IMF and governments. The best starting point would be to engage seriously and systematically with the Social Protection Floor Initiative of the UN, ILO and the World Health Organization (WHO).

The political economy of promoting social protection and inequality reduction cannot be ignored since neither inequality nor social protection is likely to be taken seriously in authoritarian contexts. This raises the issue of democratic governance, which the IMF would like to assume is far beyond its remit. And indeed, in the broadest sense, it is. Yet many of its preferred policies promote institutional and budgetary constraints on the workings of democracies.

For example, entrenching deficit caps, debt limits and expenditure ceilings all reduce the scope for voters to influence a wide array of fundamental economic and social priorities. At that point, voters are readily tempted by populist political parties with nationalistic, xenophobic and other problematic platforms.

According to Alston, the IMF frequently pays lip service to the important roles played by “development partners”, “external stakeholders”, “the World Bank and other institutions”, and “country authorities” but, as one interlocutor put it, most observers think it acts as though it is a law unto itself.

The IMF should introduce more systematic consultations with a broad range of civil society groups in the context of in-country Article IV reviews, and it should be genuinely open to learning and adjusting its approach. The worldview that emerges from dealing only with the finance ministries of the world is hardly a balanced or adequate one on its own.

In a world that is now suffering the consequences of the past lopsided approach of the IMF to globalization and its single-minded pursuit of a model of fiscal consolidation that relegated social impact to an afterthought, the IMF not only bears responsibility for the past but will also determine whether the future will be different.

“To date, the IMF has been an organization with a large brain, an unhealthy ego and a tiny conscience.”

If it takes social protection on board seriously, rather than making a tokenistic commitment to minimal safety nets, it can show that it has actually learnt from its past mistakes, Alston concluded. (SUNS8701) □

US protects home market, wants more access from South for GSP

The US’ latest push on the trade front sees Washington threatening several developing countries with withdrawal of benefits under a longstanding preferential trade scheme.

by D. Ravi Kanth

GENEVA: Even as the United States intensifies its trade wars with China and several other countries, with its “America First” approach and using spurious and fraudulent “national security” grounds to protect domestic industries, the Donald Trump administration is simultaneously demanding enhanced market access from developing countries for granting them benefits under the Generalized System of Preferences (GSP), trade envoys told the *South-North Development Monitor* (SUNS).

On 21 June, China said cautiously that it will take appropriate measures if the Trump administration presses ahead

with another \$200 billion in import tariffs on Chinese products in response to Beijing’s decision to impose retaliatory tariffs on \$50 billion worth of American goods on 15 June.

China imposed the retaliatory tariffs on American goods only after the Trump administration had slapped \$50 billion in additional tariffs on Chinese goods over alleged intellectual property theft and forced technology transfer policies that require foreign companies to share their technologies with local Chinese companies in joint ventures.

On 18 June, President Trump directed US Trade Representative (USTR)

Robert Lighthizer to identify \$200 billion worth of Chinese goods for additional tariffs at a rate of 10%. After the legal process is complete, these tariffs will go into effect if China refuses to change its practices and also if it insists on going forward with the new tariffs it recently announced, Trump said.

"If China increases its tariffs yet again," added Trump, "we will meet that action by pursuing additional tariffs on another \$200 billion of goods."

"The trade relationship between the United States and China must be much more equitable," Trump said.

China's decision to impose retaliatory tariffs on American goods "clearly indicates its determination to keep the United States at a permanent and unfair disadvantage, which is reflected in our massive \$376 billion trade imbalance in goods", charged Trump.

"This is unacceptable. Further action must be taken to encourage China to change its unfair practices, open its market to United States goods, and accept a more balanced trade relationship with the United States," Trump said.

China, which has described the US move as "extortionist", made it clear that it will take appropriate retaliatory measures if the US imposes the additional tariffs of 10% on \$200 billion of Chinese goods.

Meanwhile, in a separate development, India notified that its retaliatory tariffs against 30 US products worth \$240 million will come into effect starting 4 August in response to the US unilateral duties of 25% on steel and 10% on aluminium under the Section 232 national security provisions.

