SOUTH CENTRE

SOUTH BULLETIN

Published by the South Centre • www.southcentre.int • 7 October 2013, Issue 75

Global Crisis: Critique of US, Europe Economic Policies

The global economic slowdown is largely due to incorrect policies in the United States and Europe, which also cause spillover effects on developing countries, according to a South Centre study.

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Why the US and Europe Have Not Managed Their Economic Crises Properly

By Yılmaz Akyüz, Chief Economist, South Centre

There are two major failings in policy interventions in the crisis in the US and Europe - the reluctance to remove the debt overhang through timely, orderly and comprehensive debt restructuring and the shift to fiscal austerity after an initial reflation. These have resulted in excessive reliance on monetary policy, including non-conventional means.

However, monetary measures have largely been ineffective in stimulating credit for the expansion of spending on goods and services – hence, the crisis is taking too long to resolve. Moreover, they have created financial fragility not only in the advanced economies practising such policies, but also globally and particularly in emerging economies. Exit from the policy of ultra-easy money is full of pitfalls with attendant consequences for growth and stability.

Current economic landscape

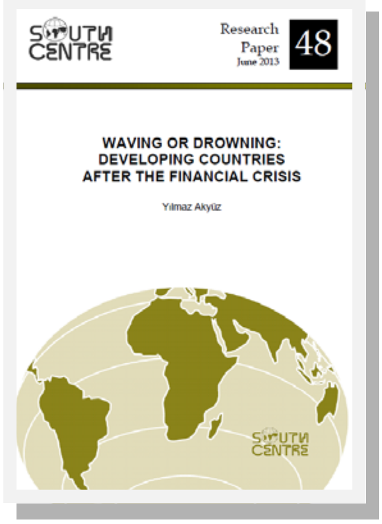
More than five years since the outbreak of the global financial crisis, the world economy has little signs of stabilizing and moving towards strong and sustained expansion. Global growth started faltering after the bounce-back in 2010-11 and there is increased agreement that in the coming years it will remain far below the exceptional rates achieved before the onset of the crisis. Because of policy shortcomings in removing the debt overhang and providing strong fiscal stimulus to make up for private sector retrenchment, the crisis in the US and Europe has been taking too long to be resolved. On the other hand, developments in the past two years have shown that developing countries (DCs) are not decoupled from conditions in advanced economies (AEs) and it is a fallacy to expect major emerging economies such as China, India and Brazil to replace AEs and act as a locomotive to the world economy.

Even though the US economy was at the origin of the crisis, it has fared much better than other AEs - the Eurozone (EZ), Japan and the UK - since the outbreak of the crisis. First, the 2009 recession was less severe in the US than in the latter economies. Second, the US economy has enjoyed continued, albeit moderate, recovery at an average annual rate of 2 per cent, registering positive growth in every quarter but one since the end of the recession in mid-2009. However, the output gap (that is, the difference between what the economy could and does produce) has diminished only a little. At the end of 2012, it was around $800 billion with the cumulative loss since 2008 reaching some $3 trillion. Although the unemployment rate has declined from its peak of 10 per cent in October 2009 to 7.4 per cent in mid-2013, part of the decline is due to the exclusion of discouraged workers as the labour force participation rate dropped since the beginning of the crisis. Indeed, total non-farm employment is still 2.5 million less than what it was at the beginning of 2008.

Most other major AEs have contracted again since 2009. Following a severe recession in 2009 the EZ as a whole managed positive growth in the subsequent two years despite continued output and employment losses in the periphery, thanks to strong recovery in Germany driven primarily by exports. However, as the impact of the crisis spread in the region through trade linkages, the core and Germany in particular could not maintain momentum. In the first quarter of 2013 the region had its 6th consecutive quarter of negative growth. 9 of the 17 EZ countries were in recession with France as a notable addition to the list. IMF (WEO July 2013) projects recession for 2013 for the region as a whole. Unemployment has reached 12 per cent for the total labour force and 24 per cent for the youth. In Spain and Greece, at some 25 per cent, the unem-

Waving or Drowning: Developing Countries After the Financial Crisis

The South Centre has published a Research Paper on "Waving or Drowning: Developing Countries After the Financial Crisis " written by Dr Yılmaz Akyüz, Chief Economist at the South Centre and Former Director and Chief Economist of the United Nations Conference on Trade and Development.



The economics articles in this issue of South Bulletin are extracted from this paper. It has two major parts: (1) A critique of the policies of the US and Europe and (2) The spillover effects of these policies on developing countries. The second part of this paper will be highlighted in the next issue of the South Bulletin.

Download the paper from the following URL: http://www.southcentre.int/research-paper-48-june-2013/.

ployment rate is higher than the levels seen during the Great Depression of the 1930s; for the youth it is well over 50 per cent.

No doubt the EZ continues to be the Achilles' heel of the global economy and the immediate threat to stability and growth in DCs. Although financial stress in the region has eased considerably, continued contraction and adjustment fatigue in the periphery could bring it back and even lead to a total break up. However, it is difficult not only to predict the evolution of the EZ in the near future, but also the impact of a break-up, since past economic and financial linkages would provide little guide for estimating the consequences of such an unprecedented event. Still, even without a total break-up, an intensification of financial stress could have serious repercussions for DCs, as suggested by various downside scenarios simulated by the IMF (2012), the UN WESP (2013) and the OECD (2012).

Japan could not sustain positive growth after recovering from the 2009 recession and went into a second dip in 2011. In the last quarter of 2012 it experienced its 7th quarterly contraction since the collapse of Lehman Brothers. Its income now is below the pre-crisis level. Again, from 2009 until the end of 2012, the UK had negative growth rates in 9 out of 20 quarters and has lost 3.7 million jobs. 2013 growth is expected to be less than 1 per cent, but still the best among the EU's big 5 – Germany, France, the UK, Italy and Spain.

Table: Real GDP Growth in Selected Advanced Economies *(Per cent change)*

	2008	2009	2010	2011	2012	2013
United States	-0.3	-3.1	2.4	1.8	2.3	1.9
Eurozone (EZ)	0.4	-4.4	2.0	1.4	-0.6	-0.3
Germany	0.8	-5.1	4.0	3.1	0.9	0.6
Japan	-1.0	-5.5	4.7	-0.6	2.0	1.6
United Kingdom	-1.0	-4.0	1.8	0.9	-0.2	0.7

IMF, World Economic Outlook (April 2013).

Why is the crisis taking too long to resolve?

In his remarks on the state of the world economy, the IMF's chief economist, Olivier Blanchard, is reported to have said that "It's not yet a lost decade… But it will surely take at least a decade from the beginning of the crisis for the world economy to get back to decent shape" (Reuters, 2012). Presumably, this remark must reflect a judgment not only on the nature and depth of the crisis, but also on the effectiveness of public interventions to resolve it.

There can be little doubt that recoveries from recessions brought about by financial crises are weak and protracted because it takes time to repair balance sheets – to remove debt overhang and unwind excessive and unviable investments generated during the bubbles that culminate in such crises. Recoveries from such crises also tend to be jobless and yield little investment. This was the case in US recoveries during the early 1990s and particularly the early 2000s from recessions brought about by the bursting of credit and asset bubbles – that is, savings and loans and dot-com bubbles, respectively. In the current recovery, the pre-crisis income in the US had been restored by the second quarter of 2011, but employment was lower by some 6.5 million. Sluggish job and investment growth is also a common feature of recoveries of DCs from financial crises (Akyüz, 2006).

However, the pace of recovery also depends on government intervention and management of the crisis. In this respect, there are two major policy shortcomings in the policy response both in the US and Europe. First, governments have been unwilling to remove the debt overhang through timely, orderly and comprehensive debt restructuring and cleaning-up of bad loans. Instead they have resorted to extensive creditor bailouts and, in the case of the EZ, to *ad hoc*, politically motivated and disorderly mechanisms to involve private creditors in debt resolution, subject to highly procyclical policy conditionality. Comparing with interventions in earlier crises in emerging economies of Latin America and Asia, an IMF Staff Discussion Note argued that in the current crisis "*the diagnosis and repair of financial institutions and overall asset restructuring are much less advanced than they should be at this stage and that moral hazard has increased. Consequently, vulnerabilities in the global financial system remain considerable and continue to threaten the sustainability of the recovery.*" (Claessens *et al.*, 2011; italics in original).

Second, there have been serious shortcomings in macroeconomic policy measures in support of aggregate demand, growth and employment. The failure to intervene directly to remove the debt overhang in a timely and orderly manner has meant slow deleveraging and protracted retrenchment in private spending. As a result, monetary policy has become largely ineffective in expanding credit and lifting private spending even though policy interest rates were cut down drastically and central bank balance sheets expanded rapidly through quantitative easing (QE). Fiscal policy has gained added importance, but both the US and Europe have shifted to austerity after an initial reflation because of growing hostility towards public spending, deficits and debt. In the EZ, the core has also joined in the austerity imposed on the crisis-hit periphery.

The case for fiscal austerity is premised on two propositions. First, budget deficits add more to public debt than to GDP so that they would raise the debt-to-GDP ratio. Second, high ratios of public debt to GDP are detrimental to growth. It is thus believed that fiscal austerity would not undermine growth and could even stimulate it by lowering the ratio of public debt to GDP - hence the so-called "expansionary austerity".

The first proposition implies that fiscal multipliers are small. In the mainstream economic theory, this is often attributed to two different mechanisms. First, there is the crowding-out hypothesis – that is, higher public spending leads to lower private spending. The main reason is that increased public spending financed by borrowing would raise interest rates, thereby reducing private investment and other interest-sensitive private expenditures. However, this need not happen if monetary policy is accommodating or when the economy is in the so-called liquidity trap and there is considerable slack. Indeed, despite rising budget deficits and debt, US long-term rates have remained at exceptionally low levels after 2009.

The second mechanism derives from a highly controversial theorem based on neoclassical rational behavior - that is, as government spending and debt increase, the private sector would start spending less and saving more in order to provide for future tax increases needed to meet debt servicing. In the same vein tax cuts financed by borrowing would be saved by rational individuals in anticipation of future taxes. The assumption of such rationality is untenable. It is highly unlikely that when income is falling and living conditions are deteriorating households would save a greater proportion of their income as public sector deficits and debt increase.

In the early years of the crisis, the fiscal policy advice of the IMF in Article IV consultations was premised on extremely low multipliers and was invariably pro-cyclical. Because of the underestimation of fiscal multipliers, IMF growth projections turned to be more optimistic than growth outcomes in several European countries such as Greece undergoing fiscal consolidation with IMF agreements (Weisbrot and Jorgensen, 2013). However, as a result of mounting evidence on fiscal drag, the IMF has finally admitted that fiscal multipliers are much greater than was previously believed and that they are state-dependent, particularly large under recessions, with the implication that fiscal austerity could in fact raise the debt ratio by depressing income (IMF WEO October 2012; Blanchard and Leigh, 2013).

The second proposition that high debt ratios could deter growth has found support in the finding of an empirical study by Reinhart and Rogoff (2010) that economic growth slows sharply when the ratio of government debt to GDP exceeds 90 per cent, as has been the case in the US and most EZ countries hit by the crisis. However, it is generally agreed that such an association says effectively nothing about causality – slow growth could cause high debt rather than high debt leading to slow growth. More importantly, subsequent research by Herndon *et al.* (2013) has found that several critical findings advanced in the Reinhart and Rogoff (2010) study are wrong and the corrected evidence shows that a 90 per cent debt ratio is associated with a much higher rate of growth than was found by these authors.

Excessive Reliance on Monetary Policy

Supported by such dubious theories and shaky empirical evidence, fiscal austerity has gone unabated both in the US and Europe, dragging growth. The reluctance to use public spending to expand aggregate demand has meant excessive reliance on monetary policy, particularly as fiscal austerity has become self-defeating by lowering growth. Not only have interest rates been kept at exceptionally low levels for an extended period, but unconventional means have been used including long-term central bank lending to banks and purchases of asset-backed securities in order to expand liquidity and lower long-term interest rates.

Rapid expansion of liquidity and historically low interest rates, notably in the US, has led to a non-negligible build-up of financial fragility and vulnerability by triggering a search for yield and excessive risk taking, both in the US and globally, very much in the same way as during the sub-prime bubble. Inflows into high-yielding assets in emerging economies have placed strong pressures on their exchange rates, leading to unsustainable current account deficits in some. Exceptionally low interest rates have also encouraged corporate borrowing in reserve currencies, which has risen by 50 per cent over the past five years, resulting in increased exposure to interest rate and exchange rate risks (IMF, 2013a; Oprita, 2013b).

There are also signs of excessive risk taking in the US in various forms including "reaching for yield," increased corporate leverage and maturity transformation - developments that seem to be causing concern at the Fed with Bernanke (2013) warning that these may delink asset prices from fundamentals and lead to mispricing (see also IMF, 2013a and Yellen, 2013b). Equity markets have already reached historical highs and may undergo a sharp correction if real economic growth lags. Furthermore, credit as well as asset bubbles could start to form and reach dangerous levels if the exit from exceptional monetary policy is delayed, as under the sub-prime boom (Roubini, 2013).

