Christoph Herrmann
Jörg Philipp Terhechte
Editors

2010

European Yearbook of International Economic Law

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Springer

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Editorial

Over the past year, it has become clear that the financial crisis that started 2 years ago in the United States' subprime mortgage market has pushed the global economy into the most severe economic crisis since World War II. Economic policy reactions by national governments as well as the European Union and global economic institutions are manifold, and only in their beginnings. However, it seems safe to assume that the international economic order we will end up with once the crisis is finally over will look different from the order we have become used to. Given both the past changes and those awaiting us in the years to come, the new "European Yearbook of International Economic Law" is all the more timely, even though it could not be foreseen how massive the impact of the crisis would prove to be, and how seriously it would put into question fundamental principles when we launched the project in the first place.

By using the notion "International Economic Law", we deliberately try to tear down the boundaries between the different branches of legal scholarship and practice that have existed over decades, as a result — among other factors — of the failure of the Havana Charter. World trade law, international monetary law, international regulation of financial markets, international investment protection and international competition law — to name only the most prominent subdisciplines — are from our point of view growing together at an increasing pace. Borrowing a term from European law scholarship, one could legitimately speak of an increasing "cross-pillarization" of international economic law. The global financial crisis provides us with the most significant example of this trend: the spill-over of the crisis from the US into other countries would not have been possible without the free movement of capital as provided for in the OECD codices and in EU law. The global imbalances that have substantially financed the excessive borrowing by the US government and American consumers would not have occurred, at least not to the same extent, had there been effective provisions limiting the ability of countries to prevent an effective appreciation of their exchange rates. Those global imbalances have also caused the massive accumulation of capital by so-called "Sovereign Wealth Funds", which in turn has led to renewed investment protectionism in some industrialized countries.

In Part I of the new European Yearbook of International Economic Law, we try to demonstrate the huge variety of topics encompassed by the notion "International Economic Law". At the same time we seek to point out the links between the different branches, as well as the growing interconnectivity of different questions. Part II is devoted to the growing trend of "going regional" that can be witnessed all over the world. The contributions in this part aim at giving an overview of the different, but at the same time similar regional integration initiatives and their recent developments in the main regions of the world. Two remarks concerning this part are necessary. Firstly, we deliberately excluded the integration process that is taking place within the European Union. This process is a very special topic in its own right (i.e. "European law"), and has already gone far beyond the traditional concepts of international economic law (free trade area, customs union, etc.). Instead, we look at the regional integration strategies and initiatives that are pursued by the European Union as an increasingly important actor in the global economy. Secondly, we did not simply "forget" Africa, as the international community is often being accused of. In fact, a separate analytical report on regional integration in Africa had been planned, but the planned author had to withdraw shortly before the deadline for submission. We strongly hope that we will be able to fill this obvious gap in the second volume of EYIEL. Part III covers major developments in some of the global institutions and fora dealing with the governance of the global economy.

EYIEL is a new project, and as such suffers from many infant diseases. Nevertheless, we are very happy about this first volume, and will try to eliminate remaining shortcomings within the next few years. As Editors, we are heavily indebted to a great number of people, first and foremost to our contributors who have produced a multitude of interesting and stimulating treatises on the current problems of international economic law scholarship. Secondly, we thank Springer and the responsible Executive Editor Law, Dr. Brigitte Reschke, for giving us the opportunity to launch a new and challenging project of this scope and supporting us in many ways in its preparation. Thirdly, we are grateful to the members of the Editorial Advisory Board, who have greatly supported this project with their advice and confidence. Lastly, we would like to thank our academic and student assistants at the Universities of Hamburg and Passau for their invaluable support in handling the manuscripts and proofs.

Passau/Hamburg
May 2009

Christoph Herrmann
Jörg Philipp Terhechte

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Part I
Topics

International Regulation and Supervision of Financial Markets After the Crisis

Christoph Ohler

Introduction

The title of this contribution could suggest that the financial crisis which hit the world first in summer 2007 and then with a second, even stronger strike in the second half of 2008, has already come to a halt. Sooner or later this will be the case; however, in early March 2009, when this essay was finalised, the USA and several European countries had just increased their rescue packages for financial markets and, in a parallel move, their aid programmes for the general economy.[1] The full effects of this turmoil are still not foreseeable. Yet it has become clear that few economic events after World War II have touched public opinion and altered a broad set of economic factors as much as the financial crisis of 2007–2009 has.

Large banks which in early 2007 gave the impression of full economic prosperity and strength do not exist any more. The massive loss of capital as expressed in write-downs of assets was the immediate effect of the crisis, and made some of them go insolvent within only a few days. Many banks were merged with institutions which still seemed to be sufficiently robust; other banks could only be saved by an extensive public bail-out, in some cases even by nationalisation.[2]

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[1]Cf. Financial Times, 21.01.2009: Geithner pledges "dramatic" action, http://www.ft.com/cms/s/0/6322d126-e7de-11dd-b2a5-0000779fd2ac.html; Handelsblatt, 22.01.2009, Staat will Bankbilanzen entgiften, http://www.handelsblatt.com/politik/deutschland/staat-will-bankbilanzen-entgiften;2131236; FAZ, 14.2.1009, Das größte Konjunkturprogramm in der Geschichte der Bundesrepublik, p. 1.

[2]Financial Times Deutschland, 22.1.1009: Britische Banken vor Verstaatlichung, http://www.ftd.de/unternehmen/finanzdienstleister/:Finanzsystem-am-Abgrund-Britische-Banken-vor-Verstaatlichung/464091.html. With respect to Germany, see Gesetz zur weiteren Stabilisierung des Finanzmarktes, draft of 18 February 2009, http://www.bundesfinanzministerium.de/nn_82/DE/BMF__Startseite/Aktuelles/Aktuelle__Gesetze/Gesetzentwuerfe__Arbeitsfassungen/entw__Finanzmarktstabilisierungsergaenzungsgesetz__anl,templateId=raw,property=publicationFile.pdf.

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These processes have fundamentally changed the economic position of most banks on a global scale. Measured by market capitalization, US and European banks lost ground in comparison to China, which has now become the country with the biggest banks in the world.[3] The long-term macroeconomic effects of these structural changes in the banking sector are still open. However, the concentration process in the USA and Europe is problematic, at least from the perspective of competition policy and perhaps financial stability, as far as those banks are concerned which were created by rescue mergers, since their "growth" was not based on normal business decisions. Practically all remaining banks came under heavy regulatory pressure to recapitalize, which is hardly possible as long as private equity investors step aside due to lack of confidence in the development of the market. This in turn forced the states to maintain or even extend their aid programmes.

The effects of the financial crisis on the real economy are massive, too. Within only a few months, the financial crisis caused a tightening of credit conditions in many countries, which made it difficult for private enterprises and other borrowers to raise the capital they required.[4] The severe credit conditions resulted in a contraction of investment activities, with negative effects on economic growth. The sharp economic downturn by the end of 2008[5] has grasped the whole world economy, with unemployment threatening to rise substantially in many countries.[6] To counter the various elements of this development, most states rushed to set up public rescue programmes, which aim at saving their finance industries and providing financial aid to industries massively hit by the credit crunch. Again, these programmes carry fundamental risks. Due to the immense amounts necessary, the programmes could not be funded by regular tax revenues, but were financed by a massive public debt. As a result, the refinancing costs as reflected in the interest rates for government bonds started rising in some countries.[7] The dynamic of this development became visible when for the first time after several years not only developing and emerging economies, but also highly industrialised countries[8] asked the IMF for financial support. In the case of Iceland, this proved to be the

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[3] See Reuters UK, 16 January 2009: US banks' market capitalization shrinks, http://uk.reuters.com/article/marketsNewsUS/idUKN1548387620090116.

[4] See ECB, Euro Area Bank Lending Survey, 6 February 2009, http://www.ecb.int/stats/pdf/blssurvey_200901.pdf?f440961f2e7d53f6ffc5d16c094e5f3c.

[5] Handelsblatt, 16.2.2009: Derartiger Rückgang wäre bislang einmalig, http://www.handelsblatt.com/politik/konjunktur-nachrichten/derartiger-rueckgang-waere-bislang-einmalig;2157331.

[6] See ECB, Monthly Bulletin, February 2009, p. 9; http://www.ecb.int/pub/pdf/mobu/mb200902en.pdf; Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung, Jahresgutachten 2008/09, p. 19 et seq.

[7] Cf. Financial Times, 21.01.2009: Portugal suffers S&P rating cut, http://www.ft.com/cms/s/0/31884d0e-e7f1-11dd-b2a5-0000779fd2ac.html; Handelsblatt, 22.01.2009: Ökonomen warnen vor britischem Staatsbankrott, http://www.handelsblatt.com/politik/international/oekonomen-warnen-vor-britischem-staatsbankrott;2131304.

[8] These countries are (at the end of February 2009) Hungary, Ukraine, Pakistan, Latvia, Belarus and Iceland, see http://www.imf.org/external/index.htm.

only means of preventing a sudden state insolvency.[9] In the field of international monetary policy, leading central banks coordinated their short-term policy,[10] offering additional liquidity as an emergency measure since the money markets threatened to dry up.[11] Beyond these liquidity injections, many central banks cut their key interest rates, in some cases to historically unprecedented levels, as, for example the Federal Reserve System and the Bank of England, who lowered their rates to about 0.2% and 0.5% respectively by March 2009. The political signal from such decisions was that the stability of financial markets was given priority, at least for a certain period of time, over the monetary goal of price stability.[12]

The crisis was also a catalyst for renewed state activity in the markets,[13] first to save failing banks and other institutions, second to restore public confidence in the financial markets, and third to reform the fundamental rules of these markets which, as it seems, were not able to prevent the crisis. The reform process taking place on the international level and also in regional fora like the EU has just begun, and will certainly continue in the years to come. One of the starting points was the "Summit on Financial Markets and the World Economy" in Washington, D.C. on November 15, 2008, where the Heads of State of the Group of Twenty (G20)[14] postulated the need for more global cooperation and better regulation.[15] Other international organisations, like the IMF,[16] followed with their suggestions. Thus, this essay can only provide an interim view on what happened and what has to be done in the future to improve the regulatory conditions for financial markets. One impression from the last 18 months is: despite determined rescue actions by many governments in the world, and despite a vibrant public discussion on the origins of the crisis and a strong wish to reform the rules for these markets, there was initially great uncertainty among all participants about what really needs to be done in the long term to

[9]See Hannibalsson, The international financial crisis — The case of Iceland: Are there lessons to be learnt? Working Papers on Global Financial Markets, No. 3, 2008, http://www.gfinm.de/images/stories/workingpaper3.pdf.

[10]The first coordinated measures took place on 18 September 2008; see the press release of the ECB at http://www.ecb.int/press/pr/date/2008/html/pr080918.en.html.

[11]ECB, Financial Stability Review, December 2008, p. 12, http://www.ecb.int/pub/pdf/other/financialstabilityreview200812en.pdf. For a general overview see IMF, Financial Stability Report, October 2008, pp. 6–7; http://www.imf.org/external/pubs/ft/gfsr/2008/02/pdf/text.pdf.

[12]In the Eurosystem, the priority of monetary stability is underlined by Article 105(1) TEC, which explains the more careful steps of the ECB in the recent months.

[13]However, the regulatory state is not a new phenomenon in financial markets; see Arner, *Financial Stability, Economic Growth, and the Role of Law*, 2007, p. 95.

[14]On the G20, see the general information available at http://www.g20.org/about_index.aspx.

[15]G20, Declaration of the Summit on Financial Markets and the World Economy, 15 November 2008, http://ec.europa.eu/economy_finance/publications/publication13395_en.pdf.

[16]On 4 February 2009, the IMF published its Lessons of the Financial Crisis for Future Regulation of Financial Institutions and Markets and for Liquidity Management, http://www.imf.org/external/np/pp/eng/2009/020409.pdf.

prevent a similar turmoil in the future.[17] It is not surprising that the legal analysis, *de lege lata* as well as *de lege ferenda*, is influenced by this uncertainty. This is also reflected by the fact that the regulation of financial markets was for a long time considered to be a subject for a few experts only and not a subject for broad academic research.[18] Thus, the financial crisis might at least stimulate the academic interest of lawyers in this complex field.

Origins and Causes of the Crisis

For analytical purposes it is indispensable to discern between origins and causes of the crisis. The first category describes the concrete economic factors which triggered the crisis. The second category deals with structural factors favouring the dynamics of the crisis, the relevance of which cannot be restricted to the case at issue.

The US Subprime Mortgage Market

From a microeconomic point of view the origins of the crisis mainly go back to the US mortgage loan sector, where in the period from 2001 to 2006 many low income households received loans the repayment of which was based on unrealistic assumptions.[19] The boom in housing prices, low interest rates on the US capital markets and the politically supported vision that every citizen should own real property had triggered a broad run on mortgage loans. Three risk factors were the

[17]In this respect, see for example the divergent economic proposals in: Eichengreen/Baldwin, *What G20 leaders must do to stabilise our economy and fix the financial system*, 2008, www.voxeu.org. From a political point of view, see McCreevy, Address at the EP Committee on Economic and Monetary Affairs, Speech 09/34 of 3 February 2009, p. 3, http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/09/34&format=HTML&aged=0&language=EN&guiLanguage=en. Technical questions of adequate capital requirements are dealt with by Draghi, How to Restore Financial Stability, Bundesbank Lecture 2008, BIS Review 112/2008, p. 4 et seq., http://www.bis.org/review/r080922b.pdf.

[18]There are pre-eminent exemptions; among them see Alexander/Dhumale/Eatwell, *Global Governance of Financial Systems*, 2006; Arner, *Financial Stability, Economic Growth, and the Role of Law*, 2007; Grote/Marauhn, *The Regulation of International Financial Markets*, 2006; Lastra, *Legal Foundations of Monetary Stability*, 2006; Scott, *International Finance; Law and Regulation*, (2nd ed.) 2008; Walker, *International Banking Regulation, Law, Policy and Practice*, 2001.

[19]Draghi, How to Restore Financial Stability, Bundesbank Lecture 2008, BIS Review 112/2008, p. 1 (2) http://www.bis.org/review/r080922b.pdf; Franke/Krahnen, *The Future of Securitization*, 2008, p. 3, http://www.wiwi.uni-frankfurt.de/schwerpunkte/finance/wp/1706.pdf; Horn, Das Finanzmarktstabilisierungsgesetz und das Risikomanagement zur globalen Finanzkrise, BKR (2008), p. 452 (pp. 456–457); Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung, Jahresgutachten 2007/08, p. 93 (99).

seed of the market meltdown which started in 2007: Lending standards were generally low, and credits were granted in many cases without a proper control of the borrowers' income.[20] Additionally, the amounts of the loans exceeded the actual market value of the real property in many cases, as the banks expected the boom in housing prices to continue over the lifetime of the loans. Third, it was thought that the default risk of borrowers in the subprime sector would be countered by variable interest rates which were regularly adapted to capital market conditions.[21] This system worked as long as interest rates were low and the employment rate was high. When these fundamental macroeconomic data changed, many borrowers could not bear the costs of such loans any more, in particular because interest rates on capital markets went up in early 2007. In a parallel development, the boom in housing prices ended sharply, so that the value underpinning the mortgages shrunk equally.

Before this macroeconomic change began, it seemed that capital markets were easily able to "swallow" even the "subprime" risk of low-income borrowers.[22] Securitisation is the financial instrument under which these risks are transferred from the banking sector to capital market investors. The basic concept is that the lender (or: originator) sells the loan receivables, and the purchaser refinances the purchasing price by issuing securities on the capital market.[23] Investors acquire the securities and accordingly take on the risk of the underlying loan receivables. The legal and economic techniques for the securitisation of loan receivables had been considerably developed since the mid-1990s, and the Asset Backed Securities (ABS) market seemed to be sufficiently broad and deep to absorb any of these risks. This seduced many banks (lenders as well as investment banks) into a policy of "originate to distribute" while systematically underestimating the fundamental risks which put strain on the assets they had generated.[24]

[20] Messerschmidt, Developments in Banking Law: 2006–2007, The subprime mortgage crisis, Rev. Banking & Fin. L. 27 (2008), p. 1 (4).

[21] Messerschmidt, Developments in Banking Law: 2006–2007, The subprime mortgage crisis, Rev. Banking & Fin. L. 27 (2008), p. 1 (5).

[22] By 2006, originations of subprime mortgages rose to 600 billion US dollars, up from 160 billion US dollars in 2001; see Messerschmidt, Developments in Banking Law: 2006–2007, The subprime mortgage crisis, Rev. Banking & Fin. L. 27 (2008), p. 1 (5). See also Horn, Das Finanzmarktstabilisierungsgesetz und das Risikomanagement zur globalen Finanzkrise, BKR 2008, p. 452 (457).

[23] See Benjamin, *Financial Law*, 2007, p. 401 et seq.; Firla-Cuchra, Structured Finance, in: Freixas/Hartmann/Mayer (eds.), *Handbook of European Financial Markets and Institutions*, 2008, p. 597 et seq.; Wood, *Law and Practice of International Finance*, University Edition, 2008, p. 450 et seq.

[24] Cf. Messerschmidt, Developments in Banking Law: 2006–2007, The subprime mortgage crisis, Rev. Banking & Fin. L. 27 (2008), p. 1 (3–4). Many regulatory responses aim at this weak point, see for example McIlroy, Regulating risks: A measured response to the banking crisis, Journal of Banking Regulation 9 (2008), p. 284 (286–288).

The Role of the ABS Market

The existence of huge ABS programmes was also the decisive key to spreading the risks which were originated in a comparatively small segment of the US market to investors on a worldwide basis.[25] The hunger for yield and the abundance of profit-seeking capital were the reasons why any of these ABS programmes could place its securities, mostly commercial paper and medium-term notes, on the markets.[26] Additionally (and probably a decisive factor), the common belief was that the micro- and macroeconomic risks incorporated in the assets underlying these securities were controllable as a result of the sophisticated structures of ABS programmes. One of the techniques , for example, was that the securities issued were organised in "tranches", with senior tranches of high and junior tranches of low credit quality.[27] A default under the assets would then first hit the junior tranche, whereas the senior tranche would benefit as long as payments were made under the assets. By this technique, a pool of poor assets could be sliced into a class of highly rated securities and various classes of lower rated securities. Alternatively, existing securities under an ABS programme could be repackaged (so-called resecuritisation) in order to mix the risks involved.[28] However, all these techniques could not solve the problem that the effective defaults under the assets were bigger than the security margins. Tranching and resecuritisation even produced non-transparent structures which impeded a realistic assessment of the risks involved.[29] From a technical point of view, which perhaps has been the main (but short-sighted) perspective of many decisions taken by rating agencies, the rating was to a large extent based on credit enhancement measures which financial institutions provided to the special purpose vehicle (SPV) issuing the securities.[30] In this respect, the most important forms of credit enhancement are liquidity facilities of

[25] Bartsch, Die Geister, die ich rief..., NJW 61 (2008), p. 3337 et seq.; Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung, Jahresgutachten 2007/08, p. 93. On the economic rationales of securitisation, see Hellwig, *Systemic Risk in the Financial Sector. An Analysis of the Subprime-Mortgage Financial Crisis*, 2008, p. 10 et seq., http://www.coll.mpg.de/pdf_dat/2008_43online.pdf.

[26] Messerschmidt, Developments in Banking Law: 2006–2007, The subprime mortgage crisis, Rev. Banking & Fin. L. 27 (2008), p. 1 (4).

[27] Cf. Wood, *Law and Practice of International Finance*, University Edition, 2008, pp. 453–454.

[28] Cf. Wood, *Law and Practice of International Finance*, University Edition, 2008, p. 461. With respect to specific examples, see Hellwig, *Systemic Risk in the Financial Sector. An Analysis of the Subprime-Mortgage Financial Crisis*, 2008, p. 23 et seq., http://www.coll.mpg.de/pdf_dat/2008_43online.pdf.

[29] Franke/Krahnen, *The Future of Securitization*, 2008, p. 39, http://www.wiwi.uni-frankfurt.de/schwerpunkte/finance/wp/1706.pdf.

[30] Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung, Jahresgutachten 2008/09, p. 120.

investment-grade rated banks, guarantees by such banks and credit insurances by insurance companies.[31] Yet it seems that these institutions themselves never had a realistic expectation of the extent to which they could be drawn on by the SPV, at least in comparison to what actually happened when the losses under the assets were realised. Another theory which proved to be partly overestimated was that risks under an ABS structure would not only be effectively transferred to investors on financial markets but also evenly distributed there and accordingly watered down.[32] In reality, the diversification effects were confined to a relatively small number of globally active investors, mainly large investment banks and trading departments of commercial banks. Additionally, the diversification effects depended on the relative amount of securities which the respective investors had acquired.

What followed was a chain of panic reactions:[33] Rating Agencies suddenly lowered the ratings of these SPVs; banks had to write down the ABS on their balance sheets without knowing where to fix the current value of their assets. Panic sales of ABS by some hedge funds aggravated the tensions on the market for this investment class. In a parallel move, banks involved as liquidity providers in ABS structures that now threatened to default were drawn under the facilities, without knowing whether the SPV would ever be able to repay the amounts. This put an additional strain on many of them, with negative effects on their own rating.

Breakdown of Confidence in the Interbank Market

As soon as the first signs of this development became visible in the market, the mutual confidence in the creditworthiness of many banks broke down, and made the interbank market illiquid.[34] The interbank market, which is a part of the money market, is the primary source for prime banks to refinance themselves with short-term liquidity.[35] Unsecured lending operations form the basis of refinancing operations, which in turn means that mutual confidence in the business partner's creditworthiness is the essential factor driving this market.[36] The fundamental

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[31]Cf. Wood, *Law and Practice of International Finance*, University Edition, 2008, pp. 465–466.

[32]On this concept see Franke/Krahnen, *The Future of Securitization*, 2008, p. 9 et seq., http://www.wiwi.uni-frankfurt.de/schwerpunkte/finance/wp/1706.pdf; Walker, Editorial: The deconstruction of financial risk, Journal of Banking Regulation 9 (2007), p. 1.

[33]For a deeper analysis see Hellwig, *Systemic Risk in the Financial Sector. An Analysis of the Subprime-Mortgage Financial Crisis*, 2008, p. 78 et seq., http://www.coll.mpg.de/pdf_dat/2008_43online.pdf.

[34]Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung, Jahresgutachten 2008/09, p. 121.

[35]Hartmann/Valla, The Euro Money Markets, in: Freixas/Hartmann/Mayer (eds.), *Handbook of European Financial Markets and Institutions*, 2008, p. 453 et seq..

[36]Hartmann/Valla, The Euro Money Markets, in: Freixas/Hartmann/Mayer (eds.), *Handbook of European Financial Markets and Institutions*, 2008, p. 453 (457).

relevance of this market can be judged from the fact that the interest rates quoted (e.g. Euribor and Libor) are benchmarks for the whole money market. When it effectively failed in the course of 2008, the burden to provide liquidity for the whole market shifted to the central banks. This process was exacerbated when the US investment bank Lehman Brothers Inc., tumbling heavily under the subprime crisis, was not bailed out by the US tax payer. The decision of then US Secretary of the Treasury, Henry Paulson, taken together with the Federal Reserve on 12 September 2008, not to save Lehman Brothers[37] was received as a dramatic signal by market participants.[38] From the point of view of economic theory, there were at least two reasons for this decision, namely that in a market economy investors also bear the risk of their investments and second, that a general guarantee to bailout any bank would result in moral hazard[39] with long-term negative effects for depositors and other clients. Measured by its immediate effects, however, the result of the decision was that the crisis deepened considerably, since Lehman Brothers was regarded as a systemically relevant bank by market participants.[40]

Causes: An Overview

Open Financial Markets

From the perspective of a structural analysis, the developments on the financial markets were promoted by several factors. First, capital markets are globally open today, in the sense that international capital movements are not restricted to a large extent by national law.[41] For this reason, not only the volume of transactions but also the rate of innovation in financial products (as well as their complexity) and the amount of embedded leverage in the market could grow considerably.[42] On a technical level, these developments were fostered by improved mathematical risk models, sophisticated standards of information technology, and growing capability of the international payment and settlement system to process a large number of transactions within a very short time.[43]

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[37] Accordingly, Lehman Brothers Holding Inc. filed for bankruptcy protection in the USA under Chapter 11 Bankruptcy Code on 15 September 2008.

[38] Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung, Jahresgutachten 2008/09, pp. 122–123.

[39] On moral hazard see Lastra, *Legal Foundations of International Monetary Stability*, 2006, p. 113.

[40] ECB, Financial Stability Review, December 2008, p. 12, http://www.ecb.int/pub/pdf/other/financialstabilityreview200812en.pdf.

[41] See also Arner, *Financial Stability, Economic Growth and the Role of Law*, 2007, pp. 63–64.

[42] Draghi, How to Restore Financial Stability, Bundesbank Lecture 2008, BIS Review 112/2008, p. 5, http://www.bis.org/review/r080922b.pdf.

[43] Arner, *Financial Stability, Economic Growth and the Role of Law*, 2007, p. 64; Padoa-Schioppa, *Regulating Finance*, 2004, pp. 10–11.

From a legal point of view, the existence of internationally open markets is surprising, insofar as there exist no relevant treaty rules under international law imposing a general obligation on states to guarantee free movement of capital. To the contrary, the IMF agreement, by assuring the members' rights to control capital transactions,[44] is at best neutral with regard to free movement of capital, and the OECD Code of Liberalisation of Capital Movements merely reflects the status quo under the national law of its members.[45] Thus far, the most outstanding multilateral approach was chosen by the EU, which in Article 56(1) EC Treaty prohibits restrictions on free movement of capital not only between the Member States but also between Member States and third states.[46] Additionally, bilateral investment treaties contributed to the opening of capital markets, as some of them provide the right to free market access, in most cases, however, pursuant to the internal regulations of the host state.[47] Apart from these provisions, states unilaterally opened their capital markets, mainly to attract direct investments but also in order to benefit from other forms of international capital movements. Open capital markets do not automatically generate specific risks; on the contrary, they contribute to more competition and help to enhance worldwide economic growth. However, open capital markets are the ground on which risks arising somewhere in the world for whatever reason can spread easily from one country to another by infecting one financial institution after the other.[48] Open capital markets are also the basis for the development of large international groups of financial institutions within which risks can be easily transferred and which, by their sheer size, constitute a systemic risk in case they fail one day. In other words: open capital markets impede measures to isolate financial risks on a local or regional level or to confine the geographic reach of an ongoing crisis.