"While the retaliatory tariffs could have come into effect immediately, India seems to have given some more time to the US – given the upcoming negotiations for a 'trade package' with the US. Assistant US trade representative (USTR) Mark Linscott is likely to visit India in the last week of June to begin the negotiations," according to a news story in *Mint* on 21 June.

On 20 June, the European Commission notified that it would start imposing 25% import duty on a range of US products from 22 June, in response to the US steel and aluminium tariffs.

GSP review

Aside from the trade wars launched by the US against its allies as well as China and other developing countries, the Trump administration is now trying to extract significant reciprocal market access concessions from developing countries such as India, Thailand, Indonesia and Kazakhstan, among others.

The USTR has launched a review of GSP beneficiary countries on grounds that they are not providing equitable and reciprocal market access for American products and services.

In response, India has maintained that it cannot be expected to provide reciprocal market access in return for the preferences under the GSP scheme, which was conceived and implemented as a non-reciprocal trade preferences programme.

According to a report in *Washington Trade Daily* (WTD) on 20 June, India hinted that it might launch a trade dispute at the World Trade Organization if Washington withdraws market access under the GSP.

According to WTD, an Indian official told the US committee reviewing the GSP to developing countries on 19 June that "picking out India along with a few GSP benefiting countries for potential withdrawal of tariff preferences on the ground that India does not provide the US 'equitable and reasonable access' to its market would be inconsistent with the non-discriminatory and non-reciprocal obligations governing GSP."

Under the GATT and WTO rules, the developed countries had agreed to provide a margin of preference in the tariffs on developing-country exports to developed countries as a means to increase developing-country competitiveness.

That these GSP preferences are non-reciprocal is further clarified in the Enabling Clause adopted under the Tokyo Round of the GATT in 1979. The Enabling Clause – which is also referred to as the Decision on Differential and More

Favourable Treatment, Reciprocity and Fuller Participation of Developing Countries – says "preferential tariff treatment accorded by developed contracting parties to products originating in developing countries in accordance with the Generalized System of Preferences" would imply "generalized, non-reciprocal and non-discriminatory preferences beneficial to the developing countries."

Despite these legal provisions, the Trump administration is ready to cock a snook at international trade rules in trying to extract reciprocal market access in all areas.

For example, the US is now demanding from India substantial market access for heavily subsidized US dairy products and medical devices in return for extending the GSP scheme. Meanwhile Thailand is being asked to provide market access for US pork products following a request from the American Pork Producers Association.

The US is threatening a withdrawal of GSP benefits from Kazakhstan on account of its poor labour standards. It is also asking Indonesia to provide market access for American services providers in return for the GSP scheme.

The Trump administration, which operates on the principle of "anything goes" or "nothing is off-limits", is pursuing a twin strategy. While it is willing to torpedo existing multilateral trade rules and conventions, it is also simultaneously putting the WTO's dispute settlement system to bed, according to trade envoys who asked not to be quoted. (SUNS8706) □

(continued from page 11)

most successful newly industrializing countries over the past 50 years. Indeed, the speed of poverty reduction will have to be even faster than it has been in China.

"This illustrates the scope of the challenge for each of the LDCs and for the international community."

With Agenda 2030, the international community has acknowledged that LDCs can achieve the SDGs only with the strengthened financial and technical support of more advanced countries. Therefore, developed countries are called upon to fully implement their official development assistance (ODA) commitments, including raising their ODA to the target range of 0.15-0.20% of their gross national income. They are encouraged to consider setting their targets even higher.

UNCTAD said that the compendium

does not intend to provide a blueprint for policy intervention in LDCs. Country-specific circumstances differ considerably among LDCs and experience from successful development episodes shows that a variety of policies and institutional arrangements may be successful in supporting economic development in poor countries.

Although LDCs have many challenges in common, each LDC government must take a pragmatic approach that involves a combination of policy measures tailored to country-specific conditions. The key constraints for sustained and inclusive economic development must be individually identified in each country. Similarly, policies to overcome these constraints must be designed at the country level, taking into account different historical, cultural and structural circumstances, said UNCTAD. (SUNS8699) □