There is considerable uncertainty regarding the implications of an extended period of ultra-easy money for future financial stability, since these are largely uncharted waters (White, 2012). As discussed in the final section, it may not be possible to engineer an orderly exit so as to combine financial stability with strong and sustained growth in AEs as well as emerging economies. Although the Fed and the IMF appear to be taking note of the longer-term risks to stability and growth, they may not be able to identify them correctly or act in a timely and effective manner better than they did during the sub-prime build-up.

Severe Future Vulnerabilities

While central banks in the US and the EU have provided ample liquidity to banks and financial markets and purchased government debt in secondary markets in order to lower interest rates and payments on public debt, they have not been willing to abandon the obsession against direct financing of budget deficits and permanent monetization of government debt. However, as recognized by several mainstream analysts, under present circumstances these need be no riskier for monetary and financial stability than the ultra-easy monetary policy. For instance, former chairman of the UK Financial Services Authority, Lord Turner, has argued that the attempt to escape from the deleveraging trap by excessive monetary accommodation could lead to severe future vulnerabilities and the idea that overt money finance of fiscal deficits is inherently any more inflationary than the other policy levers used to stimulate demand is without any technical foundation. He concludes that the main challenge is how to "design institutional constraints and rules that would guard against the misuse of this powerful medicine." (Turner, 2013: p. 24; see also Wolf, 2013).

However, none of the governments in the AEs in crisis have been willing to go in that direction even though some central banks including the Bank of England are reported to have given considerations to such a solution (Financial Times, 2012).

The US Crisis: Bailouts, Debt Overhang & Fiscal Drag

KeystoneUSA-ZUMA/Rex Features

Occupy Wall Street protests, New York, 2011

The US intervention in the sub-prime crisis has taken two main forms. First, through its $700 billion Trouble Asset Relief Programme (TARP) of 2008-09, the Treasury injected capital into banks whose net worth was moving into red as a result of loss of asset values as well as some large corporations in the auto sector to prevent bankruptcy. Second, after cutting its policy rate sharply, the Fed started relying heavily on quantitative easing (QE) implemented in several rounds, buying US government bonds and mortgage-backed securities to boost their prices and lower long-term rates. It also used the so-called Operation Twist whereby the expiring short-term Treasury bills were replaced with long-term notes and securities. In December 2012 the Fed announced that it would keep buying $85 billion in Treasuries and asset-backed securities (QE3) until unemployment fell below 6.5 per cent or inflation rose above 2.5 per cent.

These interventions have no doubt helped contain the crisis. However, they have not just averted banks' net worth moving into negative territory, but created ample profit opportunities for financial markets and institutions through, *inter alia*, arbitrage between the Fed and the Treasury. At the end of 2012, US banks had restored their pre-crisis level of profits, reaching the best position since 2006. The crisis has also resulted in an increased concentration in the US banking system. The so-called "too-big-to-fail" banks are now bigger than they were on the eve of the crisis; the assets of the top 5 banks now reach 55 per cent of GDP in the US, compared to 43 per cent 5 years earlier.

However, these interventions have done little to reduce the debt overhang, prevent foreclosures or increase lending. TARP did not require the banks to expand lending. The US Treasury also approved large bonuses for executives at banks that received bailouts. But it has not been willing to bring down household mortgages in line with their ability to pay by forcing the banks to write down debt and bondholders to take haircuts. The two voluntary schemes introduced to alleviate the debt burden of mortgage holders have had only little impact: the Home Affordable Modification Program to encourage the lenders to lower monthly mortgage payments of homeowners facing the risk of foreclosure; and Home Affordable Refinance Program designed to help homeowners with negative equity to refinance their mortgages.

It is true that household debt dropped from 100 per cent of GDP at the beginning of the crisis to less than 90 per cent at the end of 2012, but much of this improvement has been due to foreclosures and hence reflects a corresponding reduction in household wealth. Homes of many households are worth less than the principal balances on their mortgages. Many of those who continue to own and live in their homes acquired during the sub-prime bubble are still grappling with large debt and retrenching, and this is still an important impediment to strong growth in consumer demand.

All these have widened the income gap between the rich and the poor. From 2009 to 2011, average US real income per family grew by 1.7 per cent. But while the top 1 per cent incomes grew by 11.2 per cent the bottom 99 per cent incomes shrunk by 0.4 per cent. Moreover, "gains in household net worth have been concentrated among wealthier households, while many households in the middle or lower parts of the distribution have experienced declines in wealth since the crisis". The households in the middle have now lower real incomes than they did in 1996. This is slowing the recovery by holding back aggregate spending since the middle class has a higher propensity to spend than the top 1 per cent and is the "true job creator" .

The US recovery is also hindered by fiscal orthodoxy. The initial fiscal response to consumer deleveraging and retrenchment through one-off transfers and tax cuts no doubt played an important role in restraining the downturn and initiating recovery. For instance the fiscal stimulus is estimated to have raised 2010 real GDP by as much as 3.4 per cent, held the unemployment rate about 1½ percentage points lower and added almost 2.7 million jobs to U.S. payrolls. However, as soon as the economy started to show signs of life, fiscal orthodoxy has returned. Government employment fell to 21.8 million in 2013 after reaching a peak of almost 23 million in May 2010. Cuts in public sector jobs and other government spending reduced GDP growth by 0.6-0.8 percentage points during 2011-12.

Thus, "discretionary fiscal policy hasn't been much of a tailwind during this recovery. In the year following the end of the recession, discretionary fiscal policy at the federal, state, and local levels boosted growth at roughly the same pace as in past recoveries… But instead of contributing to growth thereafter, discretionary fiscal policy this time has actually acted to restrain the recovery." Fiscal retrenchment has continued into 2013. The expiry of the payroll tax cut, increases in marginal tax rates and spending cuts through sequestration are estimated to result in a significant drag on GDP growth. Growth in the first half of the year has dropped below the 2 per cent average registered after 2009. Moreover, further tightening may be introduced when negotiations restart on the budget and public debt ceiling, slowing down an already slow recovery .

The Eurozone Crisis: Wrong diagnosis, harmful recipes

This and other articles in the cover story are by Dr. Yılmaz Akyüz, Chief Economist, South Centre.

Table: Pre-Crisis Debt and Deficits in the Eurozone (Per Cent of GDP)

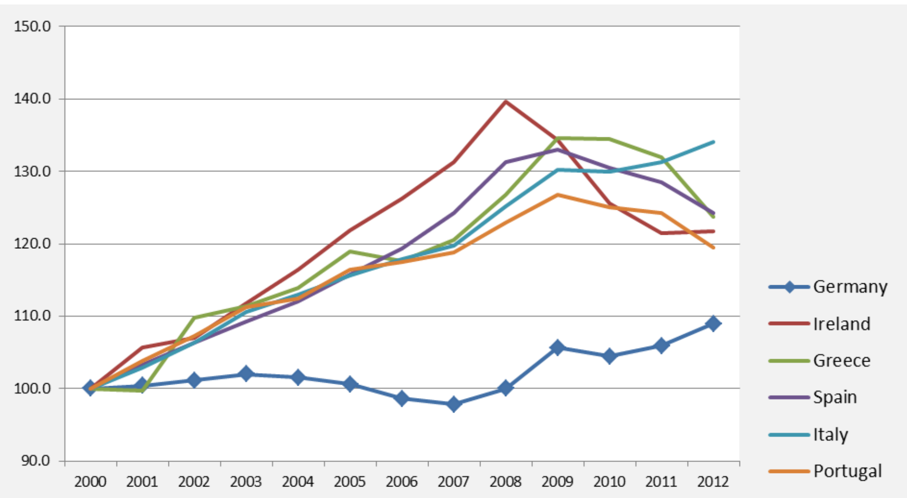
	Fiscal Bal. (2000-07)	Public Debt (2007)	Priv. Bal. (2000-07)	CA Balance (2000-07)
Greece	−5.6	107.3	−2.8	−8.4
Italy	−3.0	103.3	+2.4	−0.6
Portugal	−4.1	68.3	−5.2	−9.3
Spain	+0.4	36.3	−6.2	−5.8
Ireland	+1.4	25.0	−3.3	−1.9
Germany	−2.3	65.4	+5.5	+3.2

Source: IMF WEO (April 2013) and IMF (2013b).

While the US recovery has been held back by inadequate policy measures, in the Eurozone (EZ) the policy response has been premised on a wrong diagnosis, thereby deepening the recession. The EZ periphery is, in effect, facing a balance-of-payments-*cum*-external-debt crisis resulting from excessive domestic spending and foreign borrowing of the kind experienced by several developing countries (DCs) in the past few decades. Contrary to the official diagnosis, the rapid increase in payments deficits and external debt that took place in the run-up to the crisis had little to do with fiscal profligacy (Lapavitsas *et al.*, 2010; De Grauwe, 2010). With the exception of Greece, in all crisis-hit countries fiscal policy was tightened after 1999. During 2000-07 Spain and Ireland adhered to the Maastricht Treaty much better than Germany. Portugal had a relatively high deficit, but its debt ratio was not much higher than that of Germany (Table).

External debt is the key to the EZ crisis and the focus on total public debt is misleading (Gros, 2011). Belgium had a higher public debt ratio than Portugal, Spain and Ireland, but did not face any pressure and in fact enjoyed a low risk premium because it has had a sustained current account surplus and a positive net external asset position. Again, Italy is less affected than other periphery countries because it has had a much smaller current account deficit and a large proportion of its public debt is held domestically.

Chart 1: Unit Labour Costs in the Eurozone (2000=100)



Source: Eurostat.

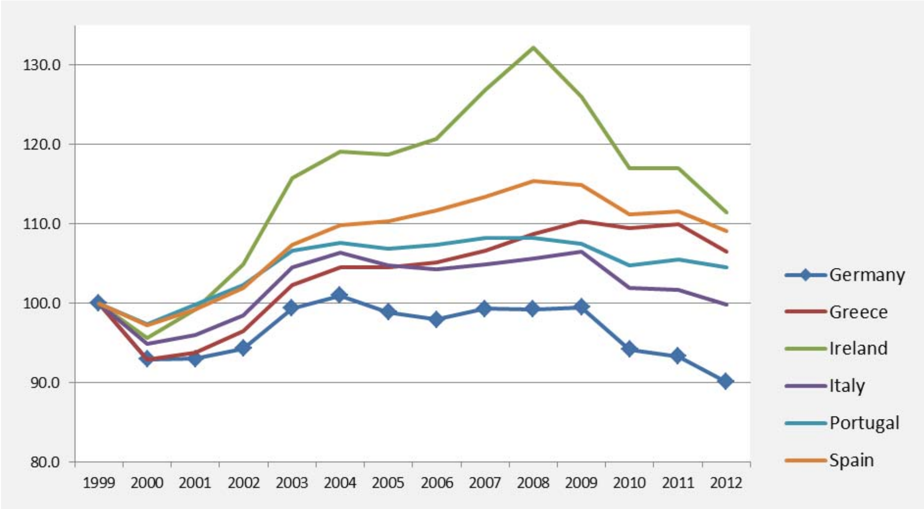
A common feature of the periphery countries in the Table is that they were all running larger current account deficits than all other EZ members in the run-up to the crisis. In Spain and Ireland, deficits were entirely due to a private savings gap. Even in Greece the current account deficit rose faster than the budget deficit because of a private spending boom.

Two interrelated factors played an important role in rapid increases in current account deficits and external debt in the periphery. First, after the monetary union, wage and price movements diverged sharply between the periphery and the core (Chart 1). From early 2000 Germany was engaged in a process of "competitive disinflation", keeping real wages virtually stagnant and reducing unit labour costs and relying on exports for growth (Akyüz, 2011; Palley, 2013). Improved German competitiveness was not always due to a superior productivity growth and wage suppression played a central role. By contrast, in the periphery wages went ahead of productivity, leading to an appreciation of the real effective exchange rate and loss of competitiveness (Chart 2). This created a surge in imports, mainly from other EU countries.

This process was greatly helped by a boom in capital flows from the core to the periphery, including loans from German banks, triggered by the common currency and abundant international liquidity (Sinn, 2011). They fuelled the boom in domestic demand, reduced private savings and widened the current account deficits in the periphery (Atoyan *et al.*, 2013). They also helped Germany to increase exports and hence maintain a higher level of activity than was possible on the basis of domestic demand. As in Latin America in the early 1980s, this process also ended with an external shock from the US, this time the sub-prime crisis, which caused a panic turnaround in creditor sentiments and a sharp cutback in lending.