Conflicts Between Monetary and Financial Stability

Based on a monetary policy which, due to benign macroeconomic conditions, could consider the risks for price stability to be relatively small, global interest rates were generally at low levels over a longer period of time. In particular, the Federal

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[44] Art. VI Sec. 3 IMF Agreement. For further reading, see Lowenfeld, *International Economic Law*, (2nd ed.) 2008, p. 608; Qureshi/Ziegler, *International Economic Law*, 2007, pp. 182–183.

[45] For a current version of the code, see http://www.oecd.org/dataoecd/10/62/39664826.pdf.

[46] The far-reaching effects have been cut down by the ECJ as far as capital movements are linked with the free movement of services or the right of establishment; see ECJ, C-452/04, Fidium Finanz AG, [2006] ECR I, 9521, paras. 25 and 47; C-524/04, Test Claimants in the Thin Cap Group Litigation, [2007] ECR I, 2107, paras. 101 and 104. Also C-102/05, A and B, [2007] ECR I, 871 para. 27.

[47] Article 3(1) US Model BIT (2004); see also Dolzer/Schreuer, *Principles of International Investment Law*, 2008, pp. 80 et seq.

[48] Cf. Arner, *Financial Stability, Economic Growth, and the Role of Law*, 2007, p. 37; Busch, *Banking Regulation and Globalization*, 2009, p. 246.

Reserve System had been offering money at very low rates since 2001,[49] whereas the European Central Bank pursued a more careful policy.[50] A specific strain came from the Bank of Japan which, under the pressure of a severe internal banking crisis since the mid-1990s, kept its interest rates hardly above 0%. These interest rate differentials resulted in massive carry trades from Japan to other monetary areas, i.e. international banks borrowed in Japan and invested the money somewhere else.

The existence of easy credit conditions on the global level is said to have induced many banks to take higher risks because on the one hand, capital was available at low costs and on the other hand, yields in regular business were small.[51] The existence of cheap money may also have fuelled the bubble in asset prices, as was the case for example in the US housing market. In any event, these developments point at an underlying tension between monetary stability and financial stability, even if under normal conditions both objectives should mutually reinforce each other.[52] Whereas the objective of monetary stability is bound to the development of the level of consumer prices (and measured by standardised consumer price indices),[53] financial stability may, *inter alia*, depend on the development of asset prices, which are not supposed to be considered by central banks. This does not mean that central banks may ignore the development of asset prices. Rather, the problem is that in a monetary system where the legal priority for central banks is price stability,[54] the room for manoeuvre remains limited.[55] Additionally, the open market and credit instruments of regular monetary policy are not apt to directly influence asset prices other than those of financial assets. The only strategy offered by such monetary policy tools would be to raise interest rates pre-emptively in the absence of risks for price stability.[56] Such policy would require that a rise in asset

[49]With respect to the Fed, see the historical development of federal funds rates at http://www.federalreserve.gov/fomc/fundsrate.htm.

[50]For a statistical overview of the ECB rates from 1999 to 2008, see http://www.ecb.int/stats/monetary/rates/html/index.en.html.

[51]Cf. Draghi, How to Restore Financial Stability, Bundesbank Lecture 2008, BIS Review 112/2008, p. 6, http://www.bis.org/review/r080922b.pdf; Report of the High Level Group on Financial Supervision in the EU (de Larosière Group), 25 February 2009, paras. 43–45. See also Busch, *Banking Regulation and Globalization*, 2009, p. 251.

[52]See in this respect Draghi, How to Restore Financial Stability, Bundesbank Lecture 2008, BIS Review 112/2008, p. 5 et seq., http://www.bis.org/review/r080922b.pdf. The long-term mutual reinforcement of both objectives is stressed by Issing, Monetary and financial stability — is there a trade-off? BIS Review 16/2003, p. 2; http://www.bis.org/review/r030331f.pdf. See also Padoa-Schioppa, *Regulating Finance*, 2004, p. 112 et seq.

[53]For the ECB, see http://www.ecb.int/mopo/html/index.en.html; from a legal point of view, Häde, in: Calliess/Ruffert (eds.), *EUV/EGV*, (3rd ed.) 2007, Art. 105 para. 3; Ohler, Die hoheitlichen Grundlagen der Geldordnung, JZ (2008), p. 317 (322).

[54]See Article 105(1) TEC. On this aspect, see Padoa-Schioppa, *Regulating Finance*, 2004, p. 115.

[55]Cf. Issing, Monetary and financial stability — is there a trade-off? BIS Review 16/2003, p. 5; http://www.bis.org/review/r030331f.pdf.

[56]Draghi, How to Restore Financial Stability, Bundesbank Lecture 2008, BIS Review 112/2008, p. 6, http://www.bis.org/review/r080922b.pdf.

prices is clearly identified as being an unhealthy bubble and that the costs of an economic downturn — as a result of higher interest rates — are lower than the costs of a sudden bursting of the bubble.[57] In practice, this policy poses severe prognostic problems for central banks and, if implemented, creates a high risk of distorting market developments. More fundamentally and from a legal point of view, the question may be raised why a central bank should be responsible for the business decisions of banks and other market participants. Legally speaking, those actors remain solely responsible for their decisions as long as the central bank does not intentionally motivate them to take higher risks. In the real world of monetary policy, however, there exists a broad consensus that central banks bear a psychological responsibility for side-effects of their monetary decisions, which they may also exercise by appropriate "take care" calls to the market.[58]

The Relevance of Fair Value Accounting

Structurally, there are indications that the existing system of financial reporting standards under IAS 39 of the International Accounting Standards Board (IASB) contributed to the massive breakdown of the markets. The IASB is a private standard-setter, based in London, which develops accounting standards (today known as International Financial Reporting Standards, IFRS). A main purpose is to achieve convergence of worldwide accounting standards, in particular with the US GAAP. This is also the reason why the IASB cooperates intensively with the corresponding US organisation, the Financial Accounting Standards Board (FASB),[59] and other local standard setters.[60] In the EU, IAS and IFRS are incorporated under a regulation pursuant to Article 249(2) EC Treaty as secondary community law.[61] Any decision to incorporate a new international accounting standard requires its full adoption without the possibility to restrict or amend it.[62] A leading principle for the development and implementation of accounting standards is the fair-value presentation, according to which the valuation of assets and liabilities is based on current market prices ("mark-to-market"). This is a solid and realistic basis in all cases where there is a liquid market for an asset. In practice, however, the valuation is very often not made with respect to a specific market or

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[57]Cf. Issing, Monetary and financial stability — is there a trade-off? BIS Review 16/2003, p. 5; http://www.bis.org/review/r030331f.pdf.

[58]Cf. Padoa-Schioppa, *Regulating Finance*, 2004, p. 115.

[59]For a comparison between IASB and FASB, see Fleckner, FASB and IASB: Dependence despite Independence, Virginia Law & Business Review 3 (2008), p. 275 et seq.

[60]See Memorandum of Understanding between IASB and FASB of 27 February 2006, http://www.iasb.org/NR/rdonlyres/874B63FB-56DB-4B78-B7AF-49BBA18C98D9/0/MoU.pdf.

[61]Regulation (EC) No 1606/2002, OJ 2002 L 243, p. 1. A codified set of IAS and IFRS incorporated under this regulation is provided by Commission Regulation (EC) No 1126/2008 of 3 November 2008, OJ 2008 L 320, p. 1.

[62]Article 3 of Regulation (EC) No 1606/2002.

real transactions but on the basis of mathematical models (e.g. because the market is too small or because there is no trade at all in the asset), so that discretionary elements may distort the valuation. In addition, the fair-value principle fails when an existing market for an asset turns illiquid or faces another form of external stress, as was the case for many structured securities in the wake of the financial crisis. The impossibility of pricing assets under such conditions made those securities seem worthless even if there was no default by the individual issuer. Finally, the financial crisis proved that the fair-value principle operates procyclically by increasing the cyclical movements of the economy.[63] The IASB tried to react to public criticism, in particular by the G20,[64] by amending the relevant IAS 39 and IFRS 7, which was also incorporated into EU law immediately.[65] This amendment opened the way to the reclassification of certain financial instruments out of the trading book of the banks. However, this move does not solve the fundamental question: whether a general, more restrained valuation which is not influenced by the short-term volatility of markets for financial assets but by long-term considerations, following the precautionary principle, would help stabilising financial markets.[66] There are also indications that the fair-value method of valuation had a strong impact on compensation schemes for traders and the top management in banks. The bonus-based pay systems which have been common in all bigger banks so far relied on the development of asset prices and increased, accordingly, the willingness of banks to take short-term risks.[67] From this perspective, bonus systems seem to be an essential factor at least for the appetite for risk in the market, which may have contributed to the development of economic bubbles.

Weaknesses of Regulation and Supervision

Lastly, and decisively for the purpose of this contribution, the crisis revealed certain weaknesses within the system of public regulation and supervision of financial

[63] IMF, Global Financial Stability Report, October 2008, p. 113 et seq., http://www.imf.org/external/pubs/ft/gfsr/2008/02/pdf/text.pdf; Hellwig, *Systemic Risk in the Financial Sector. An Analysis of the Subprime-Mortgage Financial Crisis*, 2008, p. 6, http://www.coll.mpg.de/pdf_dat/2008_43online.pdf; Zeitler, Internationalisierung des Rechts — Notenbanken, Finanzstabilität und Rechnungslegung, in: Vielfalt und Einheit, Wirtschaftliche und rechtliche Rahmenbedingungen von Standardbildung, Schriften des Augsburg Center for Global Economic Law 19 (2008), p. 65 (78).

[64] G20, Declaration of the Summit on Financial Markets and the World Economy, 15 November 2008, para. 16: Strengthening Transparency and Accountability, http://ec.europa.eu/economy_finance/publications/publication13395_en.pdf.

[65] Commission Regulation (EC) No 1004/2008 of 15 October 2008, OJ 2008 L 275, p. 37.

[66] Zeitler, Internationalisierung des Rechts — Notenbanken, Finanzstabilität und Rechnungslegung, Vielfalt und Einheit, Wirtschaftliche und rechtliche Rahmenbedingungen von Standardbildung, Schriften des Augsburg Center for Global Economic Law, 19 (2008), p. 65 (79).

[67] See Draghi, How to Restore Financial Stability, Bundesbank Lecture 2008, BIS Review 112/2008, p. 5, http://www.bis.org/review/r080922b.pdf.

institutions.[68] The problems involved cover the whole area of legislation, the administrative implementation of such provisions by public authorities, the enforcement of legal requirements against banks, and the international cooperation between supervisors. In the end, these shortcomings boil down to the question as to what extent legal requirements are able to induce an adequate level of risk taking and risk transfer in financial markets, while at the same time preventing excessive risk taking. The background to this question is that banks and other institutions *must* deal with financial risks which represent the essence of their respective businesses. Accordingly, the regulation of financial markets must, on the one hand, allow financial institutions to generate and bear reasonable financial risks on an individual level. This will also include the consequence, as long as markets are open and based on undistorted competition, that banks which operate their businesses badly become insolvent and are wound up.[69] On the other hand, such regulation must prevent systemic risks from arising at all or, at least from unfolding uncontrollably. In practice, however, it will be extremely difficult to reconcile these two requirements, since they may partly contradict each other. In the words of Mario Draghi, the Chairman of the Financial Stability Forum: "No financial system will be free from crisis, whatever the rules of the game. The fundamental task for authorities is therefore to enhance the resilience of the financial system to shocks and disruptions, whatever their source, with a view to minimising the knock-on effects elsewhere".[70]

Financial Stability as a Public Good

Economic Function of Financial Markets

Banks and other financial institutions are private enterprises in most countries, but they serve important public functions.[71] In particular, banks operate as financial intermediaries by collecting capital from investors and depositors on the market and on-lending it to borrowers. This credit function enhances the opportunities for borrowers and their respective business partners to buy and sell in all cases where the contemporaneous exchange of cash against delivery is for various reasons either not possible or not desirable. Furthermore, banks deliver indispensable services for the daily functioning of payment systems which they partly operate themselves or

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[68]See the Report of the High Level Group on Financial Supervision in the EU (de Larosière Group), 25 February 2009, paras. 25 et seq.

[69]Padoa-Schioppa, *Regulating Finance*, 2004, p. 1 (99).

[70]Draghi, How to Restore Financial Stability, Bundesbank Lecture 2008, BIS Review 112/2008, p. 3, http://www.bis.org/review/r080922b.pdf.

[71]Padoa-Schioppa, *Regulating Finance*, 2004, p. 110; see also Arner, *Financial Stability, Economic Growth, and the Role of Law*, 2007, pp. 40 et seq.

which they use to transfer payments from one account to another.[72] Hence, a stable and efficient payment system contributes to the smooth operation of an economy.[73] Without these services, a vendor, for example, would not receive his money from the purchaser in a cashless transaction which today is the normal form of exchanging goods and services. Investment banking activities (after the crisis, mostly a sector of commercial banking) aim inter alia at raising debt capital, which is the common alternative to corporate lending by banks and an important instrument for the financing of public households, big private enterprises, infrastructure projects, etc. Insurance companies serve as a means of transferring and distributing specific risks (e.g. loss, theft, accident, transport, credit default, fire, water, environment) from the individual insured person to a larger group of persons, the community of policy holders. Thereby, they reduce the economic risk of many commercial transactions, and provide the basis for businesses which otherwise could not take place.

The Objective of Financial Stability

As soon as the proper functioning of these services is threatened in a major part of or even in the whole market, one may speak of systemic risks. The term "financial stability" expresses the same aspect from a positive perspective: maintaining financial stability means avoiding systemic risks from unfolding uncontrollably in the market. It is common sense today that financial stability must be considered as a pre-eminent public goal.[74] Institutionally, this is reflected at the international level in the Financial Stability Forum which the G7 established in 1999, with a secretariat at the Bank of International Settlements (BIS) in Basel.[75] It brings together national authorities responsible for financial stability in significant international financial centres, i.e. treasuries, central banks, and supervisory agencies. Representatives from the IMF, the World Bank, the OECD, the BIS, the European Central Bank and from international standard-setting bodies like the Basel Committee, IASB, IAIS and IOSCO also take part in the consultations and the exchange of information. On the level of public international law, the objective of maintaining financial stability is recognised by the Annex on Financial Services to the General Agreement on Trade in Services (GATS). Paragraph 2(a) of the Annex permits WTO Members to

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[72] The public relevance of payment systems is underlined by Article 105(2), fourth indent TEC.

[73] Arrigunaga, Deposit Insurance Schemes: Reconciling Market Discipline with Financial Stability, in: Giovanoli (ed.), *International Monetary Law*, 2000, p. 323 (330–331).

[74] G20, Declaration of the Summit on Financial Markets and the World Economy, 15 November 2008, para. 16: Strengthening Transparency and Accountability, para. 2, 6, http://ec.europa.eu/economy_finance/publications/publication13395_en.pdf.

[75] On the FSF see Arner, *Financial Stability, Economic Growth and the Role of Law*, 2007, pp. 75–76; Alexander/Dhumale/Eatwell, *Global Governance of Financial Systems*, 2006, pp. 74–75.

take measures for prudential reasons "or to ensure the integrity and stability of the financial system". Within the EU, Article 105(5) TEC provides that "the ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system". In England, it was the Banking Act 2009 which introduced the objective of financial stability for the first time and made it immediately "Objective 1" for the "Special Resolution Regime" which is applicable to distressed banks.[76] In the same way, the German legislator based its "Finanzmarktstabilisierungsgesetz" of 17 October 2008 on the express purpose of stabilising the financial markets.[77]

Despite the overwhelming importance of this objective, there exists no universally recognised definition of what should be understood by the stability of the financial system. So far, various approaches can be identified which rely either on the aspect of maintaining the positive functions of financial markets or, negatively, stress the necessity to avoid systemic risks. Very often, both aspects will also be mixed, as the following overview demonstrates. The European Central Bank formulates:

> Financial stability can be defined as a condition in which the financial system — comprising of financial intermediaries, markets and market infrastructures — is capable of withstanding shocks and the unravelling of financial imbalances, thereby mitigating the likelihood of disruptions in the financial intermediation process which are severe enough to significantly impair the allocation of savings to profitable investment opportunities.[78]

In the economic literature this approach is shared, e.g. by Issing[79] and Padoa-Schioppa.[80] The German Bundesbank rather stresses the positive functions of financial markets and defines financial stability:

> as the financial system's ability to perform its key macroeconomic functions well, even in stress situations and during periods of structural adjustment. This embraces the efficient allocation of financial resources and risks, as well as efficient payment and settlement processing. Ideally, a financial system is sufficiently robust to enable it to absorb financial and real economic shocks internally.[81]

In a more simple way, the Bank of Japan writes: "Financial system stability refers to a state in which the financial system functions properly, and participants, such as

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[76]See the text of the Act under http://www.opsi.gov.uk/acts/acts2009/pdf/ukpga_20090001_en.pdf. On the need for a special resolution regime, see Lastra, Northern Rock, UK bank insolvency and cross-border bank insolvency, Journal of Banking Regulation 9 (2008), p. 165 (169 et seq.).

[77]Bundesgesetzblatt I, 2008, p. 1982. See also Horn, Das Finanzmarktstabilisierungsgesetz und das Risikomanagement zur globalen Finanzkrise, BKR (2008), pp. 452 et seq.

[78]ECB, Financial Stability Review, December 2008, p. 9, http://www.ecb.int/pub/pdf/other/financialstabilityreview200812en.pdf.

[79]Issing, Monetary and financial stability — is there a trade-off? BIS Review 16/2003, p. 1; http://www.bis.org/review/r030331f.pdf.

[80]Padoa-Schioppa, *Regulating Finance*, 2004, p. 110.

[81]See http://www.bundesbank.de/finanzsystemstabilitaet/fs.en.php.

firms and individuals, have confidence in the system".[82] In academic discussions, many authors avoid a positive definition and stress the objective of preventing systemic risks in the financial system.[83]

Systemic Risk and Financial Stability

The essence of systemic risks is that they may result in crises which do harm to the whole financial system. In other words: a risk is of systemic nature if its negative effects are not confined to a single institution but threaten to jeopardize the proper functioning of at least a bigger part of the market.[84] A key factor for understanding systemic risks is that financial institutions do not operate in isolation but are mutually bound to each other within a broad range of business transactions.[85] A second challenge for the stability of banks in particular is that they transform short-term liquidity (provided by depositors) into illiquid long-term credits they extend to their borrowers. The maturity mismatch between these two strings of their business makes them potentially vulnerable.[86] With these provisos, the individual crisis of one institution may trigger the crisis of further institutions, which economists describe as "contagion effect", "domino effect" or "spill-over effect".[87] The problem of categorizing "contagion effects" is that the origins of a crisis at the level of an individual bank cannot be restricted to a fixed number of factors.[88] Certainly, in an *ex-post* perspective, one will always find that flawed business decisions by bank managers or bad risk management were at the origin of a crisis. Those decisions, however, were in any event influenced by a wide set of macroeconomic factors as well as by flaws in monetary policy, fiscal policy and prudential supervision. Herd behaviour in the market plays a crucial role as well as other psychological factors, like risk aversion or risk appetite, which in turn depend on the individual disposition of a person as well as on the general economic environment fostering either

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[82] See http://www.boj.or.jp/en/type/exp/seisaku/expfinsys.htm.

[83] Alexander/Dhumale/Eatwell, *Global Governance of Financial Systems*, 2006, p. 23 et seq.; Arner, *Financial Stability, Economic Growth and the Role of Law*, 2007, p. 72; Lastra, *Legal Foundations of International Monetary Stability*, 2006, p. 138 et seq.

[84] See Lastra, *Legal Foundations of International Monetary Stability*, 2006, pp. 138–139; Scott, *International Finance; Law and Regulation*, (2nd ed.) 2008, pp. 130–131.

[85] A key element is the interbank market; see Padoa-Schioppa, *Regulating Finance*, 2004, p. 107; Lastra, *Legal Foundations of International Monetary Stability*, 2006, pp. 142–143; Scott, *International Finance; Law and Regulation*, (2nd ed.) 2008, pp. 130–131.

[86] Alexander/Dhumale/Eatwell, *Global Governance of Financial Systems*, 2006, p. 24; Padoa-Schioppa, *Regulating Finance*, 2004, p. 99.

[87] See for example Alexander/Dhumale/Eatwell, *Global Governance of Financial Systems*, 2006, p. 24; Hartmann/Valla, The Euro Money Markets, in: Freixas/Hartmann/Mayer (eds.), *Handbook of European Financial Markets and Institutions*, 2008, p. 453 (480–481).

[88] Identical analysis by Lastra, *Legal Foundations of International Monetary Stability*, 2006, p. 139.

over-optimism or over-anxiety. For the purpose of crisis prevention, the *ex-post* analysis is not of direct benefit for future prudent supervision, since the next systemic crisis will probably have a different origin than the last one. From this perspective, it would also not be sufficient to analyse the issue of systemic risk according to the phenomena which possibly hint at a financial instability,[89] since first, the economic interpretation of such phenomena may be flawed and second, if they occur it may be already too late to prevent the crisis. Accordingly, the question can only be which aspects are *structurally* relevant in an *ex-ante* analysis.

Thus, three situations must be discerned on a structural level. First, a systemic risk may arise, if large numbers of banks adopt parallel business strategies and bear identical severe risks over the same period of time. Second, there is always a systemic risk if a very large bank fails. Third, there is a systemic risk if an essential market infrastructure, as would be the case with computer systems or payment systems, fails. Fourth, there is a systemic risk in most cases of so-called external shocks, such as international environmental catastrophes and wars. This is not the place and time to discuss all these issues in depth. In particular, case four refers to a situation which normally is out of reach of regulators, whereas classical regulatory issues are raised in cases one to three. As far as the problem of parallel business strategies is concerned, it must be borne in mind that not every individual business strategy or minor error is of relevance but only such long-term parallel activities as bear fundamental risks for the banks themselves. In these cases, parallel strategies lead to concentrations of risk in parts of the financial markets which may turn out to be as relevant as the concentration of risk within an individual institution. Normally, under the conditions of strong competition in open markets, parallel behaviour (and accordingly risk concentration) should be effectively avoided. Problems of parallel behaviour may arise, however, if the competition among institutions is not based on alternative business strategies any more but merely on price competition with respect to identical products. In particular, parallel investment strategies of trading departments may raise concerns over the building of systemic risks. An effective regulatory approach to parallel behaviour is, however, extremely difficult to implement, since regulators must have a detailed and deep information basis to compare the strategies of individual banks and understand the risks of counterparties. A mere comparison of figures would in most cases not suffice, since the valuation of risks requires more than using mathematical models or statistical data.[90] Realistically, the most effective means in the long-run to prevent parallel behaviour is strong and undistorted competition in the market.

As far as the systemic risk encapsulated in very large banks is concerned, this issue has already been extensively discussed for a long time. "Too big to fail" or

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[89]This is for example done by Ferguson, *Should Financial Stability be an Explicit Central Bank Objective*, p. 2; http://www.bis.org/events/conf0303/panferg.pdf. Similar approaches by Alexander/Dhumale/Eatwell, *Global Governance of Financial Systems*, 2006, p. 24; Scott, *International Finance; Law and Regulation*, (2nd ed.) 2008, pp. 132–133.

[90]Cf. Hellwig, *Systemic Risk in the Financial Sector. An Analysis of the Subprime-Mortgage Financial Crisis*, 2008, p. 60, http://www.coll.mpg.de/pdf_dat/2008_43online.pdf.

"large complex financial institutions (LCFI)" are usually the catchwords circumscribing the problem.[91] With respect to such banks one faces the following dilemma: large banks are not doing business which *per se* must be considered as riskier than the business of smaller banks. Accordingly, the question whether a bank is sound and resilient does not depend on its size. Rather, the problem posed by large banks is that, *if* they fail, for whatever reason, the adverse effects of their insolvency will automatically affect other institutions. From a regulatory perspective, this could trigger a policy under which the insolvency of a large bank should be prevented at all costs. That this is not a theoretical problem has become obvious since October 2008. The G7 politically agreed on 11 October "to take decisive action and use all available tools to support systemically important financial institutions and prevent their failure".[92] Whereas this policy may be necessary in times of a heavy crisis, the long-term problems should not be neglected. The first question to be raised in this context would be: "Which elements constitute a systemically important bank?" The answer is, so far, absolutely unclear, relevant factors being the size of the bank in relation to the size of the market,[93] or even if the bank is relatively small, its economic relevance for a specific market sector or its interconnection with other institutions.[94] In any event, a regulatory policy aiming specifically at systemically important banks could create moral hazard if it implies the promise to bail out every large bank.[95] Under such an implicit guarantee, banks are induced to increase their risk positions beyond a level they would normally choose. The perverse result is that the instrument which aims at preventing systemic risk effectively increases such risks. Additionally, the economic selection process taking place under conditions of undistorted competition and eventually resulting in an orderly liquidation proceeding[96] will be switched off. Even banks which operate inefficiently are kept alive instead of being wound up. In this dilemma, a solution can only be found by strictly differentiating between times of crisis management and normal periods.[97]

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[91] See for example Cartwright, *Banks, Consumers and Regulation*, 2004, p. 33; Crawford Lichtenstein, The Fed's New Model of Supervision for "Large Complex Banking Organizations", Transnational Lawyer 18 (2004–2005), pp. 283 et seq.; Johnston et al., Large and Complex Financial Institutions, Challenges and Policy Responses – Lessons from Sweden, IMF Working Papers, 2003; http://www.imf.org/external/pubs/ft/pdp/2003/pdp01.pdf.

[92] See http://g8live.org/2008/10/12/g7-announces-plan-of-action-for-finance-crisis/.