Monetary policy interventions in response to the EZ crisis have followed broadly the same course as in the US. Alongside the sharp cuts in policy rates, the European Central Bank (ECB) has undertaken several rounds of quantitative easing (QE), purchasing sovereign bonds in order to boost their prices and lower borrowing costs to troubled debtors. It also provided three-year loans to banks at low interest rates under the Long-Term Refinancing Operations (LTRO), enabling them to buy high-yield sovereign bonds and earn large spreads. In summer 2012, soon after its head reaffirmed the pledge to "do whatever it takes" to save the single currency, the ECB announced that it would undertake outright monetary transactions (OMT) in secondary sovereign bond markets subject to certain conditions, creating a wave of optimism in financial markets.

Chart 2: Real Effective Exchange Rates in the Eurozone (1999=100)



Source: BIS.

Several bailout facilities have also been introduced in response to the crisis including the European Financial Stability Facility (EFSF), European Financial Stabilization Mechanism (EFSM) and finally the European Stability Mechanism, a permanent bail-out fund to replace both the EFSF and EFSM. These facilities have been used, together with IMF lending, to keep debtors current on their payments to creditors and avoid default and to lower borrowing costs through bond purchases in secondary markets. The biggest rescue operation has so far been in Greece (some €170 billion), followed by Portugal (€78 billion), Ireland (€68 billion), Spain (€42 billion) and some €17 - €23 billion for Cyprus (Fidler, 2013). These operations incorporated severe retrenchment and austerity measures in recipient countries in the form of tax hikes, spending and wage cuts, leading to a deepening of contraction. In a subsequent evaluation of the 2010 Stand-By agreement for Greece, the IMF (2013c) has admitted that it had underestimated the damage done to the economy from spending cuts and tax hikes imposed in the bailout and that it deviated from its own debt-sustainability standards and should have pushed harder and sooner for lenders to take a haircut to reduce Greece's debt burden.

Indeed, despite occasional references to the need to involve the creditors in the resolution of the crisis, the initiatives taken in this respect have brought limited relief to debtors. In early 2012 Greece was lent for debt buy-back to convert high-rate short-term bonds to low-rate long-term bonds and to reduce its stock of debt through a voluntary debt restructuring, as a one-off measure. However, it has not removed the Greek debt overhang. It is generally recognized that Greece needs a deeper write-off. However, around 70 per cent of its sovereign debt is now held by the official sector, including the EFSF, ECB, IMF, national central banks and other EZ governments, and the write-down of this debt is resisted by the ECB and Germany.

The EZ has not been able to follow a coherent approach in bailing in creditors and politics has often interfered with decisions in this regard. In Ireland and Spain where the crisis originated in the banking system, creditors and depositors of troubled banks have largely escaped without a haircut. Ireland gave a blanket guarantee to its

REUTERS

Students in Nicosia, Cyprus, protesting against the policies of the European “Troika” that were conditions for the bailout loans for Cyprus in March 2013

People queuing up at bank in Cyprus during the country's financial crisis

AFP

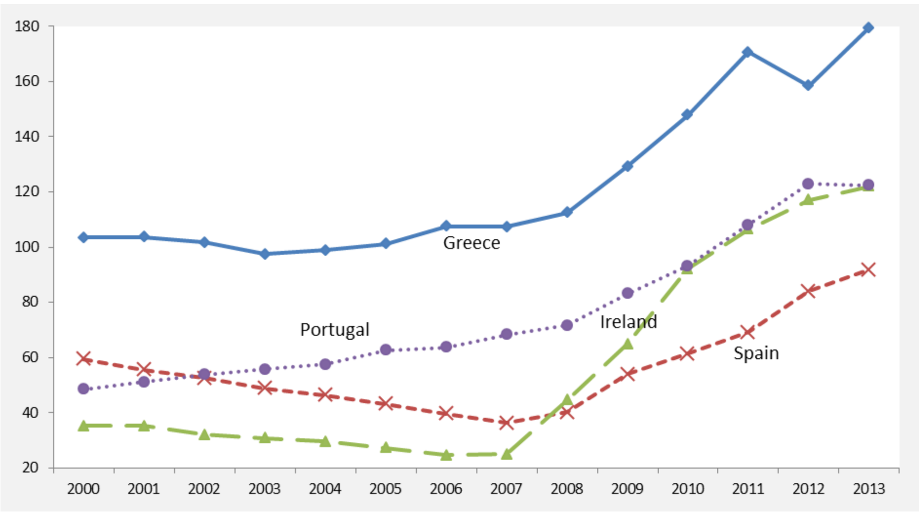
bank depositors and Greek workouts also spared deposit holders both at home and abroad. In most of these cases rescue operations involved large amounts of money to prop up and re-capitalize banks. By contrast, in Cyprus the bailout package inflicted large losses on deposit holders, notably Russians.

A key problem faced in the EZ is destabilizing interfaces between private and public debt. In Greece debt write-off caused difficulties in local banks as one-third of the discounted debt was held by them. Thus the operation necessitated recapitalization with new borrowing, thereby raising public debt. In Spain and Ireland governments have had to act to rescue heavily indebted banks and this has added significantly to public debt, increasing its financing needs. However, the very same banks are also expected to play an important role in financing heavily-indebted governments. Unable to print national currency, governments have limited capacity to bail out banks or monetize their own debt. A solution could have been to decouple public from private debt by stopping bank bailouts by national governments and introducing an EZ-wide bank resolution mechanism including bailing-in private creditors, recapitalization and liquidation (Burda *et al.*, 2012).

Public debt ratios have been rising in the periphery because of severe recession and relatively high interest rates (Chart 3). In Spain and Ireland the downward trend in debt ratios has been reversed whereas in Portugal the increase has accelerated after 2008. The Greek debt ratio has started to rise again after the decline brought about by the partial write-off. A fundamental dilemma is that when the ratio of debt to GDP is high and the real interest rate on debt exceeds the growth rate of GDP by a significant margin, the amount of primary surplus needed to stabilize the debt ratio would be quite high. Cuts made in the primary (non-interest) budget to achieve this would create a sizeable contraction in output because of relatively large fiscal multipliers noted above, making the task even more difficult. Thus, debt ratios of Spain and Ireland, which were both well below the 60 per cent threshold on the eve of the crisis, have reached 100 per cent and 120 per cent, respectively. For the same reason, the intensification of fiscal consolidation has not always resulted in lower deficits as a per cent of GDP. In Greece deficits rose from 9.5 per cent of GDP in 2011 to 10 per cent in 2012 and in Portugal from 4.4 to 6.4 per cent.

In view of the key role played by external debt and deficits in the EZ crisis, payments adjustment as well as debt restructuring is essential for the periphery to achieve a sustainable external position based on the expansion of exports. In this respect the periphery faces the additional problem of having been locked in a currency whose nominal exchange rate is beyond their control. Consequently, the only way to restore competitiveness is through cuts in wages. This problem was encountered by Argentina in the 1990s when it had fixed the peso against the dollar under the Convertibility Plan, which eventually culminated in default. So far the periphery countries with overvalued currencies have achieved a certain amount of internal devaluation and adjustment in their unit labour costs through wage suppression (Charts 1 and 2). They have also achieved significant improvements in their current accounts. However, much of these improvements have come from economic contraction, cuts in private investment and imports (Atoyan *et al.*, 2013). Unemployment would need to remain high in order for wages to be kept under control and for unit labour costs and real exchange rates to continue declining. This may face serious social and political obstacles and could eventually lead to default and exit, as in Argentina.

Chart 3: Public Debt as Per Cent of GDP



Source: IMF (2013b).

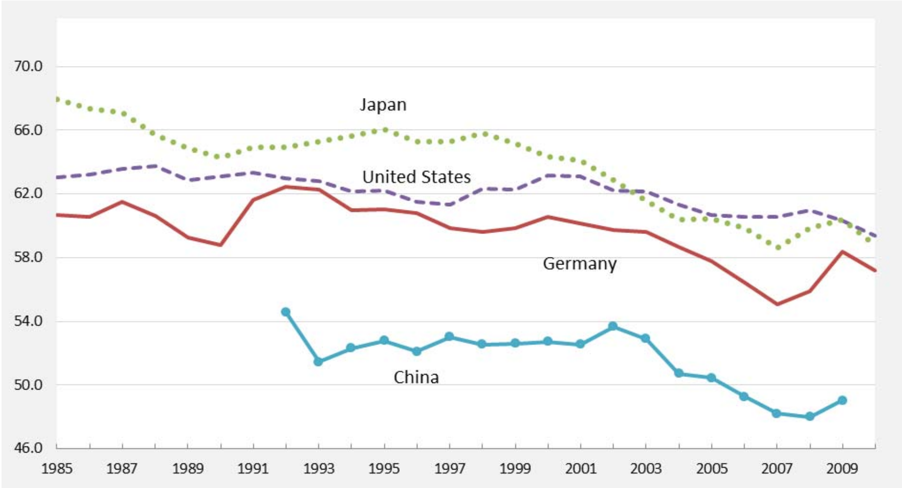
Longer-term Prospects for US, Europe

Five years into the crisis, growth in the US is still below potential, Europe is struggling to get out of recession and major emerging economies are slowing rapidly after an initial resilience during 2010-11. Longer-term prospects are not much brighter largely because the key problems that gave rise to the most serious post-war crisis, income inequalities, external imbalances and financial fragilities, remain unabated and have indeed been aggravated.

The world economy suffers from an underconsumption bias because of low and declining share of wages in GDP in all major advanced economies (AEs) including the US, Germany and Japan, as well as China (Chart 4). Still, until 2008-09 the threat of global deflation was avoided thanks to consumption binges and property booms driven by credit and asset bubbles particularly in the US and the European periphery. Several Asian developing countries (DCs), notably China, also experienced investment and property bubbles while private consumption grew strongly in many DCs elsewhere, often supported by the surge in capital inflows and asset and credit bubbles. This process of debt-driven expansion created mounting financial fragility in the US and the EU and growing trade imbalances and culminating in the Great Recession.

The crisis has not removed but reallocated global trade imbalances. Before the crisis the US acted as a locomotive to three major underconsumption-*cum*-surplus economies, China, Germany and Japan, running growing current account deficits, due to a surge in private spending driven by the sub-prime bubble. During 2004-07 GDP growth exceeded growth of domestic demand in all three surplus economies. After 2007 the US deficit fell sharply and the Eurozone (EZ) moved from a $100 billion deficit to a $300 billion surplus. Germany has continued to rely on exports and its current account surplus reached 7 per cent of GDP while both Japan and China have increasingly relied on domestic demand and their current account surpluses have dropped drastically. With the cut in current account deficits in the EZ periphery, a higher proportion of this growing German surplus is now running with the rest of the world. In other words, Germany has become a major drag on global growth by maintaining a lid on domestic demand and relying increasingly on exports.

Chart 4: Wage Share as Per Cent of GDP, 1985-2010



Source: Eurostat and China Statistical Yearbooks.

As already noted, the crisis has also widened income and wealth inequalities in both the US and EU and hence aggravated the underconsumption bias. In the EZ, the structural reforms advocated for removing intra-regional imbalances are likely to extend wage suppression further to the periphery and widen the deflationary gap. Furthermore, the crisis has produced new sources of financial fragility, largely because of excessive reliance on ultra-easy monetary policy to fight instability and contraction. Under these conditions the likelihood for the world economy to move to a path of growth that is both stable and strong is slim.

United States: Monetary policy dilemmas

Longer-term global prospects depend a lot on the US due to its central position in the world economy and the international reserves system. It is highly unlikely that the US can move to a wage-led growth in the near future. Nor can it shift to export-led growth. This would require, *inter alia*, exports to grow faster than domestic demand and the share of private consumption in GDP to fall. This is difficult to achieve since for several decades the US has constantly lived beyond its means thanks to its "exorbitant privilege" as the issuer of the central reserve currency. Besides, there is no other economy that could act as a locomotive to the US.

Thus, a key question is if the US would be inclined to go back to "business as usual" and allow credit and asset bubbles in search for a relatively rapid growth. This is closely connected to its exit from the ultra-easy monetary policy. Clearly, exit implies not just increased policy interest rates but also the normalization of monetary policy - the federal funds rate to become again the main instrument of policy, a significant contraction in the size of the Fed's balance sheet and the volume of excess reserves that depository institutions hold at the Fed and a large shift of the Fed's asset composition back to short- and medium-term Treasuries. Monetary tightening would call for raising policy rates, including interest rates on excess reserves, and these would be reflected in long-term rates. The latter would also rise as a result of portfolio rewinding.

A strategy that the Fed should gradually exit from the quantitative easing (QE) 3 but maintain low policy rates for several more years in order to support growth and use macro-prudential regulations to limit systemic risks appears to be enjoying considerable support. However, it may not be easy to engineer such a process without jeopardizing financial and macroeconomic stability. Uncertainty abound because there are not many historical precedents for exit from extended periods of zero-bound interest rates and QE.

Even a gradual return of the Fed balance sheet to "normal" size and composition may result in a considerable hike in long-term rates even if policy rates are kept low for an extended period. The prospects for exit from the QE3 in the coming months have already pushed up the yield on the US 10-year Treasury bond to almost 3 per cent in August 2013 from around 1.60 per cent in May.

Second, macro-prudential policy is uncharted waters; there is considerable ambiguity over what it contains and how it may be operationalized and linked to broader areas of policy that influence systemic risks, including monetary policy. They cannot always be relied on to prevent excessive risk taking and credit and asset bubbles if there is plenty of money available at low interest rates. In all likelihood, monetary instruments may have to be deployed as part of macro-prudential policy if bubbles threaten stability, but this could cut growth. If they are not, then the outcome may well be another boom-bust cycle.

If, on the other hand, concerns about financial instability and the effectiveness of macro-prudential measures come to dominate, the Fed may be obliged to exit rapidly. This would result in a hike in short- and long-term interest rates and give a major shock to the financial system as in 1994. It would result in slower growth and stronger dollar. A too rapid an exit and re-pricing of substantially increased stock of debt could even cause a hard landing in the US by leading to large losses for bond holders and depressing private spending.

These dilemmas arise in large part because of excessive reliance on monetary policy to combat recession and the reluctance to use fiscal expansion and debt restructuring to stimulate aggregate demand. A Goldilocks scenario in which the exit is neither too slow to endanger financial stability nor too rapid to choke off growth is likely to be no more than a fairy tale. The extended period of easy money has sharpened the trade-off between financial stability and growth by allowing considerable build-up of bank liquidity and distortions in the Fed's balance sheet. If the Fed targets growth and pursues a slow exit, credit and asset bubbles could build up rapidly, threatening to culminate in a bust. If it focuses on avoiding bubbles and exits rapidly, then it could cut recovery short and may even push the economy back into a recession.

The normalization of monetary policy in the US will also cause problems for emerging economies. Despite occasional complaints about the "currency war" entailed by liquidity expansion in several major AEs simultaneously, the policy of ultra-easy money has generally been benign for emerging economies. It has been a major factor in the sharp recovery of capital inflows after the sudden stop caused by the Lehman collapse in September 2008. Many major emerging economies such as India, Brazil, South Africa and Turkey have come to depend on such inflows as their current accounts started to deteriorate. They have invariably welcomed the asset bubbles that such inflows have helped generate and often ignored the financial fragilities caused by increased exposure to interest rate and exchange rate risks by the private borrowers abroad. Such exposures are on the rise since the beginning of 2012; as funds have started to be withdrawn from domestic securities markets, emerging economies have increasingly relied on international debt contracted in reserve currencies, which reached, in net amounts, $600 billion between the beginning of 2012 and mid-2013. As the Fed has got closer to ending the QE3 and the long-term US rates edged up, strong downward pressures have started to build up on the currencies, stocks and bonds of several emerging economies such as Brazil, India, South Africa and Turkey which were widely seen as rising stars only a couple of years ago.

The Eurozone: Bleak growth prospects

The longer-term prospects of the EZ are even less encouraging than the US. Deleveraging and recovery are likely to remain extremely slow in the periphery and many countries cannot expect to recuperate the output losses incurred after 2008 for several years to come. Even if the EZ avoids further turmoil and stabilizes, it would not generate much growth under the current policy approach – something that would also make it difficult to sustain stability. Pre-crisis growth in the EZ was mediocre, barely reaching 2 per cent per annum during 2002-07, and much of that was due to debt-driven expansion in the periphery. Post-crisis growth could even be slower.

The periphery cannot go back to a spending spree and large current account deficits that culminated in the crisis. A growth-oriented adjustment in external debt and deficits in the periphery depends on a fundamental change of policy in Germany and symmetry in adjustment between deficit and surplus EZ countries. Germany needs faster wage growth and higher, albeit moderate, inflation to appreciate its real exchange rate. It should abandon fiscal austerity and create demand to help export-oriented adjustment in the periphery. The latter should try to restore competitiveness not so much by creating unemployment and cutting wages as by investment-led productivity growth.

However, none of these are likely to come by. Recent trends and projections for external balances show a decline in deficits in the periphery without a corresponding decline in the surpluses of the core; that is, an increase in the surplus of the region, notably Germany with the rest of the world. The IMF projects that in 2018 the EZ as whole will run a current account surplus of 2.5 per cent of GDP, up from a deficit of 0.7 per cent in 2008. These imply that the periphery would cut deficits either by keeping growth low, or by joining Germany in wage suppression and competitive disinflation (internal devaluation) and expanding exports to the rest of the world. Either would call for maintaining a high level of unemployment.

Then there is the risk of low-growth hysteresis and growth stalling – weak growth generating its own negative momentum. In its latest report the OECD warned that in some AEs "output growth is now close to or below estimated stall-speed thresholds … with the risk that self-reinforcing endogenous dynamics could push them into outright recession." When a cyclical upswing is below the stall-speed threshold, growth is likely to weaken and eventually become negative. On all current projections growth in the EZ in coming years is expected to remain below the stall-speed thresholds.

Thus, without a fundamental change of policy, the EZ may be caught in a self-reinforcing deflation. A protracted weakness in economic activity would bring down the potential growth rate so that the region may get trapped in low growth, high-unemployment. Indeed in the absence of redirection of policy, the damage could be long-lasting, permanently impairing growth in the region. Thus, despite improved financial stability in the region, the spectre of exit from the euro may come back with greater force to haunt the guardians of the EZ.

SDGs: Full Employment As A Top Priority Goal

The following South Centre paper on SDGs and Employment argues that Full Employment should be a top priority development goal, on a similar level to poverty eradication and economic growth. Thus it should be a major objective of developing countries to get Full Employment accepted as a major SDG. The Rio+20 outcome document mentions Full Employment in several paragraphs (see details of this at the end of the General Section below).

This paper first stresses the global dimension (what developed countries and international organisations can do for developing countries) in each goal, then addresses national level efforts, and concludes with means of implementation (finance and technology).

Full employment should be a top-priority goal of the set of SDGs and for the Post–2015 Development Agenda.

A. General

Employment is a very important issue, for many obvious reasons. It is the great connection between the most important economic and social goals. Economic policies should lead to creation and expansion of jobs and livelihoods. Socially, if people have gainful employment or livelihoods, they can earn the income that enables them to escape poverty and to fulfill their basic needs such as food, healthcare and shelter.

We therefore propose that "the attainment of full employment" be accepted as a major SDG. It should be understood that by employment we mean jobs in the formal sector as well as livelihoods in the agriculture sector and in the informal sector.

Full employment was widely recognised as the major goal of economic policy in the post-Second World War period. This was because a long period of relatively high unemployment, suffered during the pre-war Great Depression, was seen as a major problem that even contributed to the conditions for war. After the war, international organisations like the UN, the IMF, the ILO, the GATT and later UNCTAD were set up, and employment was one of their top priorities. One of the first UN conferences was held in Havana in 1947 and it was titled United Nations Conference on Trade and Employment, and which led to the creation of the multilateral trading system.

Organisations like IMF and WTO had employment generation or full employment as their main objective, or among their top objectives. In the agreement to establish the WTO, the preamble states that Parties recognise they should conduct their relations with a view to "raising standards of living, **ensuring full employment** and a large and steadily growing volume of real income and effective demand". The IMF in Article I of its purposes includes the "promotion and maintenance of high levels of employment and real income" as primary objectives of economic policy. In standard macro-economics taught in school and universities, and in government policy circles, the attainment of full employment was accepted as the main priority in economic policy. It was also understood that full employment could be attained only if there was sufficient economic growth and economic development. Thus growth and employment went together as top priorities.

Many decades later, the prioritisation of full employment as a goal became significantly diluted as other goals were given equal or even greater prominence. These other goals included controlling inflation, reducing the budget deficit, reducing tariffs, cutting the size of the government bureaucra-

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Unemployment line: Unemployed citizens in Europe lining up for unemployment benefits. Most developing countries cannot afford such benefits—it is a better strategy to ensure full employment.

cy and the number of government agencies. These other goals became components of the typical "structural adjustment policies" that accompanied loans provided by international financial institutions to developing countries, and they sometimes also became conditionalities for aid. As a result, many developing countries took on these policies, and one of the negative side effects was that employment generation and economic growth became sidelined.

There is however in recent years a recognition that job creation and viable livelihoods are the most important development goals, and that achieving these goals is the key to achieving many other goals such as poverty eradication and social development including access to food, health care and education.

Therefore it is vital to recognise that the attainment of full employment must be adopted as one of the most important of the SDGs.

This is recognised in The Future We Want (Rio plus 20 outcome document). In the general part, Para 24 expressed "deep concern about the continuing high levels of unemployment and underemployment, particularly among young people." Para 23 reaffirmed the importance of supporting developing countries in their efforts to eradicate poverty including by "promoting full and productive employment." The outcome document also has a whole section on "promoting full and productive employment, decent work for all and social protections." The section recognised full and productive employment as a major need to be promoted and created at all levels.

There is thus a need to adopt "the attainment of full employment as a top-priority goal of economic and social policies".

B. International Cooperation

Developing countries need an enabling international policy environment to enable them to move towards full employment as an operational development goal. This is because the policies of developed countries, and of international agencies, have great influence over the policies of developing countries, which affect employment levels.

The following are proposals for sub-goals or targets at international level that are crucial for developing countries:

1. Developed countries in formulating national economic policies shall take fully into account the effects of these policies on the employment level and future employment prospects of developing countries. They should not adopt policies that adversely affect the employment and employment prospects of developing countries.

2. International financial institutions and aid agencies should comprehensively consider the impact on employment and livelihoods in developing counties of their policy advice and conditions linked to their loans or aid. Such policy advice or conditions should aim at generating employment and contribute to full employment in the developing countries.

3. In the consideration of priorities of objectives of macro-economic policy, the attainment of full employment should be adopted as a top priority objective, in the policies of international agencies, especially as they pertain to developing countries.

4. Criteria for debt sustainability for developing countries should fully take account of the requirements for generating sufficient employment as a major SDG.

5. In the development of international trade-related rules and negotiations, the maintenance and promotion of employment and livelihoods in developing countries shall be given the highest priority as a goal.

C. National Level Policies

1. All countries should consider the attainment of full employment as a top priority economic and social goal. It is understood that employment includes jobs in the formal sector and livelihoods in the small-agriculture and informal sectors.

2. It is also understood that in the context of sustainable development, full employment as a goal should be accompanied by:

(a) policies of job-intensive economic growth,

(b) the prioritising of small and medium industries and of small farmers as the focus of policy attention and incentives for growth,

(c) employment and livelihoods be of a socially and economically decent and sustainable level,

(d) environment and health related concerns are taken fully into account in the policies for generating employment,

(e) a special focus should be given to reducing youth unemployment.

3. In the formulation of fiscal policy, high priority should be given to the generation of employment and the move to attain full employment.

4. Shortfalls in domestic government budgets required to fund programmes that generate employment-intensive growth to a level sufficient to attain full employment, should be met by international financing and through international cooperation.

D. Means of Implementation

1. Adequate financial resources and appropriate technology and technical assistance and capacity building should be provided to developing countries that require such support in enabling them to have the ability to adopt national policies that give the highest priority to employment generation and full employment as a goal.

(This paper was written by Martin Khor of the South Centre.)

Rural livelihoods that provide enough income is a major component of "Full Employment".

The Novartis Decision by India's Supreme Court: A Good Outcome for Public Health

The Indian Supreme Court made a landmark decision on the Novartis patent claim for a cancer drug. This is an analysis of that decision by the South Centre's Special Advisor on Trade and Intellectual Property.

By Carlos M. Correa

The denial by the Supreme Court of India, on April 1, 2013, of a patent filed by the Swiss pharmaceutical firm Novartis on a particular form of an anti-cancer drug (imatinib mesylate) attracted unprecedented attention from civil society organizations, academics and the press. The decision has been hailed as a victory for access to medicines.

There is nothing noticeable in the fact that a patent application has been rejected: this is a normal outcome of the examination conducted by patent offices, when it is found, as it is often the case, that the patentability requirements are not met (for instance, only 47% of the final decisions made by the European Patent Office led to the grant of a patent in 2011). This article explores some of the reasons that explain the international repercussions of the Novartis case.

A public health perspective

Intellectual property rights need to be implemented taking the context where they apply and their possible socio-economic implications into account. In the case of public health, as stated by the Doha Declaration on the TRIPS Agreement and Public Health (adopted by the WTO Ministerial Conference in 2001) such rights should be interpreted and implemented in a manner supportive of the countries' right to protect public health and, in particular, to promote access to medicines for all (paragraph 4).

Some judicial decisions in several developing countries (e.g. Argentina, Kenya) have embraced this approach in litigation concerning pharmaceutical patents and the protection of test data. In India, in a 2008 decision Justice Ravindra Bhat stated that '…India entered into the TRIPS regime, and amended her laws to fulfill her international obligations, yet…the Court cannot be unmindful of the right of the general public to access life saving drugs which are available and for which such access would be denied if the injunction were granted…' (*F. Hoffman-La Roche Ltd. and Anr. Vs. Cipla Limited*, para 85).