[93] Cf. Scott, *International Finance; Law and Regulation*, (2nd ed.) 2008, pp. 131–132.

[94] Lastra, Northern Rock, UK bank insolvency and cross-border bank insolvency, Journal of Banking Regulation 9 (2008), p. 165 (172); Wood, *Law and Practice of International Finance*, University Edition, 2008, p. 342; see also Bank of England, Financial Stability Review, December 2003, p. 92, http://www.bankofengland.co.uk/publications/fsr/2003/fsr15art3.pdf.

[95] Cartwright, *Banks, Consumers and Regulation*, 2004, p. 33.

[96] On the relevance of liquidation proceedings in a market economy, see Lastra, Northern Rock, UK bank insolvency and cross-border bank insolvency, Journal of Banking Regulation 9 (2008), p. 165 (173); Padoa-Schioppa, *Regulating Finance*, 2004, p. 99.

[97] For a comparable solution, see also Report of the High Level Group on Financial Supervision in the EU (de Larosière Group), 25 February 2009, para. 127: "constructive ambiguity".

Finally, technical infrastructure of financial markets may be systemically relevant. In particular, this is the case with payment and settlement systems over which large funds are transferred between banks.[98] Payment systems are also a major channel of international contagion, since shocks can be easily transmitted, e.g. when a market disruption triggers the sudden transfer of assets to a "safe haven". The systemic risk inherent in a payment system is that the default of a participant or the breakdown of the whole system could result in the inability of other participants to meet their obligations as they become due.[99] This in turn could cause widespread liquidity or credit problems which could threaten the stability of the financial system. Against this background, the BIS in 2001 developed ten core principles for systemically important payment systems.[100]

Further Objectives of Financial Markets Regulation

Public Confidence in the Markets

Prudential supervision of financial institutions does not only deal with financial stability and systemic risks but must consider additional, often complementary objectives. One of the central objectives of banking regulations is to create a legal environment in which depositors and investors have confidence in the ability of their business partners to repay amounts when they are due.[101] Apart from very important psychological and macroeconomic factors, this confidence relies on stable and predictable legal provisions governing financial markets. It depends on the ability of supervisors to control and enforce the observance of all relevant legal provisions by financial institutions. Ideally, the legal regime applicable to a financial institution should also foster transparency and reward adequate risk-taking while punishing excessive risk-taking. At least the third condition deserves a caveat if it was understood to require supervisors to monitor each individual business decision. Rather, supervisors focus on reporting obligations by banks, internal risk management strategies and the development of financial figures of an institution and, partly, on macroeconomic conditions. Is it realistic to consider that supervisors should fundamentally change this approach? The answer is probably no, since the instruments necessary to prevent excessive risk taking on the level of individual business decisions would require an in-depth control for which neither sufficient

[98]Cf. Alexander/Dhumale/Eatwell, *Global Governance of Financial Systems*, 2006, p. 24; Lastra, *Legal Foundations of International Monetary Stability*, 2006, pp. 143–145; Padoa-Schioppa, *Regulating Finance*, 2004, p. 108.

[99]See BIS, Committee on Payment and Settlement Systems, Core Principles for Systemically Important Payment Systems, Section 3.01, http://www.bis.org/publ/cpss43.pdf?noframes=1.

[100]*Core* Principles for Systemically Important Payment Systems, Section 3.11 et seq.

[101]Cf. Cartwright, *Banks, Consumers and Regulation*, 2004, pp. 31–32; Wood, *Law and Practice of International Finance*, University Edition, 2008, p. 342.

staff nor detailed economic know-how is available. Even if both conditions were fulfilled, this kind of supervision would threaten to replace private business decisions by public welfare dirigism.

Investor Protection

Promoting financial stability may not be considered in isolation from a second objective of financial market regulation, which is investor protection.[102] It is based on the concept that in financial markets there is a strong information asymmetry between depositors and investors on the one hand, and the financial institutions on the other hand which make use of the deposits and extend credits to borrowers or invest in other assets.[103] For this reason, the central instruments for safeguarding investor protection are the provision of information to investors and enhancement of the transparency of financial businesses in general. The risk of bank failures, with adverse effects on investors, will also be reduced by regulatory capital requirements, which are at the core of banking supervision. The effects of these instruments coincide with the objective of financial stability, as they are meant to induce institutions to deal carefully with the money entrusted to them. In recent years, investor protection has been additionally reinforced by deposit insurance regulations, which aim at protecting small depositors against concrete losses suffered due to the failure of a bank.[104] A second objective of this legislation is to calm down depositors in the advent of a banking crisis, and hence to prevent a bank run which could trigger a systemic crisis.[105] It is highly questionable whether this protection mechanism works in practice since, at least within the EU, the amount guaranteed per depositor is limited to 20,000 Euro.[106] Accordingly, its stabilising effects are relatively small, because there is no coverage for amounts exceeding this limit.[107] If, on the contrary, the insured amounts were higher, this could generate an incentive for banks to take higher risks since they might assume that their

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[102]Expressly mentioned by recitals 5, 46 and 57 of Directive 2006/48 relating to the taking up and pursuit of the business of credit institutions, OJ 2006 L 177 p. 1; see also Follak, International Harmonization of Regulatory and Supervisory Frameworks, in: Giovanoli (ed.), *International Monetary Law*, 2000, p. 291 (309); Padoa-Schioppa, *Regulating Finance*, 2004, p. 97; Wood, *Law and Practice of International Finance*, University Edition, 2008, p. 342.

[103]See for example Cartwright, *Banks, Consumers and Regulation*, 2004, p. 6.

[104]Arrigunaga, Deposit Insurance Schemes: Reconciling Market Discipline with Financial Stability, in: Giovanoli (ed.), *International Monetary Law*, 2000, p. 323 (329–330).

[105]See Arrigunaga, Deposit Insurance Schemes: Reconciling Market Discipline with Financial Stability, in: Giovanoli (ed.), *International Monetary Law*, 2000, p. 323 (329); Cartwright, *Banks, Consumers and Regulation*, 2004, p. 192.

[106]Art. 7(1) Directive 94/19/EC on deposit guarantee schemes, OJ 1994 L 135, p. 5.

[107]For this reason, the EU Commission has proposed to raise the amount to 50,000 Euro, see COM (2008)661 final.

depositors are insured anyway.[108] Another concern refers to the smooth functioning of the deposit insurance scheme in the case of a severe systemic crisis, since it is doubtful whether the resources of the scheme, which in many jurisdictions is operated and funded by the financial institutions themselves, would suffice to cover in a timely manner and completely all amounts due.[109] Its smooth and proper functioning, however, will be essential for the credibility of the deposit insurance scheme and, hence, the stabilising effect on the financial system.

Innovation and Competition

To a certain extent, regulatory law may also be used to develop financial markets. The idea is that the states enacting such legislation enhance the proper functioning of markets or even create new market segments.[110] This may be particularly true in emerging markets,[111] whereas the relevance of this regulatory approach is more limited in mature markets. In any event, state regulation should avoid restricting the innovation and competition processes in financial markets as long as market processes do not threaten other important public interests or individual goods. Innovation may help to solve the problem of risk allocation in financial markets and is, in any event, necessary to react to changing demands of customers. Competition is essential for an effective allocation of capital, and contributes to the growth of markets.[112] It may also contribute to the stability of financial markets by fostering diversification and by selecting risk-adequate business strategies. In the past few years, particular attention has been paid to the regulatory objective of harmonising the conditions of competition. Creating a global "level playing field" was the express aim of the Basel Committee on Banking Supervision,[113] and also in the EU the legislation establishing the internal market for financial services should create equal conditions of competition for financial institutions.[114]

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[108]Arrigunaga, Deposit Insurance Schemes: Reconciling Market Discipline with Financial Stability, in: Giovanoli (ed.), *International Monetary Law*, 2000, p. 323 (pp. 331–332).

[109]See Report of the High Level Group on Financial Supervision in the EU (de Larosière Group), 25 February 2009, paras. 134 et seq., which suggest a pre-funding mechanism.

[110]See Hecker, *Marktoptimierende Wirtschaftsaufsicht*, 2007, pp. 31 et seq.

[111]See Lastra, *Legal Foundations of International Monetary Stability*, 2006, pp. 151 et seq.

[112]Cf for example Cartwright, *Banks, Consumers and Regulation*, 2004, p. 45 et seq.; Mayer, Regulatory Principles and the Financial Markets Services Act 2000, in: Ferran/Goodhart (eds.), *Regulating Financial Services in the 21st Century*, 2001, p. 25 (pp. 31–32).

[113]Basel Committee on Banking Supervision, International Convergence of Capital Measurement and Capital Standards, June 2006, p. 2 (para. 4), http://www.bis.org/publ/bcbs128.pdf?noframes=1; see also McDonough, Speech at a conference on "The Challenge of Credit Risk" in Frankfurt am Main on 24/11/98, BIS Review 102/1998, p. 1.

[114]Recital 5 of Directive 2006/48 relating to the taking up and pursuit of the business of credit institutions, OJ 2006 L 177 p. 1. For a general overview, see Schnyder, *Europäisches Banken- und Versicherungsrecht*, 2005, pp. 1 et seq.

Functions and Instruments of Financial Market Regulation

Crisis Management and Crisis Resolution

Three broad categories must be distinguished in the regulation of financial markets as far as the objective of financial stability is concerned: crisis prevention, crisis management and crisis resolution. The two latter aspects are at the core of current legal attempts to deal with the ongoing turmoil in the markets. Crisis management encompasses a broad range of measures which aim at stabilising markets and rescuing individual institutions. It is the realm of public interventions in the form of liquidity assistance, the provision of guarantees and equity capital, with its reflections in corporate law and insolvency law. As the financial crisis also demonstrated, the level of international coordination with respect to crisis management is low, and confined to an informal political understanding between governments. The reasons for the concentration of crisis management decisions at the level of nation states are simple. First, these measures require a quick reaction which excludes complicated forms of international consensus building. Second, these decisions involve the use of financial resources of an order of magnitude which is a matter for national budgetary authorities, as only these have the possibility to raise taxes or borrow on the market.

If one is to consider the lessons for future crisis management, the first will be that the adverse effect of a systemically important institution threatening to fail should never be underestimated, as the case of Lehman Brothers demonstrates. However, with a view to avoid moral hazard it will be practically excluded that public authorities can *ex-ante* grant a bail-out guarantee to any large or strongly interconnected financial institution. Second, the question of who is lender of last resort (and to what extent) must be answered with respect to the impact on monetary and fiscal policy and the distribution of powers between the central bank and the treasury. As concerns the division of these public functions within the EU, the distribution of competences can be outlined as follows: the ECB is in charge of implementing monetary policy, which also allows it to provide emergency liquidity under its regular instruments pursuant to Article 18 of the Statute of the ESCB and of the ECB. Thus, the ECB is the market-wide lender of last resort for the Eurosystem; however, this is confined to the range of monetary policy instruments under the Statute. Under the provisions of the Statute, it is unclear whether the ECB may also grant liquidity assistance to individual banks in the sense of concrete rescue operations. The Statute does not expressly deal with this question, whereas the EC Treaty confers on the European System of Central Banks, comprising the ECB and the National Central Banks (NCB), the power to contribute “to the stability of the financial system”.[115] This mismatch between Statute and EC Treaty is understood

[115]Article 105(5) EC-Treaty.

as leaving the power to act in individual cases with the NCBs,[116] unless the Governing Council of the ECB stops the performance of this function under Art. 14(4) of the Statute. The EC Treaty limits the powers of the NCBs from another angle: as soon as a financial institution becomes insolvent and applies for the opening of insolvency proceedings, an NCB has to stop financing the reorganisation of this institution. This limitation is derived from Article 101 EC-Treaty, a treaty provision which originally aimed at another situation. Article 101(1) EC Treaty prohibits the financing of public deficits by overdraft facilities or other credit facilities from central banks. The *ratio legis* is designed to prevent risks for price stability in the EMU and to maintain the pressure of fiscal discipline on Member States as provided by Article 104 EC-Treaty.[117] The ECB interprets Article 101(1) very extensively, and demands that "national legislation may not require an NCB to finance either the performance of functions by other public sector bodies or the public sector's obligations vis-à-vis third parties".[118] With respect to rescue operations for financial institutions, the ECB regards the reorganisation of insolvent banks as a public function which, accordingly, may be financed neither by it nor by a National Central Bank.[119] As a consequence, the treasury of a Member State will be the only legal lender of last resort once a financial institution has become insolvent (and not only illiquid). Even if it is difficult to reconcile the wording of Article 101(1) EC Treaty with this extensive interpretation, considered from the point of view of the monetary financing prohibition such an interpretation would make sense. Beyond that prohibition, the EC Treaty requires Member States to comply also with the prohibition of state aid under Article 87(1). The Commission has so far pursued a pragmatic course by exempting national emergency programmes under Article 87(3) EC-Treaty. The exact limitations of European state aid law on national rescue operations in systemic crises, however, still have to be explored.[120]

Crisis Prevention

The most important regulatory questions will have to be raised with respect to future rules for crisis prevention. The essential provisions have been developed by

[116]See Lastra, *Legal Foundations of International Monetary Stability*, 2006, pp. 305–306; critical about this approach, Smaghi, Who Takes Care of Financial Stability in Europe, in: Goodhart, *Which Lender of Last Resort for Europe?* 2000, p. 227 (pp. 240–241); Smits, The Role of the ESCB in Banking Supervision, in: ECB (ed.), *Legal Aspects of the European System of Central Banks*, 2005, p. 199 (205) allocates this function to the ECB exclusively.

[117]Cf. Häde, in: Calliess/Ruffert (eds.), *EUV/EGV*, (3rd ed.) 2007, Article 101, para. 1–5.

[118]ECB, Convergence Report, May 2008, p. 23.

[119]ECB, Convergence Report, May 2008, p. 24.

[120]See, e.g. Arhold, Globale Finanzkrise und europäisches Beihilfenrecht, EuZW (2008), pp. 713 et seq.

the Basel Committee on Banking Supervision during the last 3 decades. Although legally not binding, the recommendations by the Committee are the relevant international standard for banking regulation. Today, they contain a highly sophisticated set of rules for the capital adequacy of internationally active banks, the so-called Basel II Capital Framework of June 2006.[121] Conceptually, Basel II rests on three pillars: the minimum capital requirements, the supervisory review process, and market discipline. The fundamentally new approach of Basel II, compared to its predecessor, the Basel Capital Accord of 1988, was twofold. First, the new provisions should reflect the risk positions of banks more accurately. Second, the capital requirements should, for the first time, not only cover credit risks and market risks but also operational risks.[122] To achieve these approaches, more attention was given to internal risk assessment techniques and internal risk management procedures.[123] They are reflected both in pillar 1 (minimum capital requirements) and pillar 2 (supervisory review process). Under pillar 1, banks that internally develop sophisticated standards of assessing relevant risks (credit risks, market risks, operational risks) may benefit from reductions of the capital requirements, whereas banks that do not dispose of these techniques bear the full capital burden.[124] The rationale is to encourage banks to improve their internal risk assessment and risk management and thereby strengthen the self-responsibility of bank managers and the self-regulation of the whole sector. The tasks of supervisors (pillar 2) accordingly refer to the compliance with capital requirements by banks and the review of their internal processes.[125] Pillar 3, market discipline, conceived as an additional incentive for sound risk management, complements the other pillars. For this effect, Basel II requires the disclosure of all relevant information by the banks (e.g. capital adequacy, amount of risks), as markets may reward good and punish bad bank management.[126]

The regulatory and economic effects of Basel II on the current financial crisis are uncertain. The existing Framework was issued only in July 2004, and transposed by

[121]See http://www.bis.org/publ/bcbs128.htm.

[122]See Basel Committee on Banking Supervision, International Convergence of Capital Measurement and Capital Standards, June 2006, pp. 144 et seq. (paras. 644–683), http://www.bis.org/publ/bcbs128.pdf?noframes=1.

[123]Basel Committee on Banking Supervision, International Convergence of Capital Measurement and Capital Standards, June 2006, pp. 144 et seq. (paras. 644–683), http://www.bis.org/publ/bcbs128.pdf?noframes=1.

[124]Basel II favours the so-called Internal Ratings Based Approach, see Basel Committee on Banking Supervision, International Convergence of Capital Measurement and Capital Standards, June 2006, p. 52 et seq. (paras. 211–537), http://www.bis.org/publ/bcbs128.pdf?noframes=1.

[125]Basel Committee on Banking Supervision, International Convergence of Capital Measurement and Capital Standards, June 2006, p. 204 et seq. (paras. 719–807), http://www.bis.org/publ/bcbs128.pdf?noframes=1.

[126]Basel Committee on Banking Supervision, International Convergence of Capital Measurement and Capital Standards, June 2006, p. 226 et seq. (paras. 808–826), http://www.bis.org/publ/bcbs128.pdf?noframes=1.

the EU in June 2006.[127] The EU directive required the Member States to adopt the necessary laws and regulations by 31 December 2006, which became applicable on 1 January 2007.[128] In the USA, the implementation of Basel II started only in 2006, and has not been fully finalised by 2009.[129] Against this background, it becomes clear that the origins and causes of the financial crises are older than the new provisions. One might even argue that the crisis could have been prevented or at least been smaller in its extent if Basel II had already been implemented in important markets like the USA.[130] Nonetheless, the Basel II framework suffers from shortcomings which are partly due to political restraints in the mandate of the Committee and partly due to conceptual weaknesses.

Basel II does not deal at all with the question of adequate liquidity management, which played a pivotal role in the development of the current financial crisis. For historical reasons it focused on solvency, which is owed to the function of regulatory capital as a risk buffer and quantitative limitation against additional risk taking by the banks.[131] As a first reaction to the financial crisis, the Basel Committee started closing this gap by publishing in September 2008 its "Principles for Sound Liquidity Risk Management and Supervision".[132] The Basel Framework also does not deal at all with the question of supervisory powers of the national authorities, since this is considered to be an exclusive domain of domestic law. Yet the existence of effective, flexible and internationally harmonised supervisory powers will play a central role in the institutional design of financial markets.[133]

Conceptually, the regulatory approach of Basel II concentrates on the risk positions of individual institutions and financial groups, but less on the systemic interconnections within the financial market.[134] Although the drafters of Basel II were aware of the issue of systemic risk,[135] it was not taken into account, for example, that the systemic risk of very large or very interconnected banks is higher than that of smaller banks. One might argue that equal conditions of competition

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[127] Directive 2006/48 relating to the taking up and pursuit of the business of credit institutions, OJ 2006 L 177 p. 1.

[128] Article 157 of Directive 2006/48.

[129] See the information available at http://www.federalreserve.gov/generalinfo/basel2/default.htm.

[130] Horn, *Das Finanzmarktstabilisierungsgesetz und das Risikomanagement zur globalen Finanzkrise*, BKR (2008), p. 452 (456); Report of the High Level Group on Financial Supervision in the EU (de Larosière Group), 25 February 2009, para. 53.

[131] See Ohler, Europäisches Bankenaufsichtsrecht, Derleder/Knops/Bamberger (eds.), *Handbuch zum deutschen und europäischen Bankrecht*, (2nd ed.) 2009, § 76, para. 44.

[132] See http://www.bis.org/publ/bcbs144.pdf?noframes=1.

[133] Report of the High Level Group on Financial Supervision in the EU (de Larosière Group), 25 February 2009, para. 83.

[134] Cf. Hellwig, *Systemic Risk in the Financial Sector. An Analysis of the Subprime-Mortgage Financial Crisis*, 2008, pp. 56 et seq., http://www.coll.mpg.de/pdf_dat/2008_43online.pdf.

[135] See Basel Committee on Banking Supervision, International Convergence of Capital Measurement and Capital Standards, June 2006, paras. 4 and 49 (xvi), http://www.bis.org/publ/bcbs128.pdf?noframes=1.

preclude a differentiated treatment of banks with respect to capital requirements and supervisory review. Yet it should be considered whether a differentiation would be justified due to the different structural risks of the banks. As concerns the reliance of Basel II on internal risk assessment approaches for the calculation of regulatory capital, it seems that the risk of structural flaws in these models is underestimated when, for example, important risk factors are simply not taken into consideration. This is particularly true if risk assessment models focus too much on quantitative historical data, whereas the next systemic crisis will be triggered by an event unforeseen in the model.[136] The same is true for stress-testing models used by supervisory authorities:[137] Even if they are forward-looking, they can only use stress factors already known. Clearly, it is impossible for anybody to consider future, unknown factors in a risk assessment. Yet, if this is the problem of any risk model in general, the question must be raised whether the extent to which Basel II relies on IRBA and privileges banks using them is actually justified.

It should also be discussed whether the minimum capital ratio of 8%[138] is still adequate in a world of complex, fully interconnected global financial markets. Whereas under the initial version of Basel I this ratio covered only credit risks, it was extended later to market risks and now under Basel II also to operational risks. In other words: the growing risk coverage was not countered by a rise in regulatory capital, so the capital available for individual risk positions decreased. Certainly, higher capital requirement would not have prevented the crashes of many banks in the recent crisis, since the write-downs were far greater than the existing capital. This argument does not, however, take into account that the (adequate) level of regulatory capital contributes to the building of confidence by investors which is also reflected in current market expectations. It may also reduce the problem of moral hazard which the "too big to fail" assumption produces, and which was fuelled by the recent crisis management. Hence, higher and perhaps less procyclical minimum capital requirements would seem to have stabilising effects,[139] but they depend on the ability of banks to raise this capital on the market. As there is the threat of competitive inequality and regulatory arbitrage if not all relevant

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[136] Cf. Report of the High Level Group on Financial Supervision in the EU (de Larosière Group), 25 February 2009, para. 61. See also the sharp criticism by Hellwig, *Systemic Risk in the Financial Sector. An Analysis of the Subprime-Mortgage Financial Crisis*, 2008, pp. 51–52, p. 55, http://www.coll.mpg.de/pdf_dat/2008_43online.pdf.

[137] For an overview, see Marcelo/Rodriguez/Rocharte, Stress tests and their contribution to financial stability, Journal of Banking Regulation 9 (2008), pp. 65 et seq.

[138] Basel Committee on Banking Supervision, International Convergence of Capital Measurement and Capital Standards, June 2006, p. 2 (para. 5), http://www.bis.org/publ/bcbs128.pdf?noframes=1.

[139] This is a suggestion coming from many sides; see for example McIlroy, Regulating risks: A measured response to the banking crisis, Journal of Banking Regulation 9 (2008), p. 284 (p. 286, pp. 290–291); Report of the High Level Group on Financial Supervision in the EU (de Larosière Group), 25 February 2009, para. 59. On the deficient equity capital of banks, see also Hellwig, *Systemic Risk in the Financial Sector. An Analysis of the Subprime-Mortgage Financial Crisis*, 2008, p. 43 et seq., http://www.coll.mpg.de/pdf_dat/2008_43online.pdf.

jurisdictions actually implement a higher minimum capital ratio, it is uncertain whether the Committee will be actually prepared to tighten this requirement.

Taken as a whole, Basel II suffers from its extreme complexity, which makes it difficult to apply the regime in jurisdictions with less sophisticated supervisory systems. Due to its complexity it also lacks the flexibility to be adapted to irregular situations. Finally, it does not solve the fundamental problem that capital requirements are considered by banks as something similar to taxes, where the addressees have an interest in avoiding this burden. Even if it was conceived as a system against the avoidance of capital requirements,[140] the complexity of Basel II still induces banks to search for the “holes in the system”. The danger is that a regulatory policy which aims at the punctual steering of every specific risk will suffer from over-complexity and finally lose control over the system as a whole.

Perspectives

The reform of financial market regulation will have to deal with a broad range of problems ranging from monetary policy, financial reporting standards, corporate governance of financial institutions and remuneration schemes to questions of capital adequacy and supervisory control. All in all, the focus on the systemic aspects of financial stability will have to become stronger, since the current crisis disclosed structural shortcomings in this field. Particular attention will have to be paid, even if it has not been discussed in this essay, to the question of how the institutional design of financial supervision should be in the future. Better forms of international cooperation will be necessary, as well as institutions being able to supervise broad market developments and their impact on the financial institutions. However, two things should be born in mind. First, that any regulatory provision, whether reasonable or not, remains useless if the competent authorities are not able or not willing to enforce it effectively. Second, that any institutional design, even if it was ideally structured, will not provide an absolute protection against future crises.

[140]This was a criticism raised particularly against Basel I; see for example Weber/Darbellay, The regulatory use of credit ratings in bank capital requirement regulations, Journal of Banking Regulation 10 (2008), p. 1 (3).

Don Yuan: China's "Selfish" Exchange Rate Policy and International Economic Law

Christoph Herrmann

Introduction

If there is any single character in the history of literature that stands for egoism and selfishness, it is certainly the one of Don Juan, the restless and insatiable lover and seducer of women. If there is any trading nation that is perceived — at least in the United States — to be similarly selfish and insatiable in its conduct of foreign economic relations, it is certainly China, whose currency unit is the yuan, also called renminbi (The People's Money).[1] Given the permanent accusations that are being raised against China for its exchange rate regime for the yuan, one feels inclined to speak of China as the Don Yuan of our times. However, we should be careful with excessively quick answers to a matter that is far more complicated in reality.

Whether the yuan is undervalued or not (and if yes, whether the Chinese exchange rate policy is a breach of the rules of public international law) is of course not a question of romantic literature, but of tough international economic politics, and it is a matter of substantial "monetary power".[2] Political commentators regularly point to the possibility that China could "pull the plug" on the American economy, write off its US dollar reserves and cause the dollar to crash by putting the dollar share of its foreign reserves of about 2 trillion US dollar, approximately 650 billion US dollar in treasury bonds,[3] on the market. The language used in this

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[1] The name of the currency as a whole is Renminbi, the greatest currency unit is the yuan, divided into 10 jiao or 100 fen. The international abbreviation is CNY, the Chinese one is RMB.

[2] Cf. Kirshner, *Currency and Coercion – The Political Economy of International Monetary Power*, 1995, pp. 3 et seq. on the concept of "monetary power".

[3] As of December 2008.