In rejecting the referred to patent filed by Novartis, the Intellectual Property Appellate Board (IPAB) – which is competent to hear appeals from the decisions of the Indian patent office - explicitly considered the public health implications of the high price charged for the drug by Novartis in India. The Board held that '… the drug … in our view is too unaffordable to the poor cancer patients in India. Thus, we also observe that a grant of product patent on this application can create a havoc to the lives of poor people and their families affected with the cancer for which this drug is effective. This will have disastrous effect on the society as well. Considering all the circumstances of the appeals before us, we observe that the Appellant's alleged invention won't be worthy of a reward of any product patent…for its possible disastrous consequences on such grant as stated above, which also is being attracted by the provisions of section 3(b) of the Act which prohibits grant of patent on inventions, exploitation of which could create public disorder among other things' (p. 190).

The Indian Supreme Court has confirmed in the same case that, in interpreting and applying the patent law, public health considerations are legitimate and are a component of the context within which a decision has to be made. The court noted, in relation to the TRIPS Agreement, the concern that 'patent protection to pharmaceutical and agricultural chemical products might have the effect of putting life-

The Indian Supreme Court

Novartis AG headquarters in Basel , Switzerland

saving medicines beyond the reach of a very large section of people' (p. 38). It further noted that 'India had learnt from experience the inverse relationship between product patents and the indigenous pharmaceutical industry, and its effects on the availability of essential drugs at affordable prices' and that 'the reintroduction of product patents in the Indian patent system through the TRIPS Agreement became a cause of alarm…' (p. 43).

These decisions show how a public health perspective can be used, in particular cases, to interpret and apply intellectual property laws in relation to pharmaceutical products and processes. Incorporating such a perspective does not mean that the substantive standards of the patent law (such as the patentability requirements) are ignored. They are implemented not merely having in view the interests of the right holder, but with the aim of reaching a fair balance between patent protection and the commitment to protect and promote public health.

Importantly, the Indian Supreme court recognized, in the Novartis case, the role that the Indian pharmaceutical industry plays as a major supplier of affordable medicines, particularly antiretrovirals, to developing countries. It affirmed that the public health considerations did not only relate to India but to 'many other parts of the world' particularly the developing countries and the least developed countries (para 66). As a result, the Court of India 'has significant positive global implications. It has effectively protected the leading role of India in supplying affordable medicines to other developing countries'.

Curbing 'evergreening' of patents

In 2005 the Indian Parliament approved an amendment to the Patents Act that, among other changes, introduced a new provision, section 3(d) deliberately aimed at curbing what has been termed as 'evergreening' of patents. This is a strategy followed by pharmaceutical companies to artificially extend patent rights over drugs that have fallen or are soon to fall in the public domain.

In the words of the Indian Supreme Court: "'Evergreening' is a term used to label practices that have developed in certain jurisdictions wherein a trifling change is made to an existing product, and claimed as a new invention. The coverage/protection afforded by the alleged new invention is then used to extend the patentee's exclusive rights over the product, preventing competition". 'Evergreening' is harmful for generic producers, as patents are used to block the commercialization of lower priced generic drugs. Most importantly, however, that practice adversely affects patients and the institutions that need to pay a high price for drugs. For instance, the European Commission estimated, for a sample of 219 drugs, losses to individuals and governments of 3 billion Euros for the period 2000-2007, resulting from the strategic use of patents to block generic competition.

In order to prevent this misuse of the patent system, the referred to section 3(d) stipulated that in case of derivatives and other forms of existing drugs, patents would be granted only if a significant increase in efficacy could be shown. 'Efficacy' was understood by the Supreme Court as relating to the therapeutic effect of the claimed derivative or form. When such effect is absent, there is no patentable invention.

The Novartis patent application rejected by the Indian court provides an excellent example of an evergreening strategy. The basic patent on imatinib was initially filed in 1992 on the basis of what is known as a 'Markush claim'. This is a way of drafting patent claims to cover a large number of compounds that are deemed to share some common characteristics. This modality of patenting, very much in use in the pharmaceutical sector, allows in some cases to protect millions of compounds under a single patent. This broad coverage blocks further research on and production of any of the covered compounds during the 20-year period of exclusivity that patents generally grant.

Novartis argued before the Indian Supreme Court that, after inventing imatinib the company developed a second invention, the particular salt (mesylate) of the drug. Obtaining a patent on a salt is another typical way of evergreening. It is common knowledge in the pharmaceutical field that salts result in different solubility and, therefore, different bioavailability. The possible salts acceptable for pharmaceutical use are also well known. Hence, a patent on the salt of a particular drug would not normally meet the inventive step standard required by patent laws. Moreover, in seeking for the broadest possible patent protection, when claiming for a drug, pharmaceutical companies generally claim – as comprised of in their invention - all the corresponding salts. This is, in fact, what the Supreme Court found in the Novartis case: the original patent already covered the mesylate salt of imatinib. This was, moreover, the form under which the drug was commercialized in India and elsewhere.

In fact, the Novartis patent application did not cover the anti-cancer drug active (imatinib) as such or its salt (imatinib mesylate) - which were in the public domain in India - but a *crystalline form* of the drug. The patenting of crystalline forms or 'polymorphs' is another strategy, very popular in the pharmaceutical industry, for evergreening patents on medicines. A person with basic knowledge in organic chemistry knows that several polymorphs (i.e. different **arrangements of the molecules in the** solid-state structure) may exist for a single chemical compound, and that some polymorphs are more stable and have better properties than others for manufacturing a particular drug. Hence, only under a relaxed inventive step standard a polymorph could be considered as inventive and patentable. Moreover, a polymorph is a property inherent to a compound which is found, not 'invented', in the process of crystallizing a given compound. Although the Indian Supreme Court rejected the patent on the Novartis polymorph on the argument that an increased therapeutic efficacy had not been proven, as required by section 3(d) of the Indian Patent Act, the same conclusion could have been reached by rigorously applying the inventive step standard. Argentina, for instance, adopted guidelines for the examination of pharmaceutical patents that considers polymorphs as generally non-patentable.

Shortcomings of the patent system

The Novartis case also provides an outstanding example of the problems created by the patent system for access to drugs, and of some of its shortcomings as an incentive for innovation.

Price is a key factor in access to drugs, particularly in developing countries where patients cover most of their expenditures on medicines out-of-the-pocket. Imatinib mesylate, sold in India under the trademark 'Glivec', is many times more expensive than its generic version. As noted in the IPAB decision in this case, Glivec is 'too unaffordable to the poor cancer patients in India' (p. 191). In accordance with one source, the generic version of imatinib mesylate is up to 90% cheaper than Glivec. The reported donation of Glivec by Novartis to 'eligible patients' under the 'Glivec International Patient Assistance Program' (GIPAP) may be a palliative, but does not ensure a sustainable supply of the product to those in need. A successful strategy of patent evergreening would mean, hence, to deprive many suffering people from access to the medicine.

The high cost of research and development is the ordinary justification for the pharmaceutical industry to obtain patents and to charge high prices for the protected medicines. In the case of the imatinib, all arguments will favor, instead, commercialization of the drug at a low price. While the estimated sales of Glivec were US$ 4,6 billion in 2012, estimates for the cost of R&D of this drug are in the order of just 38-96 US$ million. In connection with Novartis' role in developing imatinib it has been noted that 'Novartis was not "the innovative force." Not only was all the basic research done in academic institutions, but so were the initial clinical investigations that showed STI 571 to be specifically effective against CML [chronic myelogenous leukemia] cells in vitro and in vivo. In fact, it took a few years for Brian Druker, the investigator most responsible for these latter studies, to convince Novartis that it should invest in a crash program to develop Gleevec and to undertake large-scale clinical trials'.

This shows, on the one hand, that patents were not the main factor in finding a new therapy for that form of leukemia and, on the other, that the social costs created by the grant of patents clearly exceeded its social benefits. This is why it would be so important, as recommended by an international expert group established by the World Health Organization, to find new mechanisms that ensure the development of new pharmaceutical products which are affordable to all patients, especially in poor countries.

A weak case

Novartis cannot certainly argue that India refused to protect a new, genuinely inventive drug. The drug as such and its salt were already known, commercialized in India and elsewhere. It cannot argue either that it has been discriminated. In accordance with the Minister of Trade and Industry, with 147 patents obtained in India, Novartis is one of the pharmaceutical companies with the largest number of patents granted in the country.

It may be surprising that Novartis chose to enter into a long legal battle in a case where the usually alleged huge costs in research and development cannot be claimed and the prices of its product are excessive, and on the basis of such a weak patent application. In the view of the Indian Supreme Court, the Novartis application appeared to be 'a loosely assembled, cut-and-paste job, drawing heavily' upon the basic drug patent (para 164) and 'as an attempt to obtain patent for Imatinib Mesylate, which would otherwise not be permissible in this country' (para 194).

The reasons for Novartis to pursue this case are probably explained by the profit expectations generated by a rapidly growing pharmaceutical market in India, and by the desire not to set a negative precedent for its patents' portfolio. The company's choice of the battle field was clearly wrong, but it has helped to make a strong case for the grant of patents only when a genuine invention exist, and for the implementation of the patent laws in a manner that takes important public interests, such as the protection of public health, into account.

Keystone

Companies are attempting to extend the period and scope for patent protection, fuelling protests in the developing world.

Contentions Issues in the TPPA Negotiations

The Trans Pacific Partnership Agreement negotiations are grappling with several contentious issues as countries weigh the advantages and disadvantages to them.

Bernama

Representatives of countries participating in the TPPA negotiations during the press conference of the 18th TPPA Round in Kota Kinabalu, Malaysia last July.

By Martin Khor

The negotiations for the Trans Pacific Partnership Agreement (TPPA) have been proceeding at full speed in recent months, giving rise to a lot of interest worldwide.

The stated goal is to conclude the negotiations by the end of 2013. However these is only a slim prospect for this, as there are still many contentions issues to resolve. (The countries participating in the TPPA negotiations are Australia, Brunei Darussalam, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, the United States, and Vietnam.)

Not much is known about the TPPA drafts. But with some of its chapters leaked and available on the internet, and since much of the TPPA is likely to be similar to bilateral FTAs that the United States has already signed, we can have a good idea of its main points.

As can be expected, there are many contentious issues to consider, especially for developing countries.

Actually, only a small part of the TPPA is about trade as such. Most chapters are on other issues, like services, investment, government procurement, disciplines on state-owned enterprises and intellectual property.

Joining the TPPA or similar FTAs will mean the country having to make often drastic changes to existing policies, laws and regulations, which will in turn affect the domestic economy and society.

On trade itself, the TPPA countries will have to remove tariffs on almost all products coming from one another. Perhaps only one or two products can still be protected.

The main implication is that local producers and farmers would have to compete with tariff-free imports from other TPP countries. This may lead to loss of market share or closure of some sectors.

Ironically, agricultural subsidies, which is the main trade-distorting practice of developed countries like the US, have been kept out of the agenda of the TPPA or other FTAs involving Europe.

The developed countries are clever not to include what would be damaging to them. Thus the developing countries are deprived of what would have been the major trade gain for them.

On services and investments, we can expect that TPP countries will have to open all their services and investment sectors to the entry and establishment of companies, in manufacturing as well as services including finance, commerce, telecoms, utilities, professional and business services.

If a country wants to exclude any sector, it will have to list this in a table of exceptions, and this will also be subject to negotiations. Future new services cannot be excluded as they are not even known yet today.

In the investment chapter, the country will have to commit not only to liberalise the entry of foreign companies, but also to protect the foreign investors' rights in an extreme way that goes far beyond what is recognised in national laws and courts.

For example, the foreign investor includes any person or company who has an asset (factory, land, shares, contract, franchise, intellectual property, etc). "Fair and equitable treatment" to be given to them has been interpreted in past cases to include a standstill on (no changes in) regulation.

Thus, any new laws or changes in laws and regulations that the foreign investor claims will affect its future revenues can be challenged in an international tribunal for monetary compensation.

The regulations could be economic (for example, terms in contracts, type of or ratios on foreign ownership, financial regulation including in a crisis), health-related (food safety, tobacco control, provision of cheaper medicines), environment-related (ban on chemicals, policies on rivers, forest, climate change) and social (for example, affirmative action for disadvantaged groups or communities).

Most TPP countries have agreed to allow foreign companies to sue governments in an international court (usually ICSID, based in Washington) for compensation for expropriation, or for not giving them fair treatment.

Expropriation is defined not only as confiscation of property or breaking of contracts, but also as reduction of revenues due to a change in policies and regulations.

The TPPA is not only about trade in goods but also affects domestic economic and social policies in areas such as investment, services, IPRs, government procurement and state-owned enterprises.