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context is of particular harshness and has a surprisingly military tone: exchange rates are described as “weapons”[4] in a “currency war”,[5] the aforementioned possible dollar sales named the “nuclear option”.[6] Generally, the international economic relations of our times are branded as a “world war for welfare”,[7] nations like China perceived as “aggressors”.[8] Some authors even see the economic policy disputes between the USA and China as a mere forerunner to a military conflict in the future.[9] We should all hope that things will turn out a lot better at the end of the day, but — against this backdrop — we should take the underlying legal questions all the more seriously.

This paper will deal with the question whether the exchange rate regime operated by the People’s Republic of China is contrary to the rules of International Economic Law, or whether it is merely a — maybe selfish but absolutely lawful — way for the Chinese government to pursue an economic policy it deems appropriate for its country for the time being. The questions dealt with in this contribution are, however, not limited to the case of China. Other countries have been accused of exchange rate manipulation as well. In the immediate past, the recent economic downturn caused increased concerns about competitive currency devaluations taking place.

The Chinese Exchange Rate Regime

Until 1978, China applied a strict policy of foreign exchange restrictions and controls as part of the centrally planned economy. Since then, the system was gradually transformed and a dual exchange rate system applied, with a fixed and a market rate existing side-by-side. In 1994, China abolished the dual system and began to formally operate a managed floating, which was in fact a strict peg against the US dollar. Between 1995 and July 2005, China fixed the external value of the yuan against the US dollar at an exchange rate of 8.28 yuan to 1 US dollar. In July 2005 China finally ended the peg, up evaluated the yuan by 2.1% against the dollar

[4]Henning, The Exchange Rate Weapon, Macroeconomic Conflict and Shifting Structure of the Global Economy, EUI RSCAS Working Paper No. 2005/11.

[5]Posen, Avoiding a Currency War, The International Economy (Summer 2004), p. 10.

[6]See, for example, Evans-Pritchard, China threatens “nuclear option” of dollar sales, http://www.telegraph.co.uk, 10 August 2007.

[7]Steingart, *Weltkrieg um Wohlstand*, 2007.

[8]Hirn, *Angriff aus Asien: Wie uns die neuen Wirtschaftsmächte überholen*, 2008.

[9]Susbielle, Chine–USA: La guerre programmée, 2006.

and began a gradual managed evaluation, with continued heavy interventions by the People's Bank of China.[10] The descriptions for this kind of policy extend from a "crawling peg" to a "managed float plus". At the end of 2008, the yuan's dollar value had increased by roughly 20%, with the yuan trading at 6.83 against 1 US dollar. At the same time, with a bilateral monthly trade surplus of 17.5 billion US dollar (September 2008) in its trading relations with the United States, China accumulated foreign reserves of 1.9 trillion US dollar (estimate, October 2008), equating to almost 20% of the United States' public debt. In order to avoid the possible negative domestic effects of the foreign exchange interventions, which go hand-in-hand with a significant increase of the amount of money in circulation and a corresponding inflation threat, China has made huge and largely successful efforts to sterilize the interventions.

From the perspective of exchange rate theory, it is obvious that the yuan is manifestly undervalued. Without the interventions of the People's Bank of China, the massive capital inflow and the record trade surplus could not persist at the same time, neither theoretically nor practically. A floating exchange rate would appreciate until the point where the balance of payments would be equalized, with the current account balance and the capital and financial account balance outweighing each other. However, this would not necessarily mean a decrease in the trade surplus with the USA. With the export price of goods increasing as a consequence of an exchange rate appreciation, the import price of imported raw materials and semi-processed goods would fall, partially outbalancing the price-increasing effect.

International Reactions to China's Exchange Rate Policy

The view that the yuan is manifestly undervalued is shared almost globally. Discussions about the topic have been on the agenda of international economic institutions for several years now. Not only the United States, but also the G7, the

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[10]For a more detailed account of China's exchange-rate policy, see Goldstein, Renminbi Controversies, Cato Journal (2006) 2, p. 251; Goldstein/Lardy (eds.), *Debating China's Exchange Rate Policy*, 2008; Griswold, Who's Manipulating Whom? China's Currency and the U.S. Economy, Cato Institute Trade Briefing Paper No. 23, 11 July 2006; Hale/Hale, Reconsidering Revaluation — The Wrong Approach to the US–Chinese Trade Imbalance, Foreign Affairs (2008) 1, p. 57; Herr, Das chinesische Wechselkurssystem, ApuZ 7/2008, p. 27; Hilpert, Transpazifische Währungskonflikte, SWP-Aktuell 41 (October 2003); Keidel, China's Currency: Not the Problem, Carnegie Endowment for International Peace Policy Brief 39 (June 2005); Lardy, Exchange Rate and Monetary Policy in China, Cato Journal (2005) 1, p. 41; Ogawa, The Chinese Yuan after the Chinese Exchange Rate System Reform, RIETI Discussion Paper Series; 06-E-019 U.S. Department of the Treasury Office of International Affairs, Report to Congress on International Economic and Exchange Rate Policies, December 2008, pp. 16 et seq.; Hartquist/Beckington/Collis, China's Policy of Substantially Undervaluing the Renminbi: A Challenge for the International Monetary and Trading System, Research Paper Prepared by the Trade Law Advisory Group, 15 September 2008, p. 43 et seq.

IMF and the European Union have repeatedly demanded a more flexible and quicker appreciation of the yuan. The G8 Summit 2007 in Heiligendamm, in its Declaration on "Growth and Responsibility in the World Economy", stressed the importance of real exchange rate flexibility for the necessary reduction of global imbalances. The European Union, in its Communication "EU — China: Closer partners, growing responsibilities" describes "[i]ncreasing exchange rate flexibility [as] an important factor, helping rebalance growth towards domestic demand and increasing Chinese households' purchasing power".[11] In a document entitled "EU–China Trade and Investment — Competition and Partnership", the formulations are similar, but more focused on the European Union's interest in the matter: "China's exports to the EU have also benefited from the currency alignment of the Chinese renminbi to the dollar, which has given them an important competitive advantage. China is now moving towards increased flexibility in its currency regime, which should help shift the balance to higher levels of domestic consumption".[12] Consequentially, the European Union has in recent times increased the pressure on China to let the yuan rise more quickly. Similarly, the IMF in its Report for the 2006 Article IV consultations noted that "movement in the renminbi's real value over a considerable period of time has not been in line with most fundamental factors that are generally considered to be important in determining the exchange rate's real value" and that "all of these developments point to the currency as being undervalued and that this undervaluation has increased further since last year's Article IV consultation".[13] In February 2008, the Managing Director of the IMF, Dominique Strauss-Kahn, at the conclusion of his visit to China stated: "On exchange rate policy, we welcome the authorities' objective of allowing greater flexibility over time. However, we encourage a faster pace of appreciation that would be helpful for addressing China's key economic challenges and would also contribute to preserving global economic stability".[14]

The highest political pressure has, however, been exercised by the United States. China's exchange rate policy has been subject of bilateral discussions between the USA and Chinese Governments in different fora, among them the US–China Joint Committee on Commerce and Trade (JCCT), the US–China Joint Economic Committee (JEC) and the US–China Strategic Economic Dialogue (SED). However, China, since having abolished the dual exchange rate regime in 1995, has never been designated as a "currency manipulator" under the Exchange Rates and International Economic Cooperation Act of 1988,[15] even though such a finding would only impose an obligation on the US Secretary of the Treasury "to take action to

[11]COM(2006) 631 final, p. 6.

[12]European Commission, Directorate General External Trade, Global Europe. EU–China Trade and Investment — Competition and Partnership, p. 8, available at http://trade.ec.europa.eu.

[13]IMF Country Report No. 06/394, p. 17, para. 24.

[14]Statement by IMF Managing Director Dominique Strauss-Kahn at the Conclusion of his Visit to China, IMF Press Release No. 08/26, 15 February 2008.

[15]The Exchange Rates and International Economic Policy Coordination Act of 1988 was passed as Title III, Subtitle A of the Omnibus Trade and Competitiveness Act of 1988.

initiate negotiations with such foreign countries" (Sect. 3004 (b)).[16] However, the pressure on China might well increase under the Obama presidency. The then presidential candidate Barack Obama, in a letter to the President of the United States National Council of Textile Organizations, dated 24 October 2008 wrote:

> A fair trading system requires fairness in each country's foreign exchange practices. The massive current account surpluses accumulated by China are directly related to its manipulation of its currency's value. The result is a large imbalance that is not good for the United States, not good for the global economy, and likely to create problems in China itself. China must change its policies, including its foreign exchange policies, so that it relies less on exports and more on domestic demand for its growth. That is why I have said that I will use all diplomatic means at my disposal to induce China to make these changes.

Barack Obama was also a co-sponsor of the "Currency Exchange Rate Oversight Reform Act" as well as the "Fair Currency Act" to which we will get back shortly. In January 2009, the new US Treasury Secretary, Timothy Geithner, explicitly accused China of manipulating its currency and suggested a more confrontational stance towards China.[17] On the other hand, in times of the global financial crisis, the USA is increasingly dependent on the continuous purchase of Treasury Bonds by the Bank of China, which naturally limits the capability of imposing pressure significantly. Furthermore, there seems to remain some scepticism within the new US administration about the right strategy to address the matter. In his hearing before the United States Senate's Committee on Finance, the then USTR nominee Ronald Kirk answered practically all questions regarding China's exchange rate policy identically with very careful wording:

> I appreciate the concerns that you have raised about China's currency practices. The Treasury Department is responsible for issues pertaining to other countries' currency practices, and will make its determination concerning China's currency in its semi-annual report to Congress on international economic and exchange rate policies. If confirmed, I will work closely with the other senior officials in the Administration to develop a comprehensive and integrated policy to address the full range of China's trade policies that impact the United States. As part of this comprehensive effort, of course, we will need to review China's actions for consistency with its WTO obligations. I will aggressively pursue WTO action whenever that approach will be the most effective and appropriate means to address U.S. concerns.[18]

[16] On this topic, see Henning, *Accountability and Oversight of US Exchange Rate Policy*, 2008, pp. 17 et seq.

[17] See Calmes, Geithner hints at harder line on China, International Herald Tribune 23 (January 2009).

[18] See United States Senate Committee on Finance, Hearing on Confirmation of Mr. Ronald Kirk to be United States Trade Representative, 9 March 2009, pp. 45, 61, 62, and 109, available at http://finance.senate.gov/hearings/testimony/2009test/031109QFRs%20for%20SubmissionRK.pdf.

Administrative and Legislative Initiatives in the United States

Whereas governmental reactions to China's exchange rate policy have remained diplomatic in character, a broad coalition of political forces in the United States since 2003 has initiated several administrative and legislative initiatives against the Chinese policy. They all share the view that China's policy is a breach of provisions of the IMF Articles of Agreement and/or provisions of WTO Agreements. However, they propose different courses of action. In the present contribution, we will restrict our considerations to the most important proposals.[19]

The Section 301 Petitions

A course of action taken against the Chinese exchange-rate regime on the basis of existing US trade laws consisted of three petitions for relief under Section 301 of the Trade Act 1974 which were filed by the "China Currency Coalition" or similar flags under which supporters of trade measures against the Chinese exchange rate regime were sailing, in 2004, 2005 and 2007. Section 301 provides for a procedure under which the USTR can take retaliatory action against foreign trade practices deemed "unfair" by the US administration.[20] All three petitions were dismissed by the USTR within the 45-day period provided for. The last petition of 17 May 2007[21] had been supported by 42 members of Congress (the "Bipartisan China Currency Coalition"), and called upon the USTR to request consultations with China under the WTO Dispute Settlement Understanding, claiming that acts, policies, and practices of the government of China had resulted in a significant undervaluation of China's currency, and that the undervaluation amounted to: (1) a prohibited export subsidy under the Agreement on Subsidies and Countervailing Measures and Articles VI and XVI of the GATT 1994, (2) exchange action under Article XV of the GATT 1994 that frustrated the intent of articles I, II, III, VI, XI, and XVI of the GATT 1994, and (3) subsidies that were inconsistent with China's obligations under Articles 3, 9, and 10 of the Agreement on Agriculture. The petition also alleged that these acts, policies, and practices of China violated rights of the United States under Articles IV and VIII of the IMF Statute. The USTR rejected the initiation of an investigation, "because, among other reasons, an investigation would not be effective in addressing the acts, policies, and practices covered in

[19]For an overview of the policy options see Morrison/Labonte, China's Currency: Economic Issues and Options for U.S. Trade Policy, CRS Report for Congress RL 32165, updated 9 January 2008.

[20]For a description and account of Section 301, see Jackson/Davey/Sykes, International Economic Relations, (4th Ed.) 2002, pp. 332 et seq.

[21]Available at http://waysandmeans.house.gov/media/pdf/110/currencypetition.pdf.

the petition".[22] The earlier petitions had been rejected using similar language. Like the Exchange Rates and International Economic Policy Coordination Act of 1988, Section 301 grants significant administrative discretion to the responsible authorities. Most of the legislative initiatives with regard to the "currency problem" can be understood as an effort of the legislature to reduce this discretion and force the administration into action. None of these initiatives has been successful up to early 2009.

The Schumer–Graham Bill of 2003

The first and certainly most prominent legislative initiative was taken by Senators Charles Schumer and Lindsey Graham. In September 2003, they proposed a bill (the so called "Schumer–Graham Bill")[23] which found the Chinese currency to be pegged against the US dollar at an artificially low level, effectively resulting in a significant subsidization of exports and a virtual tariff on imports. The undervalued Chinese currency and the Chinese Government's intervention — in the words of the draft bill — "violate[d] the spirit and the letter of the world trading system" (Sec. 1). In reaction, the draft bill imposed an additional ad valorem duty of 27.5% on "any article that is the growth, product, or manufacture of the People's Republic of China, imported directly or indirectly into the United States" (Sec. 2 (a)) for as long as China did not appreciate its currency to market levels. As a justification, the Schumer–Graham Bill referred to Art. XXI GATT, the national security exception of the GATT, which is of course not designed for situations of exchange-rate manipulation, even if such manipulation did in fact exist.[24] In later congressional sessions, similar versions of the draft bill were reintroduced.

The Ryan–Hunter Bill

A number of legislative initiatives[25] during the 109th and 110th Congress were directed at an amendment to the Exchange Rates and International Economic Cooperation Act 1988. In essence, they redefined the circumstances under which

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[22]See USTR, Trade Policy Agenda and 2007 Annual Report, p. 206 et seq., available at http://www.ustr.gov/Document_Library/Reports_Publications/2008/2008_Trade_Policy_Agenda/Section_Index.html, last accessed on 3 March 2009); see also Federal Register, Vol. 72, No. 161, p. 46688.

[23]S. 1586 [108th], A Bill to authorize appropriate action if the negotiations with the People's Republic of China regarding China's undervalued currency and currency manipulation are not successful.

[24]Denters, Manipulation of Exchange Rates in International Law: The Chinese Yuan, ASIL Insight 118 (November 2003).

[25]For a full summary of all initiatives, see Morrison/Labonte, China's Currency: Economic Issues and Options for U.S. Trade Policy, CRS Report for Congress RL 32165, Updated 9 January 2008, pp. 45 et seq.

a designation of currency manipulation were to be made, but were soft on the consequences, i.e. required only negotiations with the respective country.[26] Other proposals added a mix of different retaliatory measures, such as taking into account the determined currency manipulation in anti-dumping investigations or banning federal procurement of goods and services from the designated country. Another interesting proposal, the "Ryan–Hunter Bill" envisaged the imposition of countervailing duties on all Chinese imports, arguing that the exchange-rate policy pursued by China effectively constituted a prohibited export subsidy on Chinese goods exported into the United States.[27] The legality of such countervailing duties under WTO rules, namely the GATT and the Agreement on Subsidies and Countervailing measures is, however, questionable, as we shall see later.

Currency Manipulations and International Economic Law

Most initiatives taken by US industries inside or outside the United States' Congress build upon the assumption that China's exchange rate policies are in breach of its obligations arising from public international law sources, and that these sources confer a right on the United States to react in a particular way, e.g. by imposing countervailing duties. In the following, we will analyse these allegations, beginning with the general starting point of every public international law analysis, i.e. sovereign equality. We will then turn to obligations regarding exchange-rate policies arising from the Articles of Agreement of the International Monetary Fund (IMF), and to the Agreements entered into under the umbrella of the World Trade Organization (WTO).

Monetary Sovereignty in Public International Law

The power over money has persistently been regarded as one of the core elements of statehood since the development of the notion of "sovereignty" by Jean Bodin.[28] The emergence of national currencies as such, i.e. money that is distinct and exclusive to the territory of a State, is seen as closely related to the formation of

[26]See in particular the Currency Reform and Financial Markets Access Act of 2007 (S. 1677 [110th]).

[27]For a discussion of the proposal, see Bacchus/Shapiro, Re: The Consistency with the WTO Obligations of the United States of H.R. 1498, the Hunter–Ryan bill, Letter to the Chairman of the International Economic Affairs Policy Group, National Association of Manufacturers, 12 September 2006.

[28]Bodin, *Les six livres de la République*, 1583, Chap. X, p. 211 (223).

Nation States in modern times,[29] and the use of the respective legal tender has often been coerced by authorities upon citizens.[30] Money is considered as a symbol of national independence as well as integration and identity. In the words of John Stuart Mill:

> So much barbarism still remains in the transactions of the most civilized nations, that almost all independent countries choose to assert their nationality by having, to their own inconvenience and that of their neighbours, a peculiar currency of their own.[31]

The presumption that an independent state would normally also have its own currency is also implied in the IMF Statute. At its conclusion in 1944, it seemed rather unrealistic that an independent country could opt for not having a currency of its own.[32] Public International Law reflects this general acceptance of the state power over money. According to an often quoted decision of the Permanent Court of International Justice in 1929, "[I]t is indeed a generally accepted principle of public international law that a state is entitled to regulate its own currency".[33] The key legal consequence derived from this *ius cudendae monetae* is that the definition of a state's currency to which a reference may be made in contracts, is solely described by the law of that state, the *lex monetae*.[34] It becomes relevant first and foremost in cases of a currency reform or reconstruction such as the introduction of the Euro. Furthermore, in the absence of specific treaty obligations, there will normally be no basis for a legal challenge of another state's measures to organise its monetary system or of its conduct of monetary policy, as long as this does not interfere with the monetary sovereignty of another state, e.g. by state-controlled counterfeiting of foreign currency. Monetary sovereignty encompasses a number of sovereign rights as well as policy tools.[35] Internally, the state is free to define its unit of account, to issue banknotes and coins and to declare them legal tender, to impose criminal sanctions on counterfeiting, to prohibit the use of other currencies inside its territory, to regulate the money supply and the banking system, and to determine and change the value of its currency. Externally, states may impose exchange restrictions and controls on the flow of capital and

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[29] Helleiner, The *Making of National Money: Territorial Currencies in Historical Perspective*, 2003.

[30] Simmel, *Philosophie des Geldes*, (5th ed.) 1930, p. 173.

[31] Mill, *Principles of Political Economy*, 1848/1909, p. 615.

[32] See Gianviti, Use of a Foreign Currency Under the IMF's Articles of Agreement, in: IMF (ed.), Current Developments in Monetary and Financial Law, Vol. 3, 2005, pp. 817 et seq.

[33] PCIJ, Case concerning the Payment of Various Loans Issued in France, Judgment of 12 July 1929, Series A, No. 20/1, p. 44.

[34] Cf. Proctor, *Mann on the Legal Aspect of Money*, (6th Ed.) 2005, pp. 331 et seq. and pp. 499 et seq.

[35] On these elements, see Gianviti, Current Legal Aspects of Monetary Sovereignty, in: IMF (ed.), Current Developments in Monetary and Financial Law, Vol. 4, 2005, p. 1; Lastra, Legal Foundations of International Monetary Stability, 2006, pp. 22 et seq.; Proctor, *Mann on the Legal Aspect of Money*, 2005, pp. 500 et seq.

payments, opt for a floating or fixed exchange-rate regime, and define the exchange rate vis-à-vis other currencies.

Exchange Rate Disciplines Under the IMF Articles of Agreement

The IMF Articles of Agreement as Legal Backbone of International Monetary Law

The sovereign rights of a state are limited by the provisions of international agreements it has entered into. With regard to monetary sovereignty, the main source for such limitations is the Articles of Agreement of the International Monetary Fund (IMF).[36] With its 185 member countries, the IMF constitutes the virtually universal legal framework for the exercise of monetary sovereignty.[37]

Obligations Regarding Member's Choice of an Exchange Rate System

The IMF Articles' provisions on exchange-rate systems belong to the most important, but at the same time most difficult and complicated provisions of the entire agreement. They are nothing less than decisive for a key feature of the international monetary order. Since the second amendment to the Articles, which came into force in 1978 and was designed to adapt the legal framework to the practice of freely floating exchange rates that had emerged with the breakdown of the par value system in the early 1970s,[38] members of the IMF are in principle free to decide to fix or float the exchange rate of their currency against other currencies (Art. IV Sec. 2 (b) IMF). Even though one of the main purposes of the IMF is "to promote exchange stability, to maintain orderly exchange arrangements amongst members and to avoid competitive exchange depreciation" (see Art. I (iii) IMF), there is "no clearly defined and self-standing legal duty to maintain stable currencies" presently laid down in the IMF Articles.[39]

The diversity of exchange rate systems established by IMF members on the basis of this freedom of choice could hardly be greater. It reaches from choosing a foreign currency as legal tender (so-called "dollarisation", ten IMF members) over currency board arrangements (13 IMF members), other conventional fixed-peg

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[36]On the law of the IMF in general, see Lastra, *Legal Foundations of International Monetary Stability*, 2006, pp. 371 et seq.; Lowenfeld, *International Economic Law*, 2002, pp. 529 et seq.; Proctor, *Mann on the Legal Aspect of Money*, (6th Ed.) 2005, pp. 557 et seq.

[37]A list of the members can be consulted at http://www.imf.org/external/np/sec/memdir/members.htm.

[38]On the fixed exchange regime between 1945 and 1971 and on the transition to the new system, see Lowenfeld, *International Economic Law*, 2002, pp. 524 et seq.

[39]Proctor, *Mann on the Legal Aspect of Money*, 6th Ed., 2005, p. 564.

arrangements (70 IMF members) and managed floating with no predetermined path for the exchange rate (48 IMF members) to independently floating exchange rates [35 (mainly industrialized) IMF members including the Euro area].[40]

The Obligation to "Avoid Manipulating Exchange Rates"

An explicit and "hard" prohibition of "exchange rate manipulation" is laid down in Art. IV Sec. 1 (iii) IMF. According to this proviso "each member shall [. . .] avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members". The interpretation of Art. IV Sec. 1 (iii) is made more complicated by Art. IV Sec. 1 (ii) IMF, which obliges members to "seek to promote stability by fostering [. . .] a monetary system that does not tend to produce erratic disruptions". From the general freedom of choice regarding the exchange rate regime and from the obligation to promote stability, one can derive that intervention in foreign exchange markets as such cannot be a breach of the IMF Articles of Agreement. A currency peg, which is unquestionably legal under IMF rules, cannot be upheld without interventions by the respective monetary authority. The question is, when does a legal and legitimate policy of intervention turn into illegal and illegitimate manipulation? What exactly is meant by the IMF Articles' term "manipulating exchange rates" is not defined by the agreement itself. Moreover, it was left to the IMF bodies to develop a more precise concept of exchange rate manipulation in practice. The only firm conclusion that can be drawn on the basis of Art. IV Sec. 1 (iii) IMF alone is that an objective element ("manipulation of exchange rates") and a subjective element ("in order to") must be fulfilled to qualify an exchange rate policy as illegal under Art. IV Sec. 1 (iii) IMF. A number of interpretative questions are raised by Art. IV Sec. 1 (iii) IMF,[41] among them whether an active behaviour on the part of the alleged "manipulator" is required, whether a movement of the exchange rate is necessary or whether the prevention of movement would suffice, and last but not least which role manifold intentions for the intervention play or how to inquire into the motive of a country.[42]

[40]See International Monetary Fund, Annual Report on Exchange Arrangements and Exchange Restrictions 2007, pp. XXV et seq. On the legal differences between the several types of arrangements, see Proctor, *Mann on the Legal Aspect of Money*, (6th Ed.), 2005, pp. 566 et seq.

[41]See Gianviti, Evolving Role and Challenges for the International Monetary Fund, in: Norton/ Andenas (eds.), *International Monetary and Financial Law upon Entering the New Millennium*, 2002, p. 29 (pp. 38 et seq.); Gold, *Exchange Rates in International Law and Organization*, 1988, pp. 108 et seq.; IMF Legal Department, Article IV of the Fund's Articles of Agreement: An Overview of the Legal Framework, 28 June 2006; Lowenfeld, *International Economic Law*, 2002, pp. 534 et seq.

[42]Cf. Gold, *Exchange Rates in International Law and Organization*, 1988, p. 109.

Exchange Rate Surveillance by the IMF

Legal Foundation of Surveillance

Art. IV Sec. 3 (a) of the Articles of Agreement obliges the IMF to "oversee the international monetary system in order to ensure its effective operation, and [. . .] the compliance of each member with its obligations under Section 1 of this Article". Paragraph (b) empowers the IMF to "exercise firm surveillance over the exchange rate policies of members" and to "adopt specific principles for the guidance of all members with respect to those policies". These principles shall be consistent with cooperative exchange arrangements of IMF members and "shall respect the domestic social and political policies of members". In applying the principles, "the Fund shall pay due regard to the circumstances of members". The IMF members, on this basis, are obliged to provide the Fund with the necessary information and consult with the Fund, when requested, on their exchange rate policies. Surveillance takes place as a bilateral process between the IMF and its members, with an assessment of members' policies by IMF staff and subsequent consultations between the IMF and the monetary authorities of the respective country.[43]

The 1977 and 2007 Decisions on Surveillance

The principles referred to in Art. IV Sec. 2 (b) IMF were initially laid down in the IMF Executive Directors' "Decision on Surveillance over Exchange Rate Policies" of 29 April 1977.[44] The 1977 Decision identified a number of developments that should be "considered" by the Fund and "indicate the need for discussion with a member", with "protracted large-scale intervention in one direction in the exchange market" being the most precise among them. The 1977 Decision served as the legal foundation for 30 years of IMF surveillance practice, which, however, led only twice to ad hoc consultations ("discussions") with members on their exchange rate policies, with Sweden in 1982 and South Korea in 1987.[45] An illegal manipulation of exchange rates was never determined by the IMF in the process of bilateral surveillance.[46] Generally, exchange rate policies played a minor role in the consultation process.[47] Instead, the IMF increasingly focused on other areas of members'

[43]For the practical aspects of surveillance cf. Lastra, *Legal Foundations of International Monetary Stability*, 2006, pp. 399 et seq.; Lowenfeld, *International Economic Law*, 2002, pp. 541 et seq.