These investor-to-state disputes can cost countries a lot. A court awarded an American oil company US$ 2.3 billion against Ecuador's government in 2012. Indonesia is being sued US $2 billion for withdrawing a contract that a state government made with a UK-based company.

The TPP will also open up government procurement, with foreigners allowed to bid on similar terms as locals for goods, services and projects of the federal government (and possibly also state and municipal governments) above a threshold value.

Existing preferences in government procurement for local companies will be affected, as will be the ability of government to use its spending and procurement policy to boost the domestic economy and as a major social and economic policy instrument.

Since government procurement contracts are considered investments, the foreign supplier can sue the government at an international tribunal by claiming unfair treatment including a renegotiation of contract.

There is also a sub-chapter on state-owned enterprises (SOEs). The USA and Australia are proposing disciplines on the operations of SOEs, including commercial companies in which the government has a share.

This would restrict the state's ability to govern or manage government-linked companies, or provide them with incentives and preferences. This would have serious implications for a developing country whose success is based on the role of the state in the economy, and on public-private sector partnerships.

Some countries, notably Malaysia, Vietnam and Singapore, have several concerns about this sub-chapter on SOEs.

The chapter on intellectual property has generated public debate because it obliges the TPP countries to have IP laws far beyond the WTO rules.

Longer patent terms and restrictions on the state's policy freedom to promote generic medicines are expected to raise the prices of medicines. Tighter copyright rules would also affect access to knowledge, including books, journals and digital information.

Local producers in industry may also find it more difficult to upgrade their technologies and local farmers could have less access to agricultural inputs including seeds.

Many TPP countries are reportedly opposed to the proposals of the US to embed TRIPS-plus provisions and are putting forward counter-proposals.

These are the specific issues that are or should be in the centre of the negotiations. There are many benefits to the foreign investors or companies, as contrasted to the local, as can be seen from the above. Local companies would lose a lot of their present advantages or preferences, they cannot stake a claim to "fair and equitable treatment" nor sue the government in a foreign court, unlike the foreign.

Naturally, there are pros and cons to any agreement. Any potential gain for a country in exports or investments should be weighed against potential losses to domestic producers and consumers, and especially the loss to the government in policy space and potential pay-outs to companies claiming compensation.

The Malaysian Insider

Protesters march towards the US embassy in Kuala Lumpur, Malaysia on August 23, 2013, during a protest against the TPPA organised by the Coalition to Act Against the TPPA.

Mr Martin Khor is Executive Director of the South Centre. He can be contacted at director@southcentre.int.

FTAs & TNCs Affecting Health Policies

There is rising global concern that trade and investment treaties are affecting health, including access to medicines and tobacco control.

Are big companies making use of trade and investment agreements to challenge health policies? Evidence is building up that they do so, with medicine prices going up and tobacco control measures being suppressed.

This issue came up in the Malaysian Parliament recently when International Trade and Industry Minister Datuk Seri Mustapa Mohamed said the government would not allow the Trans-Pacific Partnership Agreement (TPPA) to cause the prices of generic medicines to go up.

He added he would defend existing policies on patents and medicines, and if they don't agree with some of the terms, they can choose not to sign.

Trade agreements and health concerns are linked because some companies selling tobacco, medicines and food are using these agreements to sue governments that introduce new regulations to safeguard public health.

The World Health Organization's Director-General Dr Margaret Chan recently noted that corporate interests are preventing health measures.

The costs of non-communicable diseases are shooting up. The costs for advanced cancer care are unsustainable, even in rich nations, and some countries spend 15 percent of the health budget on diabetes.

"In the developing world, the cost of these diseases can easily cancel out the benefits of economic gain," she said. It is harder to get people to adopt healthy lifestyles because of opposition by "unfriendly forces".

"Efforts to prevent non-communicable diseases go against business interests. And these are powerful economic operators. It is not just Big Tobacco anymore. Public health must also contend with Big Food, Big Soda and Big Alcohol. All of these industries fear regulation and protect themselves by using the same tactics," said Dr Chan.

Those tactics include "front groups, lobbies, promises of self-regulation, lawsuits and industry funded research that confuses the evidence and keeps the public in doubt."

Many studies show how trade agreements with the United States or Europe have raised the prices of medicines because of the constraints placed by the FTAs' strict patent rules on the sale of cheaper generic medicines. Patients have had to switch to much dearer branded medicines.

One study estimated that Colombia would need to spend an extra US$1.5 billion a year on medicines by 2030, or else people would have to reduce medicine consumption by 44 percent by that year.

Another study showed that the patent provision in the US-Jordan FTA resulted in a hospital increasing its medicine spending six-fold, and medicine prices in Jordan have already increased 20% since 2001 when the FTA began.

"Data exclusivity", one of the features of the FTA, has delayed the introduction of cheaper generic versions of 79% of medicines launched by 21 multinational companies between 2002 and mid-2006 and ultimately the higher medicine prices are threatening the financial sustainability of government health programs.

The tobacco industry is also making use of trade and investment agreements to challenge governments' tobacco control measures.

According to an article by Professor Mathew Portefeld of Georgetown University Law Centre, the company Philip Morris has asked the US government to use the TPPA to limit restrictions on tobacco marketing.

In comments submitted to the US trade representative (USTR), Philip Morris argued that Australia's plain packaging regulations would be "tantamount to expropriation" of its intellectual property rights, and complained of the broad authority delegated to Singapore's Minister of Health to restrict tobacco marketing.

In order to address these "excessive legislative proposals," Philip Morris urged USTR to pursue both strong protections for intellectual property and inclusion of the investor-state dispute settlement mechanism in the TPPA.

The company has instituted legal cases against Uruguay and Australia challenging packaging and labeling requirements they have adopted.

These cases are under bilateral investment agreements. The company claims that the packaging and labeling regulations violate their rights and also violate the agreement's principle of "fair and equitable treatment".

It claims that a change in government regulation that affects its profits and property is an "expropriation" for which it should be compensated.

Under such agreements, companies have sued governments for millions or even billions of dollars. An oil company was awarded over US$2 billion in a recent case against Ecuador.

The provisions in the bilateral investment treaties are also present in trade agreements including the TPPA, including that companies can directly sue the governments in an international court, under an investor-state dispute system.

Having been sued by the tobacco company for its health measure, the Australian government has decided not to enter any more agreements that have an investor-state dispute system.

In fact, in the TPPA negotiations, Australia has asked that it be granted an exemption from that agreement's investor-state dispute system. So far such an exemption has not been agreed to.

The controversies over how trade and investment agreements are threatening health policies will not go away, because the rules are still in place, and in fact new treaties like the TPPA are coming into being.

A "google search" on this issue will yield hundreds, indeed many thousands of documents. And the number will go up as long as the controversy continues.

Director Appointed, Decisions Made at GCF Board

The Green Climate Fund under the UNFCCC is the biggest hope that developing countries will obtain the resources they need to implement climate policies. However progress has been both slow and contentious. This article analyses the GCF's Board meeting in June.

By Meena Raman

The fourth meeting of the UN Framework Convention on Climate Change's Green Climate Fund (GCF) Board, which began on 26 June in Songdo, South Korea, concluded on 28 June with the selection of its Executive Director as well as the adoption of decisions on the 'business model framework', which included the private sector facility.

A decision was taken to set up three new structures under the private sector facility, to determine the terms of engagement with the private sector, exert due diligence and manage risks, as well as to review investment proposals and instruments.

Selection of the Executive Director

The GCF Board selected Ms. Hela Cheikhrouhou as the Fund Secretariat's first Executive Director (ED), following a global recruitment process.

Cheikhrouhou is a Tunisian national, and is currently Director of the Energy, Environment and Climate Change Department at the African Development Bank, and has spent the last ten years working in multilateral development banks, first in the Latin American and Caribbean region of the World Bank, and then for the African Development Bank.

The selection of the ED was done on 26 June, in a long session of the Board meeting on the first day, which was closed to observers. It was learnt that the final short list of candidates for the ED comprised of three persons, including Cheikhrouhou and two others from the Netherlands and Colombia.

Business Model Framework

Decisions on the business model framework (BMF) were taken after lengthy and intense debates, with some developing countries taking a cautious approach, with most developed countries wanting swift decisions to operationalise the Fund.

Among the issues addressed on the BMF were the GCF's objectives, results and performance indicators, country ownership, access modalities, financial instruments, the private sector facility (PSF) and the structure and organisation of the Fund.

As regards the private sector facility (PSF), the meeting began with decisions based on a paper by the co-chairs and the Interim Secretariat with many details and options on how to operationalise the facility. The initial proposals, especially the creation of a separate governance structure detached from the GCF, were opposed by several developing countries. Also opposed was the creation of a powerful Private Sector Advisory Group with vast powers of decision-making.

On the last day of the meeting, a decision was taken to set up three structures under the PSF: an Advisory Group to determine the terms of engagement with the private sector; an Investment Committee that will review investment proposals and instruments; and a Risk Management Committee that will enable the Fund to exert due diligence and manage risks prudently.

The membership and terms of reference of these structures are to be discussed at the next Board meeting in October.

During the discussion on the PSF, several developing countries also raised the issue of how the Fund's financial resources would be distributed between the public and private sector and how much will be allocated to the PSF.

This issue has yet to be determined and was not concluded.

Generally, developing countries wanted to ensure funds are channelled in the form of mainly grants and some as concessional lending to and through the public sector. They wanted funds to go to and through the public sector (direct access) rather than having to go through "international intermediaries and international implementing entities" such as the World Bank and other international organisations, with developing countries choosing the appropriate entities themselves.

In fact, the issue of direct access and country ownership were among issues that occupied a significant part of the Board's consideration.

On a related issue on financial instruments, a debate ensued whether to adopt a decision for the Fund to make use of instruments other than grants and concessional lending. The Interim Secretariat's/co-chairs' paper pushed for the use of loan guarantees, equity investments and other instruments. This led to a lengthy discussion on the

Board members of GCF

risks of such instruments, including reputational risks associated with their use.

Eventually, a decision was taken that the Fund would consider the terms and criteria of the grants and concessional lending to be deployed by the Fund for mitigation and adaptation, through accredited national, regional and international intermediaries and implementing entities at its next meeting in October.

However, a decision was also taken under the PSF that the facility will initially focus on grants and concessional lending, and will also draw on a broad range of other financial instruments and modalities to achieve its objectives. What the other instruments and modalities would be was not specified.

Direct Access Controversy

On the issue of direct access, the Board decided to consider at its first meeting in 2014, additional modalities that further enhanced direct access (devolution of fund management to the national level), including through funding entities, with a view to enhancing country ownership of projects and programmes.

This issue saw much controversy as the Board member from the United States, Mr. Alexander Severens, could not agree to having enhanced direct access, saying that it was "not logical", given that the GCF had not "experimented with direct access". He said further that this was a "big decision" for the US.

This prompted co-chair Zaheer Fakir (South Africa) to say that if this could not be agreed to, there could be no other decisions on the business model as there was need for balance in the overall BMF decisions. He and other developing country Board members urged the US to be flexible, which eventually led to the final decision being adopted on enhanced direct access.

As regards the issue of country ownership, the Board decision noted that countries may designate a national designated authority (NDA), or mandate a country focal point to interact with the Fund. The NDA/focal point will, among other things, recommend to the Board funding proposals in the context of national climate change strategies and plans and act as the focal point for the Fund's communication.

Another issue which saw an intense exchange during the final hour of the meeting was about who would be the co-chairs for the next meeting of the Board in October, which will be held in Paris. This was because the term of office of the current co-chairs, Zaheer Fakir (South Africa) and Ewen McDonald (Australia), expires on 23 August following a one year tenure.

The Board member from India, Dipak Dasgupta, notified the Board that there was an expression of interest from Asia for the seat of the developing country co-chair. He also said that there would be four new Board members from developing countries replacing some of the current members who will need to make the decision about their nominee.

The Board members from developed and some members from developing countries wanted the current co-chairs to continue their term for another one year, even when the Governing Instrument of the GCF prescribed the duration of the co-chairs to be for only a period of one year.

Following exchanges among Board members and the co-chairs, it was agreed that the current co-chairs will continue to preside over the October meeting, with the election of new co-chairs scheduled for the end of that meeting.

Meena Raman is Legal Advisor of the Third World Network.

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5 years After Lehman

(Continued from page 26)

But the tone of his article is pessimistic indeed. We can conclude we can't expect effective changes in the US, where inadequate policy response and roll-back are caused by the strong banking lobby, the weak bureaucracy and an accommodative Congress and administration.

Five years after Lehman, if the situation is bad on the regulatory front, it has even worsened in two other areas.

One is in economic policy to counter the recessionary effects of the financial crisis. The Keynesian-type reflationary actions of major economies co-ordinated by the G20 (through its London summit of 2009) did not last long, as conservative forces hit back with austerity-centred fiscal policies that seem to rule today in Europe and the US.

The big economies resorted instead to a cheap-and-abundant credit strategy, the most important of which was the "quantitative easing" policy of the Fed in the US pumping US$85 billion a month into the banking system.