[44]Executive Board Decision No. 5392-(77/63).

[45]Goldstein, Currency Manipulation and Enforcing the Rules of the International Monetary System, in: Truman (ed.), *Reforming the IMF for the 21st Century*, 2006, p. 141 (150).

[46]Hufbauer/Wong/Sheth, US–*China Trade Disputes: Rising Tide, Rising Stakes*, 2006, p. 26.

[47]For an assessment of the surveillance practice, see Independent Evaluation Office of the IMF, IMF Exchange Rate Policy Advice, Evaluation Report, 2007.

economic policies, even though the IMF mandate as well as members' obligations in that regard were much weaker. For this reason, the former General Counsel of the IMF, François Gianviti, concluded that Art. IV IMF had been de facto transformed into "soft law".[48]

After a year-long review process,[49] the 1977 Decision was replaced by a new Executive Board "Decision on Bilateral Surveillance over Members' Policies" on 15 June 2007.[50] It "clarifies the concept of exchange rate manipulation in order to gain an unfair competitive advantage over other members".[51] In many ways, the 2007 Decision resembles the 1977 Decision. However, it does also contain some new language that might be the basis for a tighter surveillance over IMF members' exchange rate policies than in the past decades.

Like the 1977 Decision, the 2007 Decision does not impose additional obligations on IMF members. Moreover, it "provides guidance" to the Fund and to members with regard to questions of exchange rate policies and surveillance. In applying the principles, "the Fund will give the member the benefit of any reasonable doubt". More generally, "[m]embers are presumed to be implementing policies that are consistent with the principles". Principle A reiterates the obligation contained in Art. IV Sec. 1 (iii) IMF; the other principles (B through D) are explicitly labelled as containing only recommendations, but confirm the assumption that interventions in exchange markets are not generally prohibited by the IMF Articles of Agreement. Like the 1977 Decision, the 2007 Decision then describes "developments" which the Fund shall consider in its surveillance of observance of the principles by members "as among those which would require thorough review and might indicate the need for a discussion with a member". Whereas the developments described in subparagraphs (i), (iii), and (iv) are identical to those in the 1977 Decision, subparagraphs (ii), (v), (vi) and (vii) are phrased differently and introduce new concepts into the analysis. In subparagraph (ii), the "excessive and prolonged official or quasi-official accumulation of foreign assets" is added; subparagraph (v) lists "fundamental exchange rate misalignments", subparagraph (vi) adds "large and prolonged current account deficits or surpluses" to the indicative

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[48]Gianviti, Evolving Role and Challenges for the International Monetary Fund, in: Norton/Andenas (eds.), *International Monetary and Financial Law upon Entering the New Millennium*, 2002, p. 29 (47).

[49]The following IMF documents contain large parts of the discussions: Review of the 1977 Decision on Surveillance Over Exchange Rate Policies — Preliminary Considerations, 28 June 2006; — Background Information, 30 June 2006; — Summing Up of the Executive Board Meeting, 19 July 2006; — Further Considerations, 11 January 2007; — Summing Up of the Executive Board Meeting, 14 February 2007; — Companion Paper, 22 May 2007; — Proposal for a New Decision Supplement, 13 June 2007; 1 year after the adoption of the 2007 Decision, a further document, entitled Guidance on Operational Aspects of the 2007 Surveillance Decision, 4 August 2008, was published; all documents are available at http://www.imf.org.

[50]See IMF Public Information Notice (PIN) No. 07/69, 21 June 2007.

[51]IMF, Public Information Notice (PIN) No. 07/69, p. 2.

list.[52] Further guidance regarding the meaning of Art. IV Sec. 1 (iii) is contained in an Annex to the 2007 Decision. This annex repeats that "a member will only be acting inconsistently with Article IV, Section 1 (iii) if the Fund determined both that: (a) the member was manipulating its exchange rate [. . .] and (b) such manipulation was being carried out for one of the two purposes specifically identified in Article IV, Section 1 (iii)". Furthermore, the Annex clarifies the meaning of manipulation, stating that a "manipulation of the exchange rate is only carried out through policies that are targeted at — and actually affect — the level of an exchange rate" and that a "manipulation may cause the exchange rate to move or may prevent such movement". Domestic economic and fiscal policies, even if they also may have an effect on the exchange rate, will usually not be "targeted" at it and will therefore be out of the picture. The Annex also contains some guidance regarding the subjective test foreseen in Art. IV Sec. 1 (iii) IMF. According to paragraph 2, subparagraph (b) of the Annex, the intention to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members will require a determination by the Fund that "(A) the member is engaged in these policies for the purpose of securing fundamental exchange rate misalignment in the form of an undervalued exchange rate and (B) the purpose of securing such misalignment is to increase net exports". The last paragraph of the Annex stresses that it is for the Fund to make an objective assessment of whether a member complies with its obligations under Art. IV Sec. 1 (iii) IMF, but that "[a]ny representation made by the member regarding the purpose of its policies will be given the benefit of any reasonable doubt". In sum, the 2007 Decision clarifies the objective test for an exchange rate manipulation significantly. However, it does not — and cannot — waive the need to prove a specific intention on behalf of the alleged manipulator.

Whereas it is clear that China's exchange rate policy fulfils at least some of the "developments" indicating the need for discussion (in particular (i), (ii) and (vi)), it seems much less clear that China would fail the subjective test required by Art. IV Sec. 1 (iii) IMF as clarified by the Annex of the 2007 Decision. As has been pointed out repeatedly, China may have a greater set of reasons for its exchange rate policy than a plain mercantilist export expansion intention, and the macroeconomic and trade effects of the exchange rate policy seem much more complicated than sometimes assumed. Art. IV Sec. 3 (b) IMF directs the Fund to have due regard to possible domestic policy choices. It seems hence still rather unlikely that the IMF would arrive at a clear finding of exchange rate manipulation by the People's Republic of China as forbidden by the IMF Articles of Agreement, even though the likelihood of ad hoc consultations on the matter may have increased.[53]

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[52] The last development (vii) is of not of interest in the case of exchange rate manipulation as discussed in this contribution, but is rather designed for cases such as the Asian crisis of 1997/1998.

[53] Hartquist/Beckington/Collis, China's Policy of Substantially Undervaluing the Renminbi: A Challenge for the International Monetary and Trading System, Research Paper Prepared by the Trade Law Advisory Group, 15 September 2008, p. 23, speculate that such ad hoc consultations might actually be considered at present.

Consequences of a Possible Finding of Exchange Rate Manipulation

Even if the IMF found that China had illegally manipulated its exchange rate in order to gain an unfair competitive advantage, the consequences of such a finding are unclear, at best. In contrast to the WTO legal order or other international economic agreements, the IMF Articles of Agreement do not provide an effective mechanism for solving disputes between IMF members, nor do they grant an effective sanctioning power to the IMF bodies. Within the course of Art. IV consultations, the IMF may address recommendations to the member concerned which arguably would be binding on the member as a part of its obligation to cooperate. However, if the member did not comply with these recommendations, the enforcement power of the Fund is very limited. Art. XXVI Sec. 2 IMF contains a tiered catalogue of possible sanctions that may be applied to members not fulfilling any of their obligations under the IMF Articles of Agreement: a declaration of ineligibility to use the Funds resources (a), a suspension of the voting rights (b) and lastly a request to withdraw from the Fund (c).[54] Whereas options (b) and (c) with their 70% and 85% (super) qualified majorities are very unlikely to be employed against a politically and economically important IMF member like China (possibly to the benefit of the international monetary system), option (a) is an idle threat to countries possessing the largest parts of the world's foreign currency reserves.[55]

As regards disputes between IMF members over the interpretation of the Articles of Agreement, Art. XXIX IMF delegates the authority to give binding interpretations to the IMF Executive Board and the Board of Governors, preceded by a decision of the Committee on Interpretation. However, such interpretation only clarifies the meaning of obligations; it does not enforce them, and the procedure has only been used a few times decades ago. A mechanism of enforcement by retaliation, akin to the WTO's dispute settlement system, is not foreseen in the IMF Articles of Agreement.

Exchange Rate Manipulation and WTO Law

Introduction

Given the inability of the IMF legal system to effectively deal with alleged breaches of its obligations, it is hardly surprising that critics of China's exchange rate policy turn to the WTO, which provides for one of the most effective dispute settlement and enforcement mechanisms in international law. Given the common historical roots of the IMF and the GATT and the possible trade impacts of exchange rates,

[54]For an in-depth analysis of the IMF sanctions regime, see Gold, *Legal and Institutional Aspects of the International Monetary System: Selected Essays*, 1979, pp. 148 et seq.

[55]Staiger/Sykes, "Currency Manipulation" and World Trade, NBER Working Paper 14600, p. 28.

however difficult to quantify they may be, it is also logical to include the WTO legal framework in the analysis. Furthermore, some of the reactions suggested in the United States would use trade contingency measures to counteract China's exchange rate policy. The legality of such a response, however, is governed by the WTO agreements. Two issues must be addressed in that regard. Firstly, does China's exchange rate policy amount to a breach of any provision of the WTO agreements? Secondly, does it qualify as a prohibited, actionable and countervailable export subsidy?[56]

Exchange Rate Manipulation as Breach of Art. XV GATT

The WTO agreements contain numerous provisions that deal with questions of exchange rates, balance of payments and other monetary or financial matters, in particular provisions answering the question as to which exchange rate must be chosen in different situations where calculations of duties etc. are to be made.[57] However, only Art. XV GATT explicitly addresses "exchange arrangements" and "exchange action", but not "exchange rate policies". The central obligation usually referred to in the context of the discussion of exchange rate manipulation is laid down in Art. XV:4 GATT. According to that proviso, "[WTO members] shall not, by exchange action, frustrate the intent of the provisions of this Agreement, nor by trade action, the intent of the provisions of the Articles of Agreement of the International Monetary Fund". Exchange rates do certainly not lie at the heart of the provision's scope, and it is doubtful whether exchange rate policies can be caught by it at all. The prime focus of Art. XV GATT in general is on exchange restrictions and multiple exchange rates, measures with similar effects to those of quantitative restrictions and discriminatory tariffs.[58] Exchange rates have within the framework of GATT traditionally rather been discussed as a source of instability in case of fluctuations.[59] No evidence can be found that an alleged manipulation of an exchange rate has ever been brought before the GATT or the WTO to date.[60]

The lack of positive precedence does of course not preclude the application of Art. XV:4 GATT to a manipulation of an exchange rate which is carried out with a view to increasing exports and reducing imports. However, as has been pointed out

[56]On these different "scenarios" of WTO involvement, see Ciobănaşu/Denters, Manipulation of the Chinese Yuan — May WTO Members Respond? SSRN Working Paper, p. 10, available at http://sssrn.com/abstract=1315290.

[57]For details, see WTO, Note by the Secretariat, WTO Provisions Relevant to the Relationship Between Trade and Finance and Trade and Debt, WT/WGTDF/W/3.

[58]See WTO, Note by the Secretariat, WTO Provisions Relevant to the Relationship Between Trade and Finance and Trade and Debt, WT/WGTDF/W/3, para. 4.

[59]See GATT CONTRACTING PARTIES, Decision L 57/61, November 30, 1984, 31S/15.

[60]Cf. WTO, Note by the Secretariat, WTO Provisions Relevant to the Relationship Between Trade and Finance and Trade and Debt, WT/WGTDF/W/3, pp. 13 et seq.; Jackson, *World Trade and the Law of GATT*, 1969, pp. 479 et seq.

by Denters, the IMF Articles of Agreement differentiate between exchange policies and exchange rate policies.[61] There are good reasons to assume that Art. XV:4 GATT, when speaking of "exchange action", only refers to "exchange policies" in the IMF sense, i.e. the question of convertibility, but not to exchange rate policies. Firstly, Art. XV:1 GATT puts special emphasis on "quantitative restrictions", to which exchange restrictions form the IMF correlate. Furthermore, Art. XV:9 GATT, which provides for an exemption from Art. XV GATT, including its paragraph 4, explicitly speaks of exchange controls and exchange restrictions. Secondly, when the GATT was drafted, there was no need to waste thought on exchange rate manipulation by GATT members, because as IMF members they had to seek the permission of the IMF for changes in the par values of their currencies anyway. These par values, consequentially, serve as the usual reference exchange rates in the GATT (cf. e.g. Art. II:6 (a) and Art. VII:4 (a) GATT).

Even if one considered "exchange action" to embrace a manipulative exchange rate policy as well, it is not clear, the intent of which *GATT* provision[62] could be frustrated by such policy.[63] The only provision that one could argue would be "frustrated" by exchange rate manipulation would be an explicit prohibition of export subsidies. However, such prohibition was not written into the original GATT. The legal constraints to export subsidization imposed by Art. XVI GATT as amended 1955 are not very strong and — something we will return to shortly — define an export subsidy as a subsidy that "results in the sale of such product for export at a price lower than the comparable price charged for the like products to buyers in the domestic market". However, no such effect occurs in the case of exchange rate manipulation, since it does not lead to a price spread between domestic sales and export sales. The same holds true for the alleged frustration of tariff bindings that is put forward occasionally.[64] In contrast to across-the-board tariffs, an exchange rate manipulation does not increase the price of imports in comparison with world market prices, but it translates into higher prices expressed in local currency.

Generally, Art. XV GATT is on the one hand aimed at preserving the competences of the IMF and the WTO vis-à-vis each other; on the other hand, it is inspired by the idea of complementarity and conflict avoidance. Measures legally taken under either regime shall not be forbidden by the other. In case of a dispute initiated by the USA against China claiming an illegal exchange rate manipulation, the Panel and the Appellate Body would thus have to consult the IMF (see in particular

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[61]Denters, Manipulation of Exchange Rates in International Law: The Chinese Yuan, ASIL Insight 118 (November 2003).

[62]There is no legal basis for including other WTO agreements in the circle of provisions which must not be frustrated, as suggested by Staiger/Sykes, "Currency Manipulation" and World Trade, NBER Working Paper 14600, p. 30.

[63]For a discussion of this point, see Hufbauer/Wong/Sheth, *US–China Trade Disputes: Rising Tide, Rising Stakes*, 2006, pp. 17 et seq.

[64]Staiger/Sykes, "Currency Manipulation" and World Trade, NBER Working Paper 14600, p. 30.

Art. XV:1 and Art. XV:2 GATT) with regard to the legality of China's exchange rate regime from an IMF law perspective. The basis for these consultations is laid down in the Agreement between the International Monetary Fund and the World Trade Organization, in particular paragraph 8 thereof.[65] However, such advice could only be sought by a Panel if one considered the exchange rate policy as "exchange action" in the sense of Art. XV:4 GATT. However, the staff reports and other related documents relating to Art. IV IMF consultations may only be communicated under paragraph 11 of the agreement for the confidential use of the WTO Secretariat, and subject to the consent of the member concerned. The discerning of exchange action (paragraph 8), and Art. IV consultations (paragraph 11) further support the view that exchange rate policies are not included in the notion "exchange action".

Exchange Rate Manipulation as Prohibited Export Subsidy

Whereas the provisions on subsidies in the GATT were quite weak, the WTO Agreement on Subsidies and Countervailing Measures (ASCM) entered into under the umbrella of the WTO Agreement explicitly bans export subsidies. However, the similar effect on trade flows that an exchange rate manipulation may have does not necessarily mean that it legally qualifies as a prohibited export subsidy under the ASCM. To be found a prohibited export subsidy under Art. 1, 2 and 3 ASCM, it would be necessary to determine that the Chinese exchange rate policy entails a governmental "financial contribution" (Art. 1.1(a) ASCM) which is "contingent, in law or in fact, upon export performance" (Art. 1.2, 2.3, 3.1 ASCM) and confers a "benefit" on its recipients (Art. 1.1(b) ASCM). As Benitah has concluded, "[c]hallenging China's exchange rate as a subsidy in the WTO would not be easy. Nevertheless, it might be possible in this case to satisfy all three of the WTO criteria for an actionable subsidy". Other commentators' scepticism about the validity of an ASCM claim is more pronounced.[66] Indeed, all three criteria are very difficult to apply to an undervalued exchange rate, as has been discussed

[65] See WTO Document WT/L/195 of 18 November 1996. On this topic, see Ahn, Linkages between International Financial and Trade Institutions, JWT 2000, p. 1; Roessler, The Relationship between the World Trade Order and the International Monetary System, in: Petersmann/Hilf (eds.), *The New GATT Round of Multilateral Trade Negotiations: Legal and Economic Problems*, (2nd ed.) 1991, p. 363; Siegel, Legal Aspects of the IMF/WTO Relationship: The Fund's Articles of Agreement and the WTO Agreements, AJIL (2002), p. 561.

[66] Cf. Bacchus/Shapiro, Re: The Consistency with the WTO Obligations of the United States of H. R. 1498, the Hunter–Ryan bill, Letter to the Chairman of the International Economic Affairs Policy Group, National Association of Manufacturers, 12 September 2006; Hufbauer/Wong/Sheth, *US–China Trade Disputes: Rising Tide, Rising Stakes*, 2006, pp. 20 et seq.; Staiger/Sykes, "Currency Manipulation" and World Trade, NBER Working Paper 14600, pp. 31 et seq.

exhaustively in literature and legal briefs.[67] Firstly, the measures taken by China to operate the accused exchange rate regime do not fall into any of the categories listed as "financial contributions" in the sense of Art. 1.1(a) ASCM. Secondly, it is not entirely clear what benefit is conferred to exporters as a consequence of the undervalued exchange rate. Is it the greater amount of yuan they receive in return for the US dollars which they have earned? But what if they charged yuan prices in the first place? Or is it the greater earnings due to more sales following the lower price? But what if their profits had been higher with fewer sales at higher prices? Thirdly, the "benefit" conferred — if any — is not contingent on export performance, since the exchange rate applies to all sorts of transactions, including transfers for direct investment in China.[68] Furthermore, in the interpretation of Art. 1, 2 and 3 ASCM, a look back at Art. XVI:4 GATT seems useful. This proviso defines export subsidies by reference to a comparison between the domestic and export price. At first glance, this seems to be an anti-dumping logic. However, it is exactly this element of AD-logic that is hidden behind the wording of Art. 3 ASCM. Since an undervalued exchange rate does not confer a benefit to an exporter as compared with an undertaking selling its produce on the domestic markets, the qualification of such a policy as a prohibited export subsidy would be unjustified. If one assumed to the contrary, a WTO panel would be charged with the difficult task of assessing the amount of the benefit conferred. This would include the determination of the "correct" market exchange rate and the amount of undervaluation, an exercise not even the specialised IMF staff truly dares to undertake, given the difficulties in assessing which exchange rate would prevail under a floating regime.[69]

[67]See Benitah, China's Fixed Exchange Rate for the Yuan: Could the United States Challenge It in the WTO as a Subsidy, ASIL Insight 117, October 2003; Ciobănaşu/Denters, Manipulation of the Chinese Yuan — May WTO Beiträge zum Transnationalen Wirtschaftsrecht, Issue 77, Halle, August 2008, pp. 26 et seq.; Members Respond?, SSRN Working Paper, available at http://sssrn.com/abstract=1315290; Franke, Chinas Währungspolitik in der Kritik des US-amerikanischen und des internationalen Wirtschaftsrechts, Hufbauer/Wong/Sheth (eds.), *US–China Trade Disputes: Rising Tide, Rising Stakes*, 2006, pp. 20 et seq.; Staiger/Sykes, "Currency Manipulation" and World Trade, NBER Working Paper 14600, pp. 31 et seq.; Zimmermann, Fundamental Exchange Rate Misalignment and International Law, SSRN Working Paper, available at http://ssrn.com/abract=1300542; For an overview of the different positions expressed on the matter, see A Survey of Views Regarding Whether Exchange-Rate Misalignment Is a Countervailable, Prohibited Export Subsidy Under the Agreements of the World Trade Organization (WTO), April 2007, available at http://www.chinacurrencycoalition.org.

[68]Bacchus/Shapiro, Re: The Consistency with the WTO Obligations of the United States of H.R. 1498, the Hunter–Ryan bill, Letter to the Chairman of the International Economic Affairs Policy Group, National Association of Manufacturers, 12 September 2006.

[69]To use just the most obvious example: The exchange rate between the euro and the US dollar fluctuated between approximately 85 ct = 1 euro and 1,60 US dollar = 1 euro during the last ten years. This amounts to a devaluation of the dollar of almost 50%, which does certainly not completely reflect differences in inflation rates, etc.

A Separate WTO Exchange Rate Agreement?

Given the difficulties in finding a clear prohibition of exchange rate manipulation in the WTO agreements, and the lack of dispute settlement and enforcement mechanisms in the IMF, Mattoo and Subramanian have suggested additional rules to be negotiated and concluded within the framework of the WTO, in order to make WTO dispute settlement available for the enforcement of a prohibition of exchange rate manipulation.[70] Firstly, it seems more than just unlikely that such extra agreement would be concluded under the WTO umbrella, given the consensus requirement applying to WTO decision making.[71] Furthermore, Pascal Lamy, the Director General of the WTO rather seems to disapprove of the idea.[72]

Essentially, the proposal would combine the objective criteria of the definition of exchange rate manipulation already enshrined in the IMF Articles of Agreement and in the 2007 Decision with the enforcement mechanism of the WTO. The responsibility for the determination that an exchange rate is undervalued would remain with the IMF, and a consultation mechanism similar to the one already in place would apply. Within the IMF, the information supplied to the WTO would have to be authorised at a high-level, i.e. by the Managing Directors or the Executive Board. However, from a perspective of institutional decision-making, the proposal seems problematic. Within the IMF bodies that would take the prejudicial decisions whether or not a currency was significantly undervalued, weighted voting rules apply which give the USA by far the greatest voting power. It seems inadequate to outsource a question of such importance and political sensitivity to another institution governed by completely different decision-making procedures, the application of which would — in combination with the negative consensus applying in WTO dispute settlement proceedings — amount to a quasi-automatic condemnation once the misalignment had been found. The institutional design proposed would also deviate significantly from the one we find in comparably sensitive areas, namely the question of WTO compatibility of regional trade agreements.

[70] Mattoo/Subramanian, Currency Undervaluation and Sovereign Wealth Funds: A New Role for the World Trade Organization, Peterson Institute for International Economics, Working Paper WP 08-2, January 2008.

[71] It is worth recalling at this point that China objected to the adoption of the 2007 Decision. However, the weighted voting applied in the IMF did work against China, which — contrary to the US — has no veto power in the institution.

[72] See Reuters India, Leave Currency Surveillance to IMF — WTO head, 23 October 2007, available at http://in.reuters.com.

Conclusion

An analysis of the rules of international economic law applicable to exchange rate policies does not provide a clear-cut or easy answer. Certainly, an argument can be made that China is not entirely in line with its obligations under Art. IV Sec. 1 (iii) IMF, even though there is widespread consensus that it is almost impossible to determine the correct exchange rate for a currency. However, it would be extremely difficult to prove that China is manipulating the exchange rate of the yuan in order to gain an unfair competitive advantage, as required by the IMF Articles of Agreement. Even if a breach of the IMF Articles could be determined, the IMF does not possess effective sanctioning power to enforce the obligations. Such enforcement and sanctioning power rests — to some extent — with the WTO, but even the intentional devaluation or suppression of the exchange rate does not necessarily — as I have tried to point out — infringe the WTO agreements. The US administration is hence well-advised not to take too aggressive a stance towards China on the matter, irrespective of the problem of fiscal dependency.

The analysis hence seems to expose a loophole in the international legal order governing international economic relations. Yet this is only true if one takes adjudicability before the WTO as the only relevant benchmark and does not consider the IMF consultation mechanism as relevant. The reason for this "loophole" is rather easily explainable. When the IMF Articles and the GATT were initially concluded, it was clear that exchange rates would be a matter exclusively dealt with by the IMF under its par value regime. Competitive depreciations seemed unlikely, with the requirement of IMF authorization for devaluations. With the breakdown of the par value regime, matters have become more complicated, and IMF members have gained additional policy options which may also be abused. However, at that time, in the 1970s, enforceable, "hard" rules were not common and it took almost 20 more years to make the GATT more biting. It is hardly surprising that a matter of such enormous political sensitivity and importance is not subject to the same legal review standards as the use of technical trade measures such as quantitative restrictions, customs duties and the like.

Surprisingly enough, the call to drag China before the DSB comes from the United States, which was hitherto not truly known as an enthusiastic supporter of the WTO's dispute settlement and enforcement mechanism and the restrictions on sovereignty deriving from it. Not to mention the unwillingness to subordinate any of its policies to international judicial review. At the end of the day, the exchange rate question may be one of the matters where lawyers must give way and leave the field to diplomacy. The sheer size and paramount importance of the matter puts its justiciability into question. This does not mean that international economic law has no role to play in the matter. The mere existence of rules may already be of influence in diplomatic discussions, since it makes it possible to point at behaviour and label it "illegal", even though this accusation is without legal consequences strictu sensu.

Protection of or Protection Against Foreign Investment?

The Proposed Unbundling Rules of the EC Draft Energy Directives

August Reinisch

Introduction

Recently, there has been a rather intensive debate about mostly national rules restricting the access of foreign investors to certain sectors of the economy, even in OECD countries which have generally been regarded as rather open when it came to admission of foreign investment. As opposed to many developing countries, which often make the admission of foreign investments directly dependent upon individual authorisations, OECD countries have usually pursued a fairly open investment policy. A few have even made market access commitments in bilateral investment treaties (BITs) or in investment chapters of free trade agreements (FTAs).[1] Beyond that, there was the plan to negotiate admission rules within the Energy Charter Treaty[2] and in the WTO context.[3] However, neither forum has been very successful in moving this liberalisation agenda ahead. Instead, a number of recent events evidence a more restrictive trend.

In the USA, legislation has been passed after a series of highly publicised takeover bids by foreign investors in key industry sectors.[4] This new law practically allows the US administration to block the acquisition of US firms by foreign investors for national security reasons. Equally, European States have started to discuss the adoption of legislation directed against foreign investment. Germany, in

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[1]In particular, the USA and Canada have entered into such admission obligations. See *infra* text at note 75.

[2]See *infra* text at note 57.

[3]See *infra* text at note 32.

[4]Foreign Investment & National Security Act of 2007 (FINSA); see also http://www.ustreas.gov/offices/international-affairs/cfius/docs/Summary-FINSA.pdf.

C. Herrmann and J.P. Terhechte (eds.), *European Yearbook of International Economic Law 2010*, European Yearbook of International Economic Law,
DOI 10.1007/978-3-540-78883-6_3,

particular, engaged in a highly public debate about the wisdom of such anti-foreign investment rules.[5]

Less noticed are some recent legislative plans on the European level which contain a *de facto* prohibition of investment by foreigners in particular sectors. A good example is the prohibition for individuals from third countries to control transmission systems or transmission system operators contained in Article 7a of the Draft Gas Directive of September 2007 (hereinafter: Draft Gas Directive)[6] and in Article 8a of the Draft Electricity Directive of September 2007 (hereinafter: Draft Electricity Directive)[7] which form part of the current legislative energy package.[8] The lower degree of public attention received by this legislative proposal is probably linked to the fact that the intended restrictions are rather narrow in scope and have been overshadowed by an intensive debate about the lawfulness of the intended ownership unbundling measures from a fundamental rights perspective, focusing on the question of whether the forced divestment infringes the general principle of the protection of property rights.[9]

These issues will not be pursued here. Instead, the ensuing analysis will focus on the ownership unbundling and flanking measures of the Draft Gas and Electricity Directives which *de facto* imply an investment prohibition in a very specific energy distribution sector.

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[5]See Müller-Ibold, Foreign Investment in Germany — Restrictions based on Public Security Concerns and their Compatibility with EU Law, in this volume, pp. 103.

[6]Draft directive of the European Parliament and of the Council amending Directive 2003/55/EC concerning common rules for the internal market in natural gas, COM(2007) 529 final, 19 September 2007.

[7]Draft directive of the European Parliament and of the Council amending Directive 2003/54/EC concerning common rules for the internal market in electricity, COM(2007) 528 final, 19 September 2007.

[8]The Draft Gas and Electricity Directives were proposed together with a Draft regulation of the European Parliament and of the Council establishing an Agency for the cooperation of energy regulators, COM(2007) 530 final, a Draft regulation of the European Parliament and of the Council amending Regulation (EC) No 1228/2003 on conditions for access to the network for cross-border exchanges in electricity, COM(2007) 531 final, and a Draft regulation of the European Parliament and of the Council amending Regulation (EC) No 1775/2005 on conditions for access to the network for cross-border exchanges in natural gas, COM(2007) 532 final.

[9]See Haslinger, Grundrechtsverletzungen durch ownership unbundling? Wirtschaft und Wettbewerb 57 (2007), pp. 343–350; Kahle, Die eigentumsrechtliche Entflechtung (Ownership Unbundling) der Energieversorgungsnetze aus europarechtlicher und verfassungsrechtlicher Sicht, Recht der Energiewirtschaft (2007), pp. 293–299; Malmendier/Schendel, Unbundling Germany's Energy Networks, Journal of Energy and Natural Resources Law 24 (2006), pp. 362–383; Lecheler/Herrmann, Energierechtliches Unbundling und EG-Wettbewerbsrecht, Wirtschaft und Wettbewerb 55 (2005), pp. 370–379.

Ownership Unbundling According to the Draft Gas Directive

The Draft Gas Directive, together with the Draft Electricity Directive, aims at market liberalisation and at the creation of a competitive energy market. Ownership unbundling, ensuring that energy production and energy distribution are owned by different entities, is regarded a key instrument in preventing market abuse. Thus, ownership unbundling is one of the central devices of the Draft Directives.[10] It is thought to be required in order to guarantee an effective and competitive market. Article 7 Draft Gas Directive provides for ownership unbundling in general; it applies to all persons, i.e. it requires Member States to ensure that all persons, whether European or from third countries, comply with the unbundling rules.[11]

Article 7 Draft Gas Directive provides that persons who own a transmission system may not at the same time directly or indirectly control a production or supply undertaking.[12] "Ownership unbundling" denotes a prohibition addressed to

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[10]Explanatory Memorandum to the Draft directive of the European Parliament and of the Council amending Directive 2003/55/EC concerning common rules for the internal market in natural gas [hereinafter: Explanatory Memorandum], COM(2007) 529 final, 19 September 2007, 2007/0196 (COD), pp. 4 et seq.

[11]Explanatory Memorandum, p. 7 ("[. . .] no supply or production company active anywhere in the EU can own or operate a transmission system in any Member State of the EU. This requirement applies equally to EU and non-EU companies".)

[12]Article 7 Draft Gas Directive ("*Unbundling of transmission systems and transmission system operators*

1. Member States shall ensure that as from [date of transposition plus 1 year]:
   (a) each undertaking which owns a transmission system acts as a transmission system operator;
   (b) the same person or the same persons are not entitled:
      (i) to directly or indirectly exercise control over an undertaking performing any of the functions of production or supply, and to directly or indirectly exercise control or hold any interest in or exercise any right over a transmission system operator or over a transmission system, or (ii) to directly or indirectly exercise control over a transmission system operator or over a transmission system, and to directly or indirectly exercise control or hold any interest in or exercise any right over an undertaking performing any of the functions of production or supply;
   (c) the same person or the same persons are not entitled to appoint members of the supervisory board, the administrative board or bodies legally representing the undertaking, of a transmission system operator or a transmission system, and to directly or indirectly exercise control or hold any interest in or exercise any right over an undertaking performing any of the functions of production or supply;
   (d) the same person is not entitled to be a member of the supervisory board, the administrative board or bodies legally representing the undertaking, of both an undertaking performing any of the functions of production or supply and a transmission system operator or a transmission system.
2. The interests and rights referred to in paragraphs 1(b) shall include, in particular:
   (a) the ownership of part of the capital or of the business assets, or
   (b) the power to exercise voting rights, or

transmission system owners to control production or supply entities and *vice versa*.[13] The prohibition of "control" includes a prohibition from acquiring (through ownership or other forms of control) and a requirement to divest in case of existing combined ownership/control. Though a potential divestment obligation is not expressly mentioned in the Draft Gas Directive such an obligation follows from the obligation of result imposed upon Member States in Article 7 which calls for effective unbundling. The Draft Gas Directive's preamble speaks of "unbundling [...] by direct divestiture".[14] The Commission's Explanatory Memorandum to the Draft Gas Directive is equally clear by referring to the consequence that some energy companies "[...] may be forced to dispose of some of their assets, notably their transmission networks".[15] It is in particular this divestment obligation which has been widely commented on from a fundamental rights perspective, questioning whether it infringes property rights.[16]

The Prohibition of Foreign Transmission System Ownership

While the unbundling obligation of Article 7 Draft Gas Directive and Article 8 Draft Electricity Directive applies to all operators and aims at a separation of the production and supply sector from the transmission sector, the Draft Directives also contain a rather cryptic additional provision which in effect prohibits foreign investors from owning/controlling European gas transmission systems. Apart from the questionable wisdom of such an investment prohibition in general its currently suggested formulation appears rather problematic since its broad exceptions may make the basic rule unworkable.

(c) the power to appoint members of the supervisory board, the administrative board or bodies legally representing the undertaking, or
(d) the right to obtain dividends or other shares of the benefits".)

[13] Cf. Draft Gas Directive, preambular para. 7 ("Member States should therefore be required to ensure that the same person or persons are not entitled to exercise control, including through minority blocking rights on decisions of strategic importance such as investments, over a production or supply undertaking and, at the same time, hold any interest in or exercise any right over a transmission system operator or transmission system. Conversely, control over a transmission system operator should preclude the possibility of holding any interest in or exercising any right over a supply undertaking".)

[14] Draft Gas Directive, preambular para. 11.

[15] Explanatory Memorandum, p. 6 ("In some instances, vertically integrated energy companies may be forced to dispose of some of their assets, notably their transmission networks, or to hand over the operation of such assets to a third party, in order to comply with the proposed requirements of effective unbundling. But there does not appear to be any alternative to the options proposed if we are to ensure the full independence of the TSOs".)

[16] See *supra* note 9.

Article 7a Draft Gas Directive and Article 8a Draft Electricity Directive

The foreign ownership prohibition is almost hidden in Article 7a Draft Gas Directive and Article 8a Draft Electricity Directive which provide as follows:

> Without prejudice to the international obligations of the Community, transmission systems or transmission system operators shall not be controlled by a person or persons from third countries.
> An agreement concluded with one or several third countries to which the Community is a party may allow for a derogation from paragraph 1.[17]

This provision can be understood only in the context of the Draft Directive's broader aim at general ownership of unbundling in the energy field. It must be read in conjunction with Articles 7 and 8 which mandate ownership unbundling of transmission on the one hand, and production and supply activities on the other hand.

Article 7a Draft Gas Directive (and Article 8a Draft Electricity Directive) is a "flanking measure" which is in some respects much more limited but, in one important aspect, broader than Article 7 Draft Gas Directive (and Article 8 Draft Electricity Directive): it only prohibits control of transmission systems and it is only addressed to persons from third countries. However, it is an absolute ban and does not leave it to the choice of the foreign person to decide whether to engage in the transmission systems field or, alternatively, in the production or supply business.

Articles 7a and 8a do not define "control". From the context of this provision and, in particular, from Article 7 and 8[18] one must conclude that it comprises ownership and other forms of control mentioned therein, such as voting rights, the right to decide on the management and the right to obtain dividends and other benefits. This implies that third country persons are prohibited from acquiring and if they already own transmission systems or transmission system operators they have to divest.[19]

Article 7a and 8a are less "ownership unbundling" provisions than prohibitions of foreign ownership in a particular economic sector within the EU, i.e. the gas and electricity transmission systems sector. It is flanking the unbundling provision in the sense that it aims at ensuring that the goal of unbundling will not be circumvented by foreign entities which are more difficult to control. According to the Commission, the "aim is [to] guarantee that companies from third countries respect the same rules that apply to EU-based undertakings in both letter and spirit – not to discriminate against them".[20] Even if this may be the ultimate aim of the Draft Gas

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[17] Article 7a Draft Gas Directive.

[18] See *supra* note 12.

[19] See also Schmidt-Preuß, Energieversorgung als Aufgabe der Außenpolitik — Rechtliche Aspekte, Recht der Energiewirtschaft (2007), p. 281 (285).

[20] Explanatory Memorandum, p. 7.

Directive, the formulation of Article 7a itself is rather clear and discriminatory in so far as it excludes only non-EU nationals from the gas transmissions system sector and not EU firms.

However, Article 7a Draft Gas Directive is not only a flanking measure for effective unbundling; the prohibition of foreign ownership of transmission systems is also perceived as a measure of energy security.[21] Because of its strategic and economic importance, the security and stability of energy supplies is frequently sought through the exclusion or limitation of foreign ownership of industries in this sector.

In substance, Article 7a Draft Gas Directive and Article 8a Draft Electricity Directive mainly aim at preventing third country nationals from owning or controlling transmission systems in the EU. This strict prohibition is, however, subject to two qualifications. Article 7a Draft Gas Directive and Article 8a Draft Electricity Directive contain a proviso ("Without prejudice to the international obligations of the Community") and specify that the Community may derogate from the prohibition by way of concluding international agreements.

The meaning of both qualifications is not entirely clear. In particular, it is unclear whether there are already any Community obligations in existence that may effectively limit the prohibition of Article 7a Draft Gas Directive and Article 8a Draft Electricity Directive. It is equally doubtful whether Article 7a Draft Gas Directive and Article 8a Draft Electricity Directive will have the intended effect if existing international obligations limit their application. Finally, it is unclear how Article 7a Draft Gas Directive and Article 8a Draft Electricity Directive relate to international obligations of EU Member States that may conflict with a prohibition of foreign ownership or control of transmission systems in the EU.

The Proviso in Article 7a Draft Gas Directive and Article 8a Draft Electricity Directive

By not providing a choice whether to control production or supply undertakings instead of transmission systems, Article 7a Draft Gas Directive and Article 8a Draft Electricity Directive provide a stricter rule than Article 7 Draft Gas Directive and Article 8 Draft Electricity Directive). This stricter rule is, however, qualified by the proviso "Without prejudice to the international obligations of the Community". The proviso refers to any "international obligations" but it is likely that this means primarily market access stipulations in treaties of an economic character, since

[21]Draft directive, preambular para. 14 ("Without prejudice to the international obligations of the Community, the Community considers that the gas transmission system sector is of high importance to the Community and therefore additional safeguards are necessary regarding the influence of third countries in order to avoid any threats to Community public order and public security and the welfare of the citizens of the Community. Such measures are also necessary for ensuring compliance with the rules on effective unbundling".)

customary international law does not provide for any right of access to a specific market.[22] In the Explanatory Memorandum to the Draft Gas Directive, the Commission actually mentions "WTO rules" in this context;[23] other similar obligations may be contained in certain investment instruments as well as in international agreements entered into by the Community. In fact, the proviso ("Without prejudice to the international obligations of the Community") raises a number of delicate questions.

If the proviso is meant to exempt from the foreign control prohibition any foreign control protected by any Community treaties it is doubtful whether the prohibition will have the intended effect.[24] At one extreme, it could lead to the paradoxical effect that wherever "international obligations of the Community" exist, the prohibition of foreign ownership of transmission systems would remain ineffective because the "international obligations" would prevail over it. If there are indeed "international obligations" contrary to the intended prohibition on a significant scale this would imply that foreign investors had a right to access transmission systems and that the prohibition remains pointless because they could rely on the proviso.

Another problem of the proviso concerns the scope of the "international obligations" referred to. The proviso speaks of "the international obligations of the Community" and not of the Member States. This limitation may seem surprising since there are potential "international obligations" of Member States that may run counter to the prohibition of foreign ownership of transmission systems. The wording of Article 7a of the Draft Directive and Article 8a Draft Electricity Directive is, however, very clear. It applies only where Community obligations are involved. Also the fact that the Commission appears to be concerned primarily about WTO rules supports the view that this was not a drafting error but a deliberate choice in favour of Community obligations only.

If the proviso does indeed concern "the international obligations of the Community" only and not the obligations of its Member States, this could lead to serious problems for those Member States which have incurred "international obligations" potentially contrary to the foreign ownership prohibition of the Draft Directives.[25] As a result of the EC's freedom of establishment, the problem is not limited to single Member States. Rather, it becomes an EU-wide one. Foreign investors may enter the European gas transmission sector via market access rights in one Member State and then rely upon the freedom of establishment in order to expand into other Member States.[26] Before addressing such problems, it is useful to survey whether there are indeed any "international obligations" of either the Community or the Community's Member States.

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[22]See UNCTAD (ed.), *Admission and Establishment. UNCTAD Series on issues in international investment agreements*, 1999, p. 7; Joubin-Bret, Admission and Establishment in the Context of Investment Protection, in: Reinisch (ed.), *Standards of Investment Protection*, 2008, pp. 9–28.

[23]Explanatory Memorandum, p. 7.

[24]See *infra* text at note 81.

[25]See *infra* text at note 78.

[26]See *infra* text at note 94.

International Obligations Affected by the Draft Directives' Ownership Unbundling Provision Concerning Third Country Nationals

Ownership unbundling as specified in Article 7a Draft Gas Directive (and Article 8 Draft Electricity Directive) means that third country nationals are prohibited from acquiring transmission systems or transmission system operators in the EU and, if they already own or control any such systems, it requires them to divest. These two requirements may conflict with the potentially existing rights of third country nationals to have access to the European gas market and their right not to be expropriated protected by international instruments. It is thus necessary to identify potential sources of such rights.

There are broadly speaking two sets of possible sources of international obligations that may be affected by the intended Community measure of excluding third country nationals from the gas and electricity transmission sector: (1) market access provisions in WTO law, and (2) market access and expropriation provisions in international investment agreements.

WTO Law: GATS

As already mentioned,[27] in its Explanatory Memorandum to the Draft Gas Directive, the Commission refers to "WTO rules"[28] in order to explain what kind of "international obligations of the Community" might be affected by the exclusion of third country nationals from the EU gas transmission sector. Except for this broad and general reference to WTO rules there is no more precise indication which specific rules the Commission considered to be affected by Article 7a Draft Gas Directive.

At present WTO law does not contain any general access provisions for investors from one WTO Member State to the market of another Member State, either in general or in specific sectors, as they can be found in a number of international investment agreements.[29] The GATT regulates trade in goods, the TRIMs Agreement addresses some trade-related investment measures, such as in particular performance requirements, and there are some minor investment relevant provisions in the TRIPs Agreement. Only the GATS contains rules on trade in services including conditioned market access which may be relevant in the present context and will be discussed below.[30]

[27] See *supra* text at note 23.

[28] Explanatory Memorandum, p. 7.

[29] See *infra* text at note 74.

[30] See *infra* text at note 34.

Since the 1996 Singapore WTO Ministerial Meeting there had been plans for a multilateral investment agreement to be added to the existing agreements.[31] In this context, market access may turn out to become a crucial aspect. The 2001 Doha Declaration adopted by the WTO Ministerial Conference indicated that any future WTO agreement on investment would be basically limited to market access obligations softened in accordance with the current GATS-type of positive list commitments.[32] However, these plans have not progressed during recent years. In fact, following a decision in August 2004 these negotiations are currently no longer pursued within the "Doha Round".[33]

GATS Rules on Market Access

At present it is therefore the GATS which may be most relevant. This WTO agreement may include "WTO rules" containing "international obligations of the Community" which could conflict with the ownership unbundling obligation as provided for in Article 7a Draft Gas Directive.

The GATS applies to trade in services provided through four different "modes" – distinguished pursuant to the type of supply of a service. The GATS envisages: (1) "cross border supply", (2) "consumption abroad", (3) "commercial presence", and (4) "presence of natural persons".[34] In particular, "Mode 3" ("commercial presence") is relevant to the right of service providers from one WTO Member State, operating "through commercial presence in the territory of any other Member".[35]

The GATS obliges WTO Member States to treat services from other Members according to certain general "obligations and disciplines", such as most-favoured-nation treatment (MFN) or transparency. However, it does not require them to automatically extend national treatment or to provide market access to services from other Members. These latter obligations both belong to the so-called specific commitments of the GATS which need to be separately agreed upon.

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[31]See Singapore Ministerial Declaration, adopted on 13 December 1996, WT/MIN(96)/DEC, available at http://www.wto.org/english/thewto_e/minist_e/min96_e/wtodec_e.htm.

[32]The Doha Declaration expressly refers to "modalities for pre-establishment commitments based on a GATS-type, positive list approach". Doha Ministerial Declaration, adopted on 14 November 2001, WT/MIN(01)/DEC/1, 20 November 2001, available at http://www.wto.org/english/thewto_e/minist_e/min01_e/mindecl_e.htm, para. 22.

[33]See WTO, Doha Working Programme, Decision adopted by the General Council on 1 August 2004 ("July Package"), WTO Doc. WT/L/579 of 2 August 2004, para. 1 lit. g ("Relationship between Trade and Investment, Interaction between Trade and Competition Policy and Transparency in Government Procurement: the Council agrees that these issues, mentioned in the Doha Ministerial Declaration in paragraphs 20–22, 23–25 and 26 respectively, will not form part of the Work Programme set out in that Declaration and therefore no work towards negotiations on any of these issues will take place within the WTO during the Doha Round".)

[34]See Article I(2) GATS.

[35]Article I(2)(c) GATS.

The GATS uses a “positive list” or “opt-in” approach, whereby Members incur market access obligations only with respect to specific commitments by sector or sub-sector.[36] In sectors where market-access commitments have been undertaken, the Members have to refrain from “limitations on the number of service suppliers whether in the form of numerical quotas, monopolies, exclusive service suppliers or the requirements of an economic needs test”,[37] from limitations on the total value of service transactions[38] or the total number of service operations or the total quantity of service output.[39]

The specific commitments are the result of negotiations between WTO Members and, once agreed upon, will be inscribed in schedules which specify, among others, the “terms, limitations and conditions on market access”.[40] Schedules of specific commitments are an integral part of the GATS[41] and thus binding international obligations.

Specific Commitments on Market Access

WTO Members make their specific commitments according to different types of sectors laid down in the Services Sectoral Classification List[42] prepared by the WTO Secretariat. The EC and its Member States have clarified that in their offers references to individual sectors and sub-sectors are made in accordance with this classification list and other internationally recognised classification.[43] While the Services Sectoral Classification List does not contain any special reference to electricity transmission and distribution services, specific commitments in the gas transmission sector would be expected under “Pipeline transport of fuels” which is found under Sector 11 “Transport Services”, subsector G “Pipeline Transport”.[44]

[36]Article XVI(1) GATS provides: “With respect to market access through the modes of supply identified in Article I, each Member shall accord services and service suppliers of any other Member treatment no less favourable than that provided for under the terms, limitations and conditions agreed and specified in its Schedule”.

[37]Article XVI(2)(a) GATS.

[38]Article XVI(2)(b) GATS.

[39]Article XVI(2)(c) GATS.

[40]Article XX(1)(a) GATS.

[41]Article XX(3) GATS.

[42]Services Sectoral Classification List, MTN.GNS/W/120, 10 July 1991.

[43]See Conditional Initial Offer, Communication from the European Communities and its Member States, TN/S/O/EEC, 10 June 2003, p. 1 [“In this offer, the individual sectors and sub-sectors are identified in accordance with the classification list in Document MTN.GNS/W/120 or other internationally recognised classification (e.g. Financial Services Annex) and corresponding CPC number wherever possible”.]

[44]The reference at this entry of the Services Sectoral Classification List is to No. 7131 of the UN Central Product Classification which refers to “Transportation of petroleum and natural gas”.

To date no specific commitments have been made by the EC in this service field.[45] This corresponds to the 2003 Conditional Initial Offer of the EC and its Member States[46] which did not contain any proposed commitment under the relevant entry "Pipeline Transport".

The Revised Offer of the EC and its Member States from 2005,[47] while containing an entry referring to subsector G "Pipeline Transport", clarified that the Community and its Member States, with limited exceptions for Hungary and Lithuania, did not wish to make any specific commitments with regard to market access in this subsector.[48]

While at present the "WTO rules" referred to in the Commission's Explanatory Memorandum on the Draft Gas Directive[49] do not appear to preclude the application of the exclusion of third country nationals from the gas transmission sector within the EU, it is clear that future commitments made by the EC and its Member States may well trigger the application of the proviso of Article 7a Draft Gas Directive.

Investment Law

Investment law is mainly based on bilateral, to some degree also on multilateral, treaties protecting foreign investments against expropriatory measures as well as other acts harmful to investors by providing for fair and equitable treatment, full protection and security, national and most favoured nation treatment, etc.[50] Only a few investment treaties contain market access obligations; the majority only protect existing investments. Where market access obligations exist, ownership unbundling and, in particular, investment prohibitions as contained in Article 7a of the Draft Gas Directive and Article 8a of the Draft Electricity Directive may become unlawful from an investment law perspective.

Ownership unbundling measures may also be problematic from the point-of-view of the protection against expropriation regularly contained in almost all investment treaties insofar as they require the divestment of existing investments.

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[45] See WTO Services database online http://tsdb.wto.org/wto/WTOHomepublic.htm (last visited 15 January 2009).

[46] Conditional Initial Offer, Communication from the European Communities and its Member States, TN/S/O/EEC, 10 June 2003.

[47] Conditional Revised Offer, Communication from the European Communities and its Member States, TN/S/O/EEC/Rev.1, 29 June 2005.

[48] The offer clarifies that in general all EU Member States should remain unbound with regard to all four modes of supply. With regard to Mode 3 Lithuania has totally liberalised ("None"), while Hungary provides for concession agreements ("Services may be provided through a Contract of Concession granted by the state or the local authority".) TN/S/O/EEC/Rev.1, p. 389.

[49] See *supra* note 23.

[50] See, on investment law in general, Dolzer/Schreuer, *Principles of International Investment Law*, 2008; Muchlinski/Ortino/Schreuer, *The Oxford Handbook of International Investment* Law, 2008; Reinisch, *Standards of Investment Protection*, 2008; Rubins/Kinsella, *International Investment, Political Risk and Dispute Resolution*, 2005.

Most bi- and multilateral investment protection treaties are concluded by individual states, in the case of the EU, by its Member States and not by the EU or EC. However, there are a number of international agreements to which both the EC and its Member States are parties, so-called "mixed agreements", which contain investment provisions. Among such mixed agreements containing rules on investment, the Energy Charter Treaty and various other treaties, such as Partnership and Cooperation Agreements, Stabilization and Association Agreements, as well as some more recent free trade agreements with special investment chapters, deserve special attention in the present context.

Energy Charter Treaty

The Energy Charter Treaty (ECT)[51] is certainly the most important "mixed agreement" which contains investment rules for the energy sector. The ECT came into force in 1998 and is binding for the EC and its Member States, most other European states as well as the successor states of the former Soviet Union, and Japan. As of mid-2007, the ECT is provisionally applied with regard to the Russian Federation and Belarus.[52]

The investment chapter of the ECT applies to any investment by an investor of another ECT Contracting Party associated with an "economic activity in the energy sector", which includes the exploration, extraction, refining, production, storage, land transport, transmission, distribution, trade, marketing or sale of energy materials and products.[53] It contains guarantees against uncompensated expropriation[54] as well as a comprehensive set of investment treatment standards.[55] The national

[51]Energy Charter Treaty, Annex 1 to the Final Act of the European Energy Charter Treaty Conference, 17 December 1994; 34 ILM 381 (1995).