But critics point out that this is planting the seeds of a new crisis in both developed and developing countries.

A significant outcome was the renewed boom of speculative capital to emerging economies, thus continuing the boom-bust cycle.

Potential Crises in the South

This brings us to the worsening in the second area. Many developing countries, which had recovered fast from the 2008-10 crisis now face new potential crises.

Their economic growth rates are dropping, their currencies falling, capital flows are reversing, and prices and demand for commodities are weakening.

Meanwhile the required reforms in the global financial system are still lacking: there are yet no adequate measures to stabilise currency fluctuations, to curb cross-border speculative capital flows, to discipline credit agencies, to reform the system of reserve currency, to set up a sovereign debt resolution mechanism, to assist developing countries facing financial and trade shocks.

One bright spark is that developing countries are taking measures to help themselves. The Chiang Mai Initiative in which Asian countries can avail themselves to funds to fight off speculative attacks and fill in gaps in a balance of payments crisis, has been joined with a similar type of arrangement with US$100 billion funding by the BRICS countries, announced at the sidelines of the St. Petersburg G20 summit. A BRICS development bank is also to follow.

It is at times of crisis or impending crisis that countries are spurred on to new initiatives to defend themselves.

A WTO Treaty on Trade Facilitation? Regulatory, Institutional, Legislative, and Cost Challenges for Developing Countries

The WTO members are negotiating a possible trade facilitation agreement, which could be a potential outcome in the WTO's Bali Ministerial in December. However, the developing countries face many challenges in such a treaty and have asked for special and differential treatment as well as finance to meet the costs of new obligations.

By Kinda Mohamadieh

Introduction

An agreement on trade facilitation is being propped as a viable outcome from the World Trade Organization (WTO) 9th Ministerial Conference, to be held in Bali at the end of 2013. Yet few weeks before the Ministerial Conference, the concerns that developing countries have repeatedly pointed to in regards to a binding trade facilitation agreement under the WTO have as yet not been addressed. These include the lack of balance within the agreement, whereby developing countries and least developed countries (LDCs) are being asked to take on extensive binding obligations while their right to special and differential treatment is being diluted.

Facilitation of trade, including setting in place enabling infrastructure and boosting productive and trade capacities, has been central to trade concerns of developing countries and LDCs. Yet, negotiations towards a trade facilitation agreement under the auspices of the WTO significantly differ from the broader process of facilitation of trade. The agreement would be narrower in scope, focusing on simplification, harmonization and standardization of trade procedures. Thus, it does not necessarily address the needs and priorities of developing countries and LDCs.

The negotiations process and content so far indicate that a trade facilitation agreement in this sense would lead to higher imports into developing countries and LDCs without corresponding higher exports, and to irreplaceable loss of tariff revenue. Hence, net macroeconomic impact of implementing a potential trade facilitation agreement under the WTO, particularly implications on trade balance and balance of payments, should be well assessed by WTO Member States.

The agreement would also be enforced through the WTO dispute settlement mechanism. Thus, if a Member fails to align its procedures with the time intervals, methods, criteria, or other stipulations addressed under the agreement, they would be exposed to a challenge under the WTO dispute settlement understanding (DSU). The implications of accepting binding commitments and the cost of non-compliance could be significant. A non-complying country in certain cases has to incur substantial costs in order to comply with its binding commitments. A member may also accept commitments for activities that may get outsourced to the private sector and over which there might be little control by the government.

Overall, a trade facilitation agreement under the WTO would carry significant implications for WTO Member States at each of the regulatory, institutional, and legislative fronts, and would carry short-term and recurring long-term costs, which are discussed in the following brief.

The negotiations mandate for a trade facilitation agreement

WTO Members formally agreed to launch negotiations on trade facilitation in 2004 pursuant to the July 2004 Framework Package (referred to as the post-Cancun decision).

It is worth remembering that trade facilitation was part of the four 'Singapore Issues', along with investment, government procurement, and competition, which developing countries had opposed including in the WTO negotiations agenda at the 5th WTO Ministerial Conference in Cancun.

The trade facilitation negotiations mandate, established in the "Modalities for Negotiations on Trade Facilitation" of the 2004 decision (Annex D) explicitly stressed that the negotiations "shall aim to clarify and improve" relevant aspects of trade facilitation articles under the GATT 1994 (i.e. Articles V, VIII and X GATT), with a view to further expediting the movement, release and clearance of goods, including goods in transit. Thus, the negotiations are not meant to limit or eliminate the rights and obligations under the three GATT articles or impinge on national policy and regulatory space. Such tendencies would be commensurate to going beyond the negotiations mandate. Yet, provisions under negotiations are in fact amending, not just clarifying, the GATT Articles V, VIII, and X.

The trade facilitation negotiating text is divided into two sections; section (I) includes the new rules being negotiated in order to clarify and improve GATT Articles, while section (II) deals with rules on special and differential treatment. Section II is central to ensuring that developing countries and LDCs have the needed flexibilities, taking into consideration their individual level of development, and ability to implement new trade facilitation obligations progressively, at their own pace, and subject to available resources.

Special and differential treatment (SDT)

Special and differential treatment and enhancing technical assistance and support for capacity building has been central to the 2004 negotiating mandate, which underlined that negotiations "shall take fully into account the principle of special and differential treatment (SDT) for developing and least-developed countries". The mandate established that SDT would extend beyond transitional periods for implementation by developing countries and LDCs would be conditioned on the acquisition of financial and technical assistance, and capacity building, based on the delivery of such assistance by developed country Members of the WTO.

Furthermore, Annex E of the Hong Kong Ministerial Declaration (2005) outlined the work program of the negotiating group on trade facilitation. The Annex required that technical assistance and capacity building commitments contained in Annex D of the July 2004 Framework be 'made operational in a timely manner' and be made 'precise, effective, and operational, and reflect the trade facilitation needs and priorities of developing countries and LDCs'. Annex E establishes that developed country Members are expected to provide support and assistance to developing and least developed country Members in a comprehensive manner and on a long term and sustainable basis, backed by secure funding, in order to allow implementation.

Intrusion on regulatory capacities and policy space

The trade facilitation rules under negotiations are designed in a manner that could undermine the regulatory capacities and space of WTO Member States. It could introduce multiple grounds based on which laws and regulations of Member States could be challenged under the WTO DSU.

It is worth recalling that dozens of dispute settlement cases have been raised based on legal grounds provided by the trade facilitation articles under the GATT 1994 (i.e. articles V, VIII and X GATT). The WTO panel and appellate body have often found WTO Members in violation of their obligations under these articles.

For example, the WTO panels have actively addressed Members' obligations under Article VIII GATT on fees and formalities connected with importation and exportation in each of the cases Argentina-Textiles and Apparel, US-Certain EC Products, China-Raw Materials, and EEC-Bananas II. Overall, the panels have undertaken an expansive approach when addressing Members' obligations under this Article, including in regards to Members' obligations to limit the amount of fees and formalities imposed on or in connection with importation and exportation to the approximate cost of services rendered.

Furthermore, the panel and appellate body actively addressed Members' obligations under Article X GATT on publication and administration of trade regulations. In multiple cases, the dispute settlement bodies (DSB) found Members in violation for not publishing a certain law, regulation, judicial decision or administrative ruling that fell within the scope of the provision, or for not doing that in a manner that is 'prompt' or that 'enable governments and traders to become acquainted with them'.

The trade facilitation negotiating text is packed with undefined and vague legal terminology as well as 'necessity tests', beyond what the GATT articles on trade facilitation include. These could establish multiple grounds for challenging a broad range of WTO Members' laws, rules, regulations, and measures that are not limited to customs, but are more broadly trade-related or regulations 'on or in connection with' import, export and transit of goods.

For example, Article 1 of the trade facilitation negotiating text addresses publication and availability of information, and seeks to clarify and improve Article X GATT. Under the GATT Article, the only qualification to the manner of publishing an act was 'promptly' and 'in such a manner to enable governments and traders to become acquainted with them' (i.e. with laws, regulations, judicial decisions and administrative rulings). Both these terms were actively addressed by the DSB. The trade facilitation negotiating text adds grounds that would be prone to being interpreted by the DSB, including the requirement to publish in a 'non-discriminatory' and 'easily accessible' manner. Thus, it multiplies the grounds based on which a member state could be challenged and found in violation of its obligations.

The inclusion of vague language that is open for interpretation and possible use as grounds to challenge the regulatory action and capacities of Member States is a trend across the various articles of section I under the trade facilitation negotiating text.

Furthermore, the design of the rules under negotiation is over-prescriptive and intrusive on national policy and regulatory space. For example, Article 6 addressing penalty systems goes a long way into addressing procedures related to conflict of interest and remuneration/ reward systems of government officials, which extend beyond what the GATT stipulates. Other articles propose detailed lists of criteria for designing and applying certain custom practices. This is the case with Article 7 on release and clearance of goods, which addresses the practice of 'risk management' systems and 'authorized operators' that benefit from extra preferences and facilities when it comes to their transactions. Such stipulations would limit the discretion and space of Members in designing and applying several of the requirements under a potential trade facilitation agreement, and would be intrusive on national policy space.

Overall, the negotiating text is designed based on mandatory language in most provisions, which has limited and uncertain flexibilities in some parts. It includes a wide variety of formulations that attempt to qualify the mandatory nature of the provisions, such as "shall, as appropriate", "shall endeavor", "shall to the extent possible", "shall where practicable", "shall to the extent practicable", among others. This language is presented in the negotiations as an alternative to the mandatory term "shall", thus is supposed to provide Members with flexibility in regards to the obligations they would carry as a result of a trade facilitation agreement.

While a qualified "shall" presents a level of mandatory obligation associated with some flexibility, there is no clarity or certainty on the extent of that flexibility. The WTO jurisprudence show that the opinions of the DSB have tended to differ in the extent of strictness it applies when interpreting these terms. For example, when addressing the language "shall endeavor", the DSB tended to indicate that the language does not hold a 'result obligation', thus is not legally binding with respect to what would be the outcome of the action. Nevertheless, the language would require Members to undertake at least certain steps in light of the provision under consideration, otherwise the Member would be found in violation of their obligation.

Challenges on the institutional and legislative fronts

The implementation of a potential trade facilitation agreement will take different forms across countries given how the practice will be integrated in national systems, and the way it will interact with the national legislative and judiciary systems.

Several of the provisions under negotiations could hold significant administrative and institutional burdens on Member States, especially developing countries and LDCs, whose customs and customs-related institutional mechanisms are not as advanced compared to developed countries. It is worth noting that most of the proposals and disciplines based on which negotiations are undertaken were presented by developed countries, thus reflect the nature and form of practice that they already undertake, and that is more suited to their priorities, interests, financial capacities, and resources.

Several provisions necessitate setting in place and continuously updating systems for managing information, and assigning staff or specific units to follow that. This is the case for Article 1 on publication and availability of information, Article 2 on prior publication and consultation, Article 6 on disciplines on fees and charges imposed on or in connection with importation and exportation, as well as Article 7 on the procedures of release and clearance of goods, among other Articles.

A legal act or formal policy may be necessary in many countries to identify the government agency (or agencies) or other entities that would be responsible for implementing the obligation. Also, legislative or administrative acts may be required to designate responsibilities and define the mandate and authority of the responsible institution. In some cases, the national legislative process would need to be changed in order to accommodate requirements stipulated by the agreement. Such would be the case in relation to publishing new or amended trade laws and regulations prior to their entry into force and accommodating the right of traders and 'other interested parties' to comment on laws and regulation, according to what is proposed under Article 2 of the draft negotiating text.

The reference to the category 'interested parties' does not appear in the GATT language, and in this sense could be considered an extension beyond the mandate of negotiations wherever it appears. As currently proposed in the draft negotiating text, it would encompass an undefined open-ended category of parties. This category could include an expanded list of entities that have a direct or indirect relation to the trade transactions covered by the agreement, and do not necessarily have to be located in the territory of the Member State implementing the measure.

The reference to 'interested parties' under Article 2 could result in an obligation to open the legislative process to prior consultation and comments on draft, new, and amended rules by traders and other interested parties located outside the territories of the Member. This may lead to speculation, lobbying pressures, and profiteering by interest groups. Such lobbying and influence could tilt the balance in national regulatory and legislative processes away from the national constituencies and development priorities.

Moreover, requirements under Article 7 on advance submission of the goods' declarations before their arrival to the member state, and Article 10 addressing formalities connected with importation and exportation and transit, deals with the sovereign role of the state in dealing with customs and could change the nature of how states deal with duty systems and collection. Many Members would need to undertake legal changes to allow release of imported goods according to the conditions established by the agreement.

It is worth noting that Members will be obliged to put these requirements in practice across the board at the national level. While some Members may already have the practice implemented in some regions or custom agencies, it remains significantly difficult to ensure a homogenous alignment with the requirements across the national level.