[52]Cf. Energy Charter Secretariat, Status of Membership — Energy Charter Treaty, 8 May 2007, available at http://www.encharter.org/fileadmin/user_upload/document/Public_ratification_Treaty.pdf (last visited 11 January 2009).

[53]Article 1(5) ECT.

[54]Article 13(1) ECT ["Investments of Investors of a Contracting Party in the Area of any other Contracting Party shall not be nationalized, expropriated or subjected to a measure or measures having effect equivalent to nationalization or expropriation (hereinafter referred to as 'Expropriation') except where such Expropriation is: (a) for a purpose which is in the public interest; (b) not discriminatory; (c) carried out under due process of law; and (d) accompanied by the payment of prompt, adequate and effective compensation".]

[55]Article 10(1) ECT ("Each Contracting Party shall, in accordance with the provisions of this Treaty, encourage and create stable, equitable, favourable and transparent conditions for Investors of other Contracting Parties to make Investments in its Area. Such conditions shall include a commitment to accord at all times to Investments of Investors of other Contracting Parties fair and equitable treatment. Such Investments shall also enjoy the most constant protection and security and no Contracting Party shall in any way impair by unreasonable or discriminatory measures their management, maintenance, use, enjoyment or disposal. In no case shall such Investments be accorded treatment less favourable than that required by international law, including treaty obligations. Each Contracting Party shall observe any obligations it has entered into with an Investor or an Investment of an Investor of any other Contracting Party".)

treatment and MFN obligations of the ECT investment rules are, however, restricted to existing investments.[56] Thus, no market access obligations can be derived from them.

Instead, the ECT includes a "soft obligation" for Contracting Parties to "endeavour to grant" national treatment and MFN treatment also to the "making of an investment" by investors of other Contracting Parties.[57] Article 10(4) TEC provides for the conversion of this endeavour clause into a binding rule in a Supplementary Treaty, to be concluded by 1 January 1998. Negotiations on such a Supplementary Treaty were started in 1996, leading to a draft Supplementary Treaty, dated 24 June 1998. However, they have not been concluded so far. In autumn 2002, the ECT Contracting Parties decided to put negotiations on hold pending the outcome of discussions in the WTO on a multilateral framework for foreign direct investment.[58] Thus, the EC has not (yet) incurred any "international obligations" concerning market access in the energy sector under the ECT.

Other Mixed Agreements

There are a number of mixed EC/Member States agreements with third countries which contain investment-relevant access provisions. Among them are Partnership and Cooperation Agreements such as the one concluded in 1997 with the Russian Federation[59] which aims, *inter alia*, at creating "conditions for bringing about freedom of establishment of companies, of cross-border trade in services and of capital movements".[60]

The EC–Russia Partnership and Cooperation Agreement addresses issues of market access via the Community approach of freedom of establishment. It defines "establishment" as "the right of Community or Russian companies [. . .] to take up

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[56]Article 10(7) TEC ("Each Contracting Party shall accord to Investments in its Area of Investors of other Contracting Parties, and their related activities including management, maintenance, use, enjoyment or disposal, treatment no less favourable than that which it accords to Investments of its own Investors or of the Investors of any other Contracting Party or any third state and their related activities including management, maintenance, use, enjoyment or disposal, whichever is the most favourable".)

[57]Article 10(2) TEC ("Each Contracting Party shall endeavour to accord to Investors of other Contracting Parties, as regards the Making of Investments in its Area, the Treatment described in paragraph (3)".)
Article 10(3) TEC ("For the purposes of this Article, 'Treatment' means treatment accorded by a Contracting Party which is no less favourable than that which it accords to its own Investors or to Investors of any other Contracting Party or any third state, whichever is the most favourable".)

[58]Information on the Supplementary Treaty by the Energy Charter Secretariat, available at http://www.encharter.org/index.php?id=33&L=1%2F%5C%5C%5C%27 (last visited 11 January 2009).

[59]Agreement on Partnership and Cooperation between the EC and their Member States and the Russian Federation (hereinafter: EC–Russia Partnership and Cooperation Agreement), Council Decision 97/800/EC, OJ L 327, 1.

[60]Cf. Article 1 EC–Russia Partnership and Cooperation Agreement.

economic activities by means of the setting up of subsidiaries and branches in Russia or in the Community respectively”.[61]

However, the EC–Russia Partnership and Cooperation Agreement does not contain an unqualified right of establishment for companies. Rather, in its provisions on “conditions affecting the establishment and operation of companies”[62] it merely provides for MFN with regard to “conditions affecting the establishment of companies” and makes this also subject to national legislation.[63] Thus, the establishment is conditional on the law in force in the Contracting Parties. The conclusion that there is no unqualified right of establishment is also confirmed by the fact that the national treatment obligation, also contained in the establishment and operation provisions of the EC–Russia Partnership and Cooperation Agreement, only relates to the operation of already established subsidiaries from the other Party.[64] This implies that no right of establishment can be derived from national treatment. In addition, the agreement cautions that the national treatment obligations cannot be used to circumvent a Party’s rules on “access to specific sectors”.[65]

Other EC/Member States mixed agreements do, however, provide already for market access to foreign investors. For instance, in the framework of the 1997 EC–Mexico Economic Partnership, Political Coordination and Cooperation Agreement[66] a certain degree of market access has been achieved through a 2001 decision of the EU–Mexico Joint Council.[67] The decision provides for market access pursuant to an opt-in model similar to the GATS schedules of commitment. The decision contains a number of specific market access commitments in the fields of insurance, banking and other financial services, but it does not seem to cover transport services in general or Pipeline Transport specifically.

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[61] Article 30(a) EC–Russia Partnership and Cooperation Agreement.

[62] Chapter II EC–Russia Partnership and Cooperation Agreement.

[63] Article 28(1) EC–Russia Partnership and Cooperation Agreement (“The Community and its Member States of the one part and Russia of the other part, shall grant to each other treatment no less favourable than that accorded to any third country with regard to conditions affecting the establishment of companies in their territories and this in conformity with the legislation and regulations applicable in each Party”.)

[64] Article 28(2) EC–Russia Partnership and Cooperation Agreement (“Without prejudice to the reservations listed in Annex 3, the Community and its Member States shall grant to Community subsidiaries of Russian companies a treatment no less favourable than that granted to other Community companies or to Community companies which are subsidiaries of any third country companies, whichever is the better, in respect of their operation and this in conformity with their legislation and regulations”.)

[65] Article 28(5) EC–Russia Partnership and Cooperation Agreement (“The provisions of paragraphs 2 and 3 cannot be used so as to circumvent a Party’s legislation and regulations applicable to access to specific sectors or activities by subsidiaries of companies of the other Party established in the territory of such first Party”.)

[66] EC–Mexico Economic Partnership, Political Coordination and Cooperation Agreement, 8 December 1997, entered into force 1 October 2000, OJ L 276 of 28 October 2000.

[67] Decision No 2/2001 of the EU-Mexico Joint Council of 27 February 2001 implementing Articles 6, 9, 12(2)(b) and 50 of the Economic Partnership, Political Coordination and Cooperation Agreement (2001/153/EC), OJ L 070 of 12 March 2001, p. 7.

Market access is also provided for in the 2002 EC/Chile Association Agreement[68] which contains, among others, positive list schedules of commitment in the services sector.[69] In these specific schedules, Chile has indeed made certain market access commitments with regard to "Transportation of fuels" under the heading of "Pipeline Transport".[70] There are, however, no corresponding EC commitments in the EC–Chile Association Agreement.

Based on previous experiences, the Council of the EU adopted in 2006 a Minimum Platform on Investment[71] as a negotiating template for future market access obligations of the EC. Its provisions are meant to be included in future Community treaties with rules on the admission of investments. It "applies to measures by the Parties affecting establishment" and provides that "[w]ith respect to market access through establishment, each Party shall accord to investors of the other Party a treatment no less favourable than that provided for in the specific commitments contained in Annex [. . .]".[72] The system of commitments corresponds to the opt-in model of the GATS as it has also been used in various cooperation and association agreements.

Since the Lisbon Reform Treaty inserts an express Community competence for the conclusion of treaties in the field of foreign direct investment[73] it is likely that

[68]Agreement establishing an association between the European Community and its Member States, of the one part, and the Republic of Chile, of the other part (= EC–Chile Association Agreement), 18 November 2002, OJ L 352 of 30 December 2002, p. 3.

[69]According to Article 97 EC–Chile Association Agreement "[. . .] each Party shall accord services and service suppliers of the other Party treatment no less favourable than that provided for under the terms, limitations and conditions agreed and specified in its Schedule [. . .]".

[70]EC/Chile Association Agreement, p. 1295.

[71]Council of the EU, Minimum Platform on Investment, 15375/06, 27 November 2006. See also Maydell, The European Community's Minimum Platform on Investment or the Trojan Horse of Investment Competence, in: Reinisch/Knahr (eds.), *International Investment Law in Context*, 2008, pp. 73–93.

[72]Council of the EU, Minimum Platform on Investment, *supra* note 71, provisions on Coverage and Market Access.

[73]The new Article 188C Treaty of Lisbon (Article 207 Treaty on the Functioning of the European Union) replacing the existing Article 133 TEC on the Common Commercial Policy provides: "The common commercial policy shall be based on uniform principles, particularly with regard to changes in tariff rates, the conclusion of tariff and trade agreements relating to trade in goods and services, and the commercial aspects of intellectual property, *foreign direct investment*, the achievement of uniformity in measures of liberalisation, export policy and measures to protect trade such as those to be taken in the event of dumping or subsidies. The common commercial policy shall be conducted in the context of the principles and objectives of the Union's external action". (Emphasis added). On the controversy whether this new article comprises a treaty-making power regarding all aspects of FDI or only with regard to some aspects, see Ceyssens, Towards a Common Foreign Investment Policy? — Foreign Investment in the European Constitution, Legal Issues of Economic Integration 32 (2004), p. 3; Karl, The Competence for Foreign Direct Investment — New Powers for the European Union? Journal of World Investment & Trade 5 (2004), p. 3; Krajewski, External Trade Law and the Constitution Treaty: Towards a Federal and More Democratic Common Commercial Policy? Common Market Law Review 42 (2005), p. 91; also see Bungenberg, Going Global? The EU Common Commercial Policy after Lisbon, in this volume, p. 123.

such external treaty-making power will also be used soon after the entry-into-force of the Reform Treaty.

It is to be expected that future EC treaties based on the Minimum Platform on Investment will contain market access obligations of the Community, some of which may cover the field of gas transmission services. This will activate the proviso of Article 7a Draft Gas Directive and imply that the prohibition of control by non-EU nationals will be curtailed vis-à-vis nationals benefiting from such market access rights.

Market Access Provisions in Bilateral Investment Treaties

Market access or the liberalisation of the admission of foreign investment is not regularly provided for in all investment instruments. In fact, it is a typical feature of USA as well as Canadian BITs and it is regularly included in the more recent BITs of Australia. However, market access is usually not part of the BITs concluded by European States.[74]

The typical market access provision in USA or Canadian BITs – based on their respective Model BITs –, which protects foreign investors not only in the post-establishment but also in the so-called pre-establishment phase, is formulated as follows:

> Each Party shall accord to investors of the other Party treatment no less favourable than that it accords, in like circumstances, to its own investors with respect to the *establishment, acquisition, expansion,* management, conduct, operation and sale or other disposition of investments in its territory.[75]

The inclusion of establishment in the national treatment obligation implies that the host State of the investment is under a legal obligation to admit foreign investors.[76] This obligation may be limited by specific, usually sector-wide, exceptions that may be made pursuant to an annex of a BIT.

In contrast to this open market access for foreign investment, European States usually impose on host States only obligations on the treatment of investments already made. MFN and national treatment clauses in such BITs regularly do not extend to the "establishment", "acquisition", or "expansion" of investments. Instead, they provide that the admission of foreign investment is subject to the

[74]See Pollan, *Legal Framework for the Admission of FDI* (2006), pp. 76 ff; see also Gómez-Palacio/Muchlinski, Admission and Establishment, in: Muchlinski/Ortino/Schreuer (eds.), *The Oxford Handbook of International Investment Law*, 2008, pp. 227–258.

[75]Article 3(1) 2004 US Model BIT; Article 3(1) 2004 Canadian Model BIT.

[76]See Joubin-Bret, Admission and Establishment in the Context of Investment Protection, *supra* note 22.

host State's laws and regulations. This is expressed, for instance, in the 2004 German Model BIT which provides:

> Each Contracting State shall in its territory promote as far as possible investments by investors of the other Contracting State and admit such investments in accordance with its legislation.[77]

Specific Market Access Obligations of EU Member States

However, this seemingly uniform European abstention from any admission or market access obligations in BITs has been eroded recently by the practice of states like Italy which have included market access provisions in their BITs.

For instance, the 2004 Italy–Nicaragua BIT[78] gives investors of one Contacting Party the right of access to investment activities in the other Contracting Party on a national treatment basis. Pursuant to Article I(9) of the Italy–Nicaragua BIT:

> The term "right of access" shall mean the right to invest in the territory of the other Contracting Party, without prejudice to any limitations stemming from international agreements, which are binding for either Contracting Party.

Article II(2) Italy–Nicaragua BIT provides:

> Investors of either Contracting Party shall have the right of access to investment activities in the territory of the other Contracting Party, which shall be not less favourable than that under Article III, paragraph 1.

Article III(1) Italy–Nicaragua BIT states the national treatment and MFN obligation in the following terms:

> Both Contracting Parties, within their own territory, shall offer investments effected by, and income accruing to, investors of the other Contracting Party no less favourable treatment than that accorded to investments effected by, and income accruing to, its own nationals or investors of Third States. The same treatment will be granted to the activities connected with an investment.

Equally, some BITs concluded by "new" EU Member States with countries following a "liberal" market access approach contain admission obligations. For instance, the 1995 US–Latvia BIT[79] provides for market access to investors by

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[77]Article 2(1) 2004 German Model BIT.

[78]Agreement between the Government of the Republic of Nicaragua and the Government of the Italian Republic on the Promotion and Protection of Investments, 20 April 2004, available at http://www.unctad.org/sections/dite/iia/docs/bits/italy_nicaragua_it.PDF.

[79]Treaty between The Government of the United States of America and The Government of the Republic Latvia Concerning the Encouragement and Reciprocal Protection of Investment, 13 January 1995, available at http://www.unctad.org/sections/dite/iia/docs/bits/us_latvia.pdf.

extending national and MFN treatment not only to the treatment of investments already made but also to the admission of such investments.[80]

The Implications of Such Market Access Obligations

Such market access provisions in BITs of single EU Member States may have far-reaching consequences for the entire EU, and not only with regard to investment coming from the specific treaty partner of the individual EU Member State.

Since BITs apply to investors from either Contracting Party which, in the case of legal persons, are usually merely defined as persons incorporated or having their seat in either Contracting Party, it may be possible for non-EU investors to qualify as protected investors through setting up the appropriate subsidiaries.

While it is not very likely that ordinary investors from Nicaragua may want to invest in the European gas transmission systems or transmission system operators, such investments might be attractive for investors from third countries which could benefit from the market access provision in the Italy–Nicaragua BIT. Third country investors could come under the protection of the Italy–Nicaragua BIT by channelling their investment through a Nicaraguan company. If investors from third countries set up a lawful subsidiary in a treaty partner of Italy, this subsidiary will enjoy the protection of the BIT concluded with Italy.

This form of "treaty-shopping" is not infrequent in international investment law and, although concerns have been voiced, it is usually not excluded by the applicable BIT provisions.[81] If, for instance, a Russian company establishes a

[80]Article II US–Latvia BIT provides: "1. Each Party shall permit and treat investment, and activities associated therewith, on a basis no less favorable than that accorded in like situations to investment or associated activities of its own nationals or companies, or of nationals or companies of any third country, whichever is the most favorable, subject to the right of each Party to make or maintain exceptions falling within one of the sectors or matters listed in the Annex to this Treaty [...]". While the USA has made a reservation concerning the "energy and power production" sector in the annex mentioned in Article II(1), Latvia has not done so.

[81]See ICSID Case No. ARB/02/3, *Aguas del Tunari S.A. v. Republic of Bolivia*, Decision on Jurisdiction, 21 October 2005, para. 330, which permitted "BIT shopping" for purposes of availing oneself of BIT arbitration. ("It is not uncommon in practice, and — absent a particular limitation — not illegal to locate one's operations in a jurisdiction perceived to provide a beneficial regulatory and legal environment in terms, for example, of taxation or the substantive law of the jurisdiction, including the availability of a BIT".) The *Aguas del Tunari* tribunal found that it was not necessary to show that a company actually participated in the management of the Bolivian subsidiary. Rather, through its ownership interest it exercised control over its subsidiary, satisfying the nationality test under the BIT. In upholding jurisdiction, the tribunal concluded that "the language of the definition of national in many BITs evidences that such national routing of investment is entirely in keeping with the purpose of the instruments and the motivations of the state parties". *Ibid.*, para. 332.

Nicaraguan subsidiary with its seat in Nicaragua it will qualify as a "legal person"[82] which as a Nicaraguan "investor"[83] will enjoy the right of market access in Italy described above.

In addition to the "treaty-shopping" option, there is another possible legal reason why non-EU nationals other than nationals of a BIT partner may claim market access rights in EU Member States as a result of market access provision in their BITs. Nationals of other BIT partners of EU Member States may be able to rely on MFN clauses in order to invoke such market access.

MFN clauses in BITs typically provide that a state accord to the nationals of the other Contracting State treatment that is no less favourable than that which it accords to nationals of third states.[84] Whether such MFN obligations relate only to the substantive treatment of investments or also to dispute settlement provisions regularly contained in BITs has proved to be a highly contentious issue. In *Maffezini v. Spain*[85] an investment tribunal held that a claimant was entitled to rely on more favourable dispute settlement provisions than those contained in the Argentina–Spain BIT as a result of the MFN clause contained in the latter treaty. This approach was adopted by a number of subsequent tribunals,[86] while other tribunals have sharply rejected it.[87]

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[82]Pursuant to Article I(4) of the Italy–Nicaragua BIT: "The term 'legal person', with reference to either Contracting Party, shall mean any entity having its head office in the territory of one of the Contracting Parties and recognized by it, such as public institutions, corporations, partnerships, foundations and associations, regardless of whether their liability is limited or otherwise".

[83]Pursuant to Article I(4) of the Italy–Nicaragua BIT: "The term 'investor' shall mean any natural or legal person of a Contracting Party investing in the territory of the other Contracting Party as well as any foreign subsidiaries, affiliates and branches controlled in any way by the above natural and legal persons".

[84]See Ziegler, Most-Favoured-Nation (MFN) Treatment, in: Reinisch (ed.), *Standards of Investment Protection*, 2008, pp. 59–86; Acconci, Most-Favoured Nation Treatment and International Law on Foreign Investment, in: Muchlinski/Ortino/Schreuer (eds.), *The Oxford Handbook of International Investment Law*, 2008, pp. 363–406; Dolzer/Myers, After Tecmed: Most-Favored-Nation Clauses in Investment Protection Agreements, *ICSID Review – Foreign Investment Law Journal*, 19 (2004), pp. 49–60.

[85]ICSID Case No. ARB/97/7, *Emilio Agustín Maffezini v. Kingdom of Spain*, Decision on Jurisdiction, 25 January 2000, 5 ICSID Reports 396 (2002).

[86]ICSID Case No. ARB/AF/00/2, *Technicas Medioambientales Tecmed S.A. v. Mexico*, Award, 29 May 2003, 43 ILM 133 (2004); ICSID Case No. ARB/02/8, *Siemens A.G. v. The Argentine Republic*, Decision on Jurisdiction, 3 August 2004, 44 ILM 138 (2005); ICSID Case No. ARB/03/10, *Gas Natural SDG, S.A. v. Argentina*, Decision on Preliminary Questions on Jurisdiction, 17 June 2005.

[87]ICSID Case No. ARB/03/24, *Plama Consortium Ltd. v. Bulgaria*, Decision on Jurisdiction, 8 February 2005, 44 ILM 721 (2005); ICSID Case No. ARB/02/13, *Salini Costruttori S.p.A and Italstrade S.p.A v. The Hashemite Kingdom of Jordan*, Decision on Jurisdiction, 29 November 2004, 44 ILM 573 (2005); ICSID Case No. ARB/04/15, *Telenor Mobile Communications A.S. v. Republic of Hungary*, Decision on Jurisdiction, 13 September 2006, also see Ziegler, The Nascent International Law on Most-Favored-Nation (MFN) Clauses in Bilateral Investment Treaties (BITs), in this volume, p. ##.

The precise scope of an MFN clause depends primarily on its exact wording. A MFN clause such as the one in the Argentina–Spain BIT referring to "all matters subject to this Agreement"[88] is certainly very broad. Other MFN provisions are much more restrictive. They may for instance directly relate to a substantive treatment standard such as fair and equitable treatment[89] or they may specifically define the situations to which MFN relates, typically listing "the establishment, acquisition, expansion, management, conduct, operation, and sale or other disposition of investments".[90]

Whether MFN can be successfully relied upon in order to invoke more favourable market access or establishment provisions in other BITs will thus largely depend upon the wording of the applicable BIT. To date this issue has apparently not yet been decided by investment tribunals.

Where MFN clauses also refer to "establishment, acquisition, expansion" it is safe to conclude that MFN treatment extends to market access or establishment, i.e. to rights normally related to the pre-establishment phase of foreign investment. Where MFN clauses only refer to the "management, maintenance, use, enjoyment or disposal of their investments"[91] it seems correct to assume that investors cannot rely on more favourable market access provisions in other BITs.

While MFN clauses relating to the pre-establishment phase are standard in US BITs they can be found less frequently in BITs of EU States. However, there are a number of examples where in particular "new" EU States have entered into such MFN commitments. For instance, the Canada–Latvia BIT expressly grants market access to foreign investors by extending national treatment and MFN treatment also with regard to establishment and acquisition.[92] Since Latvia has already granted

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[88]Article IV(2) of the Argentina–Spain BIT provides: "In all matters subject to this Agreement, this treatment shall not be less favorable than that extended by each Party to the investments made in its territory by investors of a third country".

[89]See, e.g. Article 3(1) Lebanon–Italy BIT ("Each Contracting Party shall ensure fair and equitable treatment within its territory of the investments of the other Contracting Party. This treatment shall not be less favourable than that granted by each Contracting Party to the investments made within its territory by its own investors, or than that granted by each Contracting Party to the investments made within its territory by investors of any third State, if this latter treatment is more favourable".)

[90]See, e.g. Article 4(2) 2004 US Model BIT ("Each Party shall accord to investments of investors of another Party treatment no less favorable than that it accords, in like circumstances, to investments of investors of any other Party or of a non-Party with respect to the establishtment, acquisition, expansion, management, conduct, operation, and sale or other disposition of investments".)

[91]See, e.g. Article 3(2) Hong Kong–Italy BIT ("Each Contracting Party shall in its area accord investors of the other Contracting Party, as regards their management, maintenance, use, enjoyment or disposal of their investments, treatment not less favourable than that which it accords to its own investors or to investors of any other State, whichever is more favourable to the investor concerned".)

[92]Article II(3) Canada–Latvia BIT ("Each Contracting Party shall permit establishment of a new business enterprise or acquisition of an existing business enterprise or a share of such enterprise by investors or prospective investors of the other Contracting Party on a basis no less favourable than

market access to US investors in the US–Latvia BIT[93] such market access can also be demanded by Canadian investors.

As a result of such market access provisions in the BITs of some EU Member States foreign companies have a right to set up subsidiaries in those EU Member States. Once foreign investors own subsidiaries in one of the EU Member States these subsidiaries may set up further branches and/or subsidiaries anywhere in the Community relying on the freedom of establishment.[94]

The Ownership Prohibitions of the Draft Energy Directives and the "International Obligations" of Member States

As outlined above, international obligations of Member States that may be contrary to the market access prohibition of Article 7a Draft Gas Directive and Article 8a Draft Electricity Directive are not covered by the express proviso which refers to the "international obligations of the Community".[95] Thus, there would be no exemption from the exclusion of third country nationals from the gas transmission system sector. Rather, the market access prohibitions of Articles 7a and 8a of the Draft Directives would apply and require Member States to adopt implementing legislation which would conflict with international legal obligations — at least in the case of some of them.

From the perspective of EC law, this conflict would have to be solved according to the principle of supremacy.[96] Supremacy of EC law requires the application of the Community law rule, in the present context of Article 7a Draft Gas Directive and Article 8a Draft Electricity Directive; at the same time the conflicting national law that may be based on international commitments must be disregarded.

Such a Community law solution does not alter the fact that, from an international law perspective, the violation of BIT obligations leads to the international responsibility of the Member State having entered into specific market access

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that which, in like circumstances, it permits such acquisition or establishment by (a) its own investors or prospective investors; or (b) investors or prospective investors of any other state".)

[93]See *supra* text at note 80.

[94]Cf. Article 43 TEC ("Within the framework of the provisions set out below, restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State shall be prohibited. Such prohibition shall also apply to restrictions on the setting-up of agencies, branches or subsidiaries by nationals of any Member State established in the territory of any Member State. Freedom of establishment shall include the right to take up and pursue activities as self employed persons and to set up and manage undertakings, in particular companies or firms within the meaning of the second paragraph of Article 48, under the conditions laid down for its own nationals by the law of the country where such establishment is effected, subject to the provisions of the Chapter relating to capital".)

[95]See *supra* text at note 23.