Costs associated with a trade facilitation agreement: is financial assistance enough?

Much discussion and analysis about meeting the costs of a trade facilitation agreement has been generated by the WTO secretariat, international organizations, as well as among WTO Members. Multiple assessments and forums have been organized with the aim of linking aid-for-trade with the process of negotiating a trade facilitation agreement, claiming enough funds and donor capacities are available to meet the needs of developing countries in implementing such an agreement.

Yet, it is questionable whether such efforts would address the challenges that developing countries and LDCs would face in meeting the costs of implementing a trade facilitation agreement. Costs would include human resource expenses, equipment and information-technology systems, as well as other significant infrastructure expenditures. These costs would not be limited to a one-time investment; most of them would be of a recurring nature.

For example, Turkey's efforts to modernize its customs information technology required US$2 8million. In Morocco, the ICT costs were estimated at US$10 million, while in Chile, the total investment cost of implementing an automated customs system amounted to US$ 5 million in the early 1990s. In Jamaica, the introduction of the computerized customs management system cost about US$ 5.5 million. Tunisia needed US$ 16.21 million to computerize and simplify procedures. It is also worth noting that a World Bank report notes that the costs of implementing ICT at customs is only part of the life cycle cost of these systems and that too often these maintenance and upgrading costs are underestimated and not adequately included in the life cycle costs.

Furthermore, a 2003 OECD report highlighted that in Bolivia, a five year project for customs modernization cost US$ 38 million, of which about US$ 25 million was spent for institutional improvements and US$ 9 million for computerized systems. For Chinese Taipei, express clearance alone, in such a small country with already developed infrastructure, necessitated establishing 20 new processing lines, each equipped with an X-ray scanning machine. There are a total of 117 officers at the express division, working day and night shifts so as to provide a 24/7 service.

Such infrastructure and automated systems as highlighted above are only part of the investments and expenses required to allow implementing the practices stipulated under the negotiated trade facilitation agreement.

Accordingly, meeting these costs will necessitate a carve-out from the national budgets on a yearly basis, and could essentially lead to a disproportionate diversion of limited resources from other vital institutions and public services to customs administration. A serious assessment of the needs to meet these costs should be of a long-term nature, and cannot be addressed by solely assessing the available funds at the period of negotiations.

Moreover, it is important to unpack the nature of the international funds available to support the implementation of a trade facilitation agreement. These should not be a diversion from meeting development needs and goals, nor should it be of a debt-creating nature.

Besides, WTO Member States negotiating a trade facilitation agreement ought to address the potential costs associated with irreplaceable loss of tariff revenues. Compared to developed countries, the share of customs revenues in the total tax collection is much higher in developing countries and LDCs. Given the limited reliance on customs duties in the former, there is less chance of an importer filing a false import declaration intended for evasion of customs duties in developed countries compared to developing countries and LDCs. Some of the Articles with potential implications in this area include Article 3 on advance rulings, Article 6 on disciplines on fees and charges and on penalty disciplines, and Article 7 addressing separation of release of goods from final determination of customs duties, taxes, fees, and charges.

Moreover, many provisions in the trade facilitation negotiating text are purely a policy matter; thus technical and financial assistance will not help a Member State in overcoming the implementation challenges associated with such provisions.

Concluding remarks

On the surface, trade facilitation would seem beneficial for all. However, on closer scrutiny, the benefits and costs depend on the capacities and development trajectory of each country implementing such trade facilitation measures.

A proliferation of reports, such as OECD Trade Facilitation Indicators, have attempted to make the point that a trade facilitation agreement would have positive impact on trade flows, reduce global trade costs, and result in benefits most of which would accrue to developing countries. For example, OECD trade policy papers on impact of trade facilitation measures for OECD countries claim a potential reduction of overall trade costs by almost 10%, as well as a potential cost reduction by almost 14.5% for low income countries, 15.5% for lower middle income countries, and 13.2% for upper middle income countries.

Yet these reports do not show who accrues the benefits of increased trade flows, whether the trade flows resulting from the agreement are imports or exports, and whose trade costs would be reduced. For example, the OECD paper (2013) indicates that "*potential trade costs reductions would benefit stakeholders as a whole, including both traders (importer and exporter firms) as well as the public administration*", and adds in a footnote that "*a more refined quantitative approach could shed light on a more specific identification of the beneficiaries*".

Thus, the analysis does not provide information that would help with understanding the implications on developing countries and LDCs, especially in regard to the expected impact of a trade facilitation agreement on increasing imports and related implications on balance of payment positions. Trade costs could largely go down due to developing countries bringing their systems on par with the practice in developed countries. Thus, the distribution of benefits remains unclear.

In fact, a trade facilitation agreement under the auspices of the WTO would not necessarily address the actual needs of developing countries and LDCs in terms of productive and trade capacity and inter-regional trade. Many developing countries could face an increase in imports as a result of implementing the agreement, without necessarily gaining increased capacity to export.

Accordingly, it is vital to stress that achieving the benefits from facilitating trade through enhancing infrastructure and productive capacities of developing countries is significantly different from signing an international binding agreement that is enforced under an international dispute settlement mechanism, and that establishes multiple implementation obligations that Members need to align to, within a specific period of time, and commit to without testing and without a full and realistic estimation of costs.

Kinda Mohammadieh is a Researcher at the South Centre.

The Economic Times, India

A trade facilitation treaty at WTO will create new binding obligations on countries to accelerate clearance of goods at ports and borders. Developing countries are concerned at the binding nature of the treaty, the required changes to regulations, and the types and size of costs to them in taking on the obligations.

Current Challenges and Priorities of the South in International Negotiation Issues

By Vicente Paolo Yu

Multiple challenges to development in the South

Developing countries today face multiple interlinked challenges – the financial, climate, and development crises. These are challenges that, in large part, affect developing countries more harshly than they do the developed countries.

- Addressing the global economic crisis is still a priority, 5 years after it started. We need to continue to analyse how the recession has affected the low income and middle income developing countries, as well as how the "global recovery" brings its own problems and how developing countries can cope with these problems;

- On climate change. We now have a very complex situation following the launch of a new round of negotiations in Durban aimed at reaching agreement on enhancing climate action by all countries in the mid-term (before 2020) and the long-term (after 2020). The key issue is how to combine the environmental imperative with equity so that the development prospects of developing countries are not compromised. The G77 and China have consistently called for developed countries to take the lead, under the Climate Convention, in reducing greenhouse gas emissions and to provide climate financing and technology access to developing countries to assist them in doing mitigation and adaptation actions;

- On trade issues. In the run-up to the 9th WTO Ministerial Conference, the drive by the WTO Director-General and developed countries to have a trade facilitation agreement-focused outcome as the core of the MC9 "package" could imperil the original Doha development agenda mandate. We also need to assess the development implications of free trade agreements like EPAs between North and South countries and how we can ensure that they do not throw up new obstacles to development;

- The debate over intellectual property, innovation and their links to development continue to have a high profile, as developed countries seek to strengthen IP enforcement. Developing countries need to continue pushing for IP flexibilities so that IP will not hinder development policy but is put in its proper place;

- Addressing the need to build a new international financial and economic system is going to be crucial, in order to ensure that the global economic system is more effective, transparent, legitimate, provides appropriate regulatory safeguards against excessive and speculative market behavior, and gives developing countries an increased voice in global economic governance;

- The inclusion of a strong development agenda and the promotion of the development state at the national level and the international framework and cooperation that promotes it, with adequate policy space, is necessary as part of the post-2015 development agenda discourse in the UN system.

The post-2015 development agenda

These multiple challenges highlight the continuing key developmental objectives that developing countries have with respect to the post-2015 development agenda; especially:

1. Rapid and sustained economic growth
2. Industrialization
3. Full employment
4. Greater distributional equity
5. Environmental sustainability

These encompass all three areas of sustainable development – economic and social development and environmental protection.

The post-2015 development agenda should not simply extend the MDGs, reformulating the goals, dropping one or two and adding a few in areas such as environment and human rights. It should focus, instead, on global systemic reforms to remove main impediments to development and secure an accommodating international environment for sustainable development. International action for systemic reforms should be formulated as explicit commitments with appropriate time frames, going well beyond the generalities of Goal 8 of the MDGs.

South-South policy coordination on post-2015 development agenda

Getting a good, systemic, post-2015 development agenda discourse going will very much depend on the extent to which the G77 and China, in New York, in Geneva, in Nairobi, and elsewhere, is able to coordinate its messages, craft its narratives, and present a coherent and systemic approach that will result in specific reform commitments on global issues.

UN processes face the danger of fading away through the lack of proper follow-up. An example is the 2009 UN Conference on the Financial Crisis that was organized by the UN General Assembly. It made a good start, took up various issues of importance to developing countries, and made some suggestions regarding the kind of issues to be explored in the reform of the financial architecture. A follow up process was agreed but this process has now essentially become side-lined, devolving into one or two diplomatic meetings a year in which countries make statements, but where no further follow up or implementation actions with impact are undertaken.

The post-2015 development agenda should not suffer the same fate as the UN's discourse on what to do about the global financial crisis.

G77 and UNCTAD

Within the United Nations, UNCTAD's role is particularly important for the G77 given UNCTAD's historical ties with the G77 and the long-standing tradition of critical and empirical policy research that has been done by UNCTAD on global development issues.

As such, it would be necessary for UNCTAD to continue the visionary and strategic leadership that is needed to ensure that UNCTAD's policy research role and contributions to macroeconomic development policy thinking within the UN system is not diminished.

This article is based on a speech given at a G77 and China Strategy seminar in Geneva, presented by the South Centre's Coordinator on Global Governance issues.

No Respite, 5 years After Lehman

Five years after the Lehman Brothers collapse triggered the global financial crisis, there are still no effective financial regulations in developed countries, while the developing countries face big new challenges.

CNBC

The collapse of Lehman Brothers investment bank on 15 September 2008 catalyzed the US and global financial crisis.

By Martin Khor

September 2013 marks the five-year anniversary of the collapse of Lehman Brothers that was the immediate trigger for the United States and global financial crisis.

Lehman was the tip of the iceberg. Below the surface were many contributory elements. They include financial deregulation, the conversion of finance from serving the real economy to a beast that thrived on speculation, creaming layers off the productive sectors and unsuspecting consumers through new manipulative instruments.

The US sub-prime housing mortgage crisis was the boil that burst---where massive loans were given to home-owners who could not pay, the loans were securitised and sold to unsuspecting investors, the derivatives magnified the proportions of the crisis, while the bankers made billions selling very risky "financial products" as very credit-worthy investments.

Many collapsed or collapsing banks in the US and Europe had to be rescued in bailouts totalling trillions of dollars.

The crisis also exposed the deep deficiencies of the global financial system. Globalisation of finance meant a crisis in one part could be quickly transmitted to other parts of the system.

The deregulation of capital flows caused booms and busts in emerging economies that received inflows and then suffered sudden reversals. The lack of a stable system of currency rates results in big fluctuations.

The lack of an international arbitration system for resolving sovereign debt crises meant indebted countries could be mired in a debt-income death spiral for years.

Five years later, the lessons have not been learnt with respect to the US, according to Princeton University economist and former Federal Reserve vice-chairman Alan Blinder, in a Wall Street Journal article. The US Dodd-Frank Act of 2010 was a weak response to the crisis which, worse, is withering in the poor follow-up.

"Far from being tamed, the financial beast has gotten its mojo back and is winning. The people have forgotten and are losing," concludes Blinder, giving four examples of how Dodd-Frank is not working.

First, on mortgages and securitisation, the rule that Wall Street firms that issue asset-backed securities retain at least 5% of the credit risk (and thus make them cautious on what they securitise) has definitional escape clauses that allow exemption for up to 95% of all mortgages.

Second, the attempt to rein in the deadly derivatives that was the source of reckless leverage that blew up in the crisis, has been woefully inadequate. Dodd-Frank calls for greater standardisation with safer and more transparent trading environment -- but the law exempts the vast majority of derivatives, and the implementation of this already weak law has run into resistance.

Third, although credit rating agencies were blamed for its role in the crisis by blessing financial junk with top ratings, the Congress has so far only asked for a study to reform the way the agencies work. The report has come out but is gathering dust.

Fourth is the attempt to ban banks from "proprietary trading", i.e. gambling using their own funds. The so-called Volcker rule has not been implemented since Dodd-Frank became law in July 2010 because of resistance from the banks and bureaucratic squabbles.

Blinder warns that the Dodd-Frank Act is "taking on water fast" (meaning: the ship is sinking) and proposes that the new Federal Reserve chair must move bureaucratic mountains and fend off banking lobbyists, instead of sympathising with Wall Street.

(Continued on page 20)

SOUTH BULLETIN

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The South Bulletin is published by the South Centre, an intergovernmental think-tank of developing countries.

South Centre website:
(in English, French and Spanish)
www.SouthCentre.int

South Centre
Tel: +41 22 791 8050
Email: south@southcentre.int