[96]Cf. ECJ, Case 6/64, *Flaminio Costa v ENEL*, [1964] ECR, 585; ECJ, Case 11/79, *Internationale Handelsgesellschaft*, [1970] ECR, 1125; ECJ, Case 106/77, *Amministrazione delle Finanze dello Stato v Simmenthal SpA*, [1978] ECR, 629.

commitments. Concurrent conflicting obligations — such as those under the EC Treaty — cannot be relied upon to absolve a Member State from its international obligations.[97]

Since the prohibition of Article 7a Draft Gas Directive and Article 8a Draft Electricity Directive are still formulated in draft versions, EU Member States which have already made market access commitments to third countries may want to avoid incurring international responsibility by urging a change to the text of the present draft. One possible way of avoiding a conflict between contradictory obligations would be to insert the words "or its Member States" after the word "Community" in the first sentence and to insert the words "or one of its Member States" after the word "Community" in the second sentence of the draft articles. The amended text of this article would then provide:

> Without prejudice to the international obligations of the Community *or its Member States*, transmission systems or transmission system operators shall not be controlled by a person or persons from third countries. An agreement concluded with one or several third countries to which the Community *or one of its Member States* is a party may allow for a derogation from paragraph 1.

Such a formulation would ensure that EU Member States that have already anticipated the trend of opening their markets will not have to violate their international obligations by implementing a market restrictive directive.

At the same time, the broadening of the material scope of the proviso by including Member States' international obligations would further weaken the intended effect of Article 7a Draft Gas Directive and of Article 8a Draft Electricity Directive, i.e. to prevent foreign control of gas and electricity transmission systems in Europe. It would open additional loopholes for third country nationals wishing to enter the European energy transmission sector.

This again demonstrates that the investment prohibition inherent in Article 7a Draft Gas Directive and Article 8a Draft Electricity Directive may not be the wisest choice from a policy perspective because the exceptions may make the rule unworkable.

Conclusions

The specific ownership unbundling provision of Article 7a Draft Gas Directive and Article 8a Draft Electricity Directive prohibits non-EU nationals from owning or controlling gas and electricity transmission systems in Europe. This prohibition is qualified by a proviso which effectively exempts third country nationals if "international obligations" of the Community give them a right of access to these market sectors.

Such internationally protected rights may be contained in WTO law, in particular within the framework of the GATS, or in other areas of international economic

[97]See SCC Case No. 088/2004, *Eastern Sugar B.V. v. Czech Republic*, 12 March 2007.

law. At present, the Community has not made any firm commitments of market access in the gas transmission sector pursuant to the GATS negotiations. Since the GATS aims at liberalizing trade in services such commitments may be made in the future.

Also the Energy Charter Treaty does not include market access obligations of the Community. A planned agreement on market access has been put on hold by the Contracting Parties of the Energy Charter Treaty.

At present, in addition, various other mixed agreements concluded by the Community and its Member States do not seem to include any firm market access commitments in the energy transmission sector. However, the increased activity of the Community in the field of investments and services — as evidenced by the 2006 Minimum Platform on Investment and the new Treaty provisions on the conclusion of agreements in the field of foreign direct investment — make future obligations of this kind likely.

To a limited extent EU Member States have made market access commitments in a binding way. Though such undertakings — mainly in bilateral investment treaties — are rare, they may have broad implications as a result of the free movement of establishment, services and capital which would allow a third country investor to move freely within the Community once its has lawfully established a subsidiary in any one Member State.

Such Member States' obligations are not covered by the express *proviso* of Article 7a Draft Gas Directive and Article 8a Draft Electricity Directive which refers to the "international obligations of the Community". Thus, there would be no exemption from the exclusion from the gas transmission system sector. Rather, the market access prohibition of the directives would apply and lead to a conflict with national legal obligations pursuant to international law.

From the perspective of EC law and national law, this conflict would have to be solved according to the principle of supremacy, i.e. the EC law prohibition of the directives would apply. From an international law perspective, the violation of BIT obligations leads to the international responsibility of the Member State having entered into market access commitments.

The Nascent International Law on Most-Favoured-Nation (MFN) Clauses in Bilateral Investment Treaties (BITs)

Andreas R. Ziegler

Introduction

> The divergent interpretations of the most-favoured-nation clause continue to cause difficulties, and it may be necessary to reconsider the view expressed by the League of Nations Committee of Experts that the subject, which it discussed in detail on the basis of a thorough report, can be best dealt with by way of bilateral agreements.[1]

> [T]he "law" on MFN clauses is, in part, in a nascent stage of development — which is why there are such divergent responses by different ad hoc Committees to different MFN Clauses (and sometimes even similarly worded MFN clauses) in Bilateral Investment Treaties.[2]

Despite early calls after World War II for a need to clarify the scope of MFN clauses in international treaties, this general debate remained rather silent since the International Law Commission suspended its work on the issue in the mid 1970s.[3] With regard to bilateral investment treaties (BITs), clauses relating to Most-Favoured-Nation (MFN) treatment did not give rise to any particular

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[1]United Nations, Memorandum submitted by the Secretary-General, "Survey of International Law in Relation to the Work of Codification of the International Law Commission", extract from the Book of the ILC 1949. Document A/CN.4/1/Rev.1, para. 91, United Nations Publications, 1948. Vol. 1, pp. 52–53.

[2]*Wintershall Aktiengesellschaft v. Argentine Republic*, ICSID Case No. ARB/04/14 (Germany/Argentina BIT), Award, 8 December 2008, para. 92. See on this decision L. Peterson, Investment Arbitration Reporter, 1 (2008) 16, p. 11, online at http://www.iareporter.com (last visited 4 January 2009).

[3]It was recently suggested that this work should be resumed in the ILC. For a historic overview, see Ziegler, Most-Favoured Nation (MFN) Treatment, in: Reinisch (ed.), *Standards of Investment Protection*, 2008, pp. 29–86.

C. Herrmann and J.P. Terhechte (eds.), *European Yearbook of International Economic Law 2010*, European Yearbook of International Economic Law,
DOI 10.1007/978-3-540-78883-6_4, © Springer-Verlag Berlin Heidelberg 2010

questions until very recently.[4] These clauses were normally considered as a relic of the traditional way of negotiating establishment and treatment rights for foreign investors in the nineteenth century.

Only very recently, the scope of the MFN treatment clauses has become of interest to arbitrators and legal scholars.[5] It is especially the question whether the clause applies also to procedural rights (in particular dispute settlement) and definitions (e.g. the definition of a foreign direct investment or a foreign investor) that remains controversial. This discussion is very different from the more substantive discussion in other areas of international economic law, e.g. in relation to trade under the General Agreement on Tariffs and Trade (GATT), the General Agreement on Trade in Services (GATS) or to trade-related aspects of intellectual property rights under the TRIPs-Agreement of the World Trade Organization (WTO).[6]

This article tries to give an overview on the practice of (arbitral) tribunals in this field. In order to do so, it looks first at the main types of MFN clauses as currently found in BITs of major players in this field. It then proceeds to an overview of the topical arbitration awards up to December 2008. The following section will try to classify the existing awards and the opinions expressed therein relating to the proper application of MFN clauses in investment agreements. An outlook on the open issues and questions taking into account the most recent developments in academia and international negotiations will conclude this contribution.

Main Types and Economic Foundation of MFN Treatment

Most-favoured-nation treatment is treatment accorded by the granting State to the beneficiary State, or to persons or things in a determined relationship with that State, not less favourable than treatment extended by the granting State

[4]See, on the MFN clause in the area of Foreign Direct Investment (FDI) in general: UNCTAD, Most-Favoured-Nation Treatment, Series on Issues on International Investment Agreement Series, Document UNCTAD/ITE/IIT/10 (Vol. III), 1999, based on a manuscript prepared by J. Karl.

[5]For very recent examples, see Egli, Don't Get Bit: Addressing ICSID's Inconsistent Application of Most-Favored-Nation Clauses to Dispute Resolution Provisions, Pepperdine Law Review 34 (2007), pp. 1045 ff.; Vesel, Clearing a Path Through a Tangled Jurisprudence: Most-Favored-Nation Clauses and Dispute Settlement Provisions in Bilateral Investment Treaties, The Yale Journal of International Law 32 (2007), pp. 125 ff.; Chukwumerije, Interpreting Most-Favoured-Nations Clauses in Investment Treaty Arbitrations, The Journal of World Investment and Trade 8 (2007), pp. 597 ff.; see also earlier Freyer/Herlihy, Most-Favored-Nation Treatment and Dispute Settlement in Investment Arbitration: Just How "Favored" is "Most-Favored"? ICSID Review — Foreign Investment Law Journal 20 (2005), pp. 58 ff.; Hsu, MFN and Dispute Settlement — When the Twain Meet, The Journal of World Investment and Trade 7 (2006), pp. 25 ff.; Orrego Vicuña, Bilateral Investment Treaties and the Most-Favored-Nation Clause: Implications for Arbitration in the Light of a Recent ICSID Case, in: Kaufmann-Kohler (ed.), *Investment Treaties and Arbitration: ASA Swiss Arbitration Association Conference in Zurich of January 25, 2002*, 2002, pp. 133 ff.

[6]For an overview see also Acconci, Most-Favoured Nation Treatment and International Law on Foreign Investment, in: Muchlinski/Ortino/Schreuer (eds.), *The Oxford Handbook of International Investment Law*, 2008, pp. 363–407.

to a third State or to persons or things in the same relationship with that third State.[7]

A most-favoured-nation treatment clause per se entails international obligations and rights not only among the Contracting States of the international treaty incorporating it (often referred to as "the basic treaty"), but also among these Contracting States and other States (often referred to as "the third-party treaty") by virtue of different international treaties. Therefore, a most-favoured-nation treatment clause is not only a normal treaty clause, but also a source of international obligations other than those explicitly included in the basic treaty. It allows "borrowing" treaty provisions from other treaties or possibly State practice regarding third States. The material scope of MFN is thus open as the contents of future treaties and state practice cannot be totally foreseen and identified when the basic treaty is concluded. Even with regard to existing treaty obligations in relation to third States, it may be that negotiators are not always completely aware of them.[8]

By its very nature, the MFN clause is different from other international obligations that are usually agreed upon as it seems at first view contrary to the general principle of treaty negotiations that normally a treaty does not create either obligations or rights for a third State without its consent, as enshrined also in Article 34 of the United Nations (Vienna) Convention on the Law of Treaties.[9] However, a closer analysis shows that MFN is in conformity with the principle that the consent of a State can lead to the creation of new rights as a consequence of a treaty between third States (Article 36 of the Vienna Convention) although it is not a requirement that the contracting States of the later treaty intended the provision to accord that right also to the third State. More importantly, one can say that with regard to MFN treatment the new right is not created by the new treaty but was already encompassed under the basic treaty, and thus is not a case of the application of the rules covered by Part III Section 4 of the Vienna Convention on the Law of Treaties. As a matter of fact, the 1969 Vienna Convention left this issue basically untouched, thereby justifying the ongoing work of the ILC in this context.[10]

In the case of the MFN clause, the basic treaty becomes a dynamic source of law, in so far as the practice of either Party, in particular with regard to later treaties, in

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[7]See Article 5 Draft Articles on Most-Favoured-Nation Clauses (1978), International Law Commission, as available online at http://untreaty.un.org/ilc/texts/instruments/english/draft%20articles/1_3_1978.pdf (last visited on 4 January 2009).

[8]See International Law Association, Report of the Committee on Foreign Direct Investment presented at the Biennial Meeting 2008, Section B4, forthcoming 2009.

[9]1155 U.N.T.S. 331, reprinted also in 8 *International Legal Materials* (1969) 679; signed in Vienna 23 May 1969, entry into force: 27 January 1980.

[10]See Article 5 Draft Articles on Most-Favoured-Nation Clauses (1978), International Law Commission, as available online at http://untreaty.un.org/ilc/texts/instruments/english/draft%20articles/1_3_1978.pdf (last visited on 4 January 2009) and Acconci, Most-Favoured Nation Treatment and International Law on Foreign Investment, in: Muchlinski/Ortino/Schreuer (eds.), *The Oxford Handbook of International Investment Law*, 2008, pp. 363–407 with reference to para. 59 of the Rapport de la Commission à l'Assemblée générale sur les travaux de sa trentième session, p. 16.

relation to the basic treaty becomes of relevance to existing rights and duties under the basic treaty. The MFN clause thus constitutes a prior consent to extend favours extended to third States to the Contracting Parties of the basic treaty.

It is important to note that the MFN principle does not require identical treatment but "treatment at least as favourable". Often, this will mean identical treatment as any other treatment would lead to new problems in relation to third states, but it may also lead to a better treatment or different treatment that is considered to be qualitatively identical or at least as favourable as the treatment of third parties. This distinction may be of lesser importance in the area of investment but can be important when it comes to tariff concessions in the area of trade.

This very nature of the MFN principle is obviously also contrary to a strict application of the reciprocity principle so cherished by states in their traditional diplomatic relations.[11] While, normally, states will grant each other MFN treatment, the material content of this provision may differ from the beginning or, especially, change over time. This is the main reason why some politicians and even lawyers have always been critical of the MFN clause. They consider it to be a disincentive to negotiate mutually acceptable improvements in their relations, e.g. investment or trade, as one party may benefit from improvement only made by the other party without having to improve its own standards. It can thus lead to so-called free rider effects. MFN clauses are only reciprocal in the sense that they are reciprocally granted but their content is open to divergences and dynamic developments and thus not subject to the reciprocal granting of identical treatment and market access rights.

One way to limit these effects of the MFN principle is to make it not automatic or unconditional but conditional (conditional MFN treatment). An alternative is to provide explicit (temporary) exceptions. This has been discussed[12] in particular with regard to tariff concessions before WW II, but also with regard to more recent negotiations such as under the GATS.[13] Conditional MFN treatment normally means that the application of new, more favourable rules or preferences is only granted to existing treaty partners if they agree to apply the same rules; conditional MFN treatment therefore is basically a right to obtain more favourable treatment upon condition of doing the same (reciprocity) while unconditional MFN treatment requires no renewed commitment by the beneficiary. Economic theory, especially in the field of trade, has shown that liberalization, even unilateral, is more likely to lead to increased welfare, and hence often recommends unconditional MFN treatment.[14] Generally, MFN clauses found in modern BITs are

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[11] See for example Lo, The Reciprocity Principle in the International Regulation of Economic Relations (Typescript (photocopy), Thesis (S.J.D.) Harvard Law School, 1989, available at http://de.scientificcommons.org/4449832 (last visited on 4 January 2009).

[12] See for example Wolf, Vorwort, in: Glier (ed.) *Die Meistbegünstigungsklausel*, 1905, p. v.

[13] Article II:2 GATS; see in this respect Lowenfeld, *International Economic Law*, 2002, p. 117.

[14] See for an overview on recent economic studies in this field Zarazaga, Measuring the benefits of unilateral trade liberalization; part 2: dynamic models, Economic and Financial Policy Review Issue Q1 (2000), pp. 29–39.

unconditional[15] but they may be limited in scope and/or subject to exceptions. The basic problem of developing a coherent theory in view of the existing case law stems from the fact that the clauses at stake were often very differently phrased. While they all fall into the same category, their wording allows (at least) technically for differentiation with regard to their scope.[16]

Important Investment Arbitration Awards Relating to MFN

The MFN clause has been rediscovered in the context of international investment arbitration following the decision of an arbitral tribunal in the case *Maffezini v. Spain*[17] in 2000. Since then a number of tribunals have had to address the issue of the correct application and interpretation of the MFN clause.[18]

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[15]See also Acconci, Most-Favoured Nation Treatment and International Law on Foreign Investment, in: Muchlinski/Ortino/Schreuer (eds.), *The Oxford Handbook of International Investment Law*, 2008, pp. 363–407, Section 3.

[16]See the diverging case law as reported in the next section and, for details, Acconci, Most-Favoured Nation Treatment and International Law on Foreign Investment, in: Muchlinski/Ortino/Schreuer (eds.), *The Oxford Handbook of International Investment Law*, 2008, pp. 363–407, Section 3.1, who rightly refers to Anzilotti, Cours de droit international, 1929, pointing out that "... juridiquement parlant, il n'existe pas *une clause* de la nation la plus favorisée; il existe autant de stipulations distinctes qu'il y a de traités qui la contiennent, de sorte que toute question relative à la nature et aux effets de la clause est avant tout une question d'interprétation d'une clause donnée dans un traité déterminé" (at 438). See also Dolzer and Myers, After Tecmed: Most-Favored-Nation Clauses in Investment Protection Agreements, ICSID Review – Foreign Investment Law Journal 19 (2004), p. 49 (50 ff.); Gaillard, Establishing Jurisdiction through a Most-Favored-Nation Clause, New York Law Journal (June 2005) p. 8; for an overview over existing examples see UNCTAD, Recent Developments in International Investment Agreements, UNCTAD/WEB/ITE/IIT/2005/1, 30 August 2005 and UNCTAD, International Investment Rule-Setting: Trends, Emerging Issues and Implications, TD/B/COM.2/68, 18 January 2006.

[17]ICSID Case No. ARB/97/7, *Maffezini v. Spain*, Decision on Jurisdiction, 24 January 2000, paras. 53 ff. This and all other awards mentioned in this article are available online at http://ita.law.uvic.ca/index.htm (last visited on 4 January 2009). See immediately below point 3 in main text for details. For comments, see Fietta, Most Favoured Nation Treatment and Dispute Resolution under Bilateral Investment Treaties: a Turning Point? International Arbitration Law Review (2005) pp. 131–138; Liberti, Arbitrato ICSID, clausola della nazione più favorita e problemi di attribuzione, Rivista dell'arbitrato (2004), pp. 580 ff.

[18]For an overview on the case law see Houde/Pagani, Most Favoured Nation Treatment in International Investment Law, in: OECD (ed.), *International Investment Law: A Changing Landscape — A Companion Volume to International Investment Perspectives*, 2005, Chap. 4; Teitelbaum, Who's Afraid of Maffezini? Recent Developments in the Interpretation of Most-Favored-Nation Clauses, Journal of International Arbitration 22 (2005), pp. 225–238; Acconci, Most-Favoured-Nation Treatment and International Law on Foreign Investment, in: Muchlinski/Ortino/Schreuer (eds.), *The Oxford Handbook of International Investment Law*, 2008, pp. 363–407; Reinisch, "Maffezini v. Spain Case", in: *Encyclopaedia of Public International Law — EPIL*, forthcoming 2010.

The following section provides a very short overview of the most relevant cases with respect to their contribution to discussion of MFN treatment in order to facilitate later discussion of the specific issues addressed:

1. Asian Agricultural Products Ltd. (APPL) v. Sri Lanka (1990). In this first ICSID case relating to an arbitration clause contained in a BIT (1980 BIT between the UK and Sri Lanka), Article 3 of the agreement provided for most-favoured-nation treatment which, according to the investor, allowed for the incorporation of the liability standards (no “war clause” and no “civil disturbance exemption”) contained in the 1981 BIT between Switzerland and Sri Lanka, as they were more favourable than those contained in the UK–Sri Lanka BIT. The ICSID Tribunal rejected this claim, by establishing that it was not clear that the Sri Lanka–Switzerland Treaty contained more favourable provisions.[19]

2. Pope and Talbot v. Canada (1999). A US investor had originally invoked the MFN treatment clause of NAFTA (Article 1103) against Canada in order to be given the “fair and equitable treatment” as contained in various BITs concluded by Canada with third States which might go beyond what is contained in Article 1105 NAFTA (Minimum Standard of Treatment). The claim was later dropped and therefore not assessed substantively by the tribunal.[20]

3. Maffezini v. Spain (2000). An Argentinean investor in Spain requested the application of the MFN clause contained in Article IV (2) of the Spain–Argentina BIT to benefit from the allegedly more favourable provision in the Chile–Argentina BIT (no waiting period of 18 months until arbitral tribunal can be seized). The tribunal rejected Spain’s argument that the application of the MFN clause was limited to substantive matters or material aspects of the treatment granted to investors and did not cover procedural or jurisdictional questions.[21]

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[19]ICSID Case No. ARB/87/3, *AAPL v. Sri Lanka*, Award of 27 June 1990, para. 54. On this award, see Acconci, Most-Favoured-Nation Treatment and International Law on Foreign Investment, in: Muchlinski/Ortino/Schreuer (eds.), *The Oxford Handbook of International Investment Law*, 2008, pp. 363–407, Sect. 4.1; Manciaux, Investissements étrangers et arbitrage entre États et ressortissants d’autres États, 2004, pp. 582–585.

[20]*Pope & Talbot Inc. v. The Government of Canada*, UNCITRAL (NAFTA), Procedural Order No. 2, 28 October 1999, as referred to in Kinnear/Bjorklund/Hannaford, Investment Disputes under NAFTA — An Annotated Guide to NAFTA Chapter 11, 2006, pp. 1103–1109. See also Acconci, Most-Favoured Nation Treatment and International Law on Foreign Investment, in: Muchlinski/Ortino/Schreuer (eds.), *The Oxford Handbook of International Investment Law*, 2008, pp. 363–407, Sect. 4.2.

[21]ICSID Case No. ARB/97/7, *Maffezini v. Spain*, Decision on Jurisdiction, 24 January 2000, paras. 53 ff; and on this award, among others, Acconci, Most-Favoured Nation Treatment and International Law on Foreign Investment, in: Muchlinski/Ortino/Schreuer (eds.), *The Oxford Handbook of International Investment Law*, 2008, pp. 363–407, Sects. 4.2 and 5.1. For a critical assessment of the *Maffezini* award, see Fietta, Most Favoured Nation Treatment and Dispute Settlement Resolution Under Bilateral Investment Treaties: A Turning Point, International Arbitration Law Review 8 (2005) pp. 131 ff.; for a more favourable assessment see Boscariol/Silva, The Widening Application of the MFN Obligation and its Impact on Investor Protection, International Trade Law and Regulation 11 (2005), pp. 61 ff.

4. ADF v. USA (2003). A Canadian investor invoked the MFN clause contained in Article 1103 NAFTA in order to benefit from the allegedly further-reaching protection in the US–Estonia and US–Albania BITs (fair and equitable treatment), similar to the original claims presented in *Pope & Talbot v. Canada* (2001/2). The tribunal concluded that even if the United States had granted a better protection under the respective BITs (which seemed doubtful to the tribunal) the US was not in breach of this standard.[22]

5. The Loewen Group, Inc., Raymond L. Loewen v. The United States of America (2003). NAFTA's most-favoured-nation treatment clause (Article 1103) was invoked to avoid the requirement of maintaining "'continuous nationality' during investment disputes" which allegedly was not necessary under other BITs concluded by the US. The ICSID Tribunal did not address this claim and upheld the US's objection to its jurisdiction due to the lack of the claimant's continuous nationality.[23]

6. Yaung Chi Oo (YCO) Trading Pte Ltd. v. *Myanmar* (2003). Myanmar was not a member of ASEAN at the time YCO (an investor from Singapore) had entered a joint venture with Myanmar Foodstuff Industries and the State Industrial Organization of Myanmar. Myanmar acceded to the 1987 ASEAN Agreement only in July 1997 and became a party to the 1998 Framework Agreement for ASEAN Investment. YCO, inter alia, claimed that the ASEAN Arbitral Tribunal had jurisdiction under the 1998 Framework Agreement (to which both Singapore and Myanmar were parties) relating to measures taken before 1998 by invoking the most-favoured nation provision of Article 8, citing more favourable treatment to investors under the 1998 Philippines–Myanmar Bilateral Investment Treaty ("BIT") (consent to international arbitration). The Tribunal declined jurisdiction on this ground, noting that the Claimant had failed to invoke the MFN clause at the initiation of arbitration proceedings. It further observed that, in any event, there was no indication that there would be arbitral jurisdiction under any BIT entered into by Myanmar under the present facts. The Tribunal therefore concluded that it was unnecessary for it to consider jurisdiction under the 1998 Framework Agreement.[24]

7. Tecmed v. Mexico (2003). A Spanish investor tried to overcome jurisdictional limitations *ratione temporis* by invoking an MFN clause in the Mexico–Spain BIT of 1995, and thereby borrowing the more generous clause on temporal scope in the

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[22]ICSID Case No. ARB (AF)/00/1 (NAFTA), *ADF Group Inc. v. United States*, Award, 9 January 2003, paras. 193 ff.; see also Acconci, Most-Favoured Nation Treatment and International Law on Foreign Investment, in: Muchlinski/Ortino/Schreuer (eds.), *The Oxford Handbook of International Investment Law*, 2008, pp. 363–407, Sect. 4.2.

[23]ICSID Case No. ARB(AF)/98/3, *The Loewen Group, Inc., Raymond L. Loewen v. The United States of America*, Award of 26 June 2003, in particular at para. 225. See also *Raymond L. Loewen* v. *The United States of America*, Petition to Vacate of 13 December 2004, footnote 2. On 31 October 2005, the US District Court for the District of Columbia denied this petition.

[24]ASEAN I.D. Case No. ARB/01/1, *Yaung Chi Oo Trading Pte Ltd. v. Myanmar*, Award of 31 March 2003; see also Acconci, Most-Favoured Nation Treatment and International Law on Foreign Investment, in: Muchlinski/Ortino/Schreuer (eds.), *The Oxford Handbook of International Investment Law*, 2008, pp. 363–407, Sect. 5.3.

1998 BIT between Mexico and Austria. The ICSID tribunal did not allow the retroactive application of substantive standards as contained in this treaty with a third party "because it deem[ed] that matters relating to the application over time of the Agreement [. . .] due to their significance and importance, go to the core of matters that must be deemed to be specifically negotiated by the Contracting Parties".[25]

8. MTD v. *Chile* (2004). The Malaysian company *MTD Equity Sdn Bhd.* had invoked the MFN clause contained in the Chile–Malaysia BIT in order to benefit from two other BITs concluded by Chile with Denmark and Croatia which contained more detailed treaty language on "fair and equitable treatment", including obligations to award permits subsequent to the approval of an investment, the prohibition of Unreasonable and Discriminatory Measures, and the fulfilment of contractual obligations (umbrella clause), respectively. The tribunal agreed to incorporate the provisions of the Croatian and Danish treaties into the Treaty between Malaysia and Chile by virtue of the "wide scope" of the latter treaty's MFN clause, deeming this importation to be "in consonance with" the purpose of the Malaysia–Chile investment treaty.[26]

9. Siemens v. Argentina (2004). The investor, the German company Siemens, invoked the more favourable terms of a bilateral investment treaty (absence of a waiting period of 18 months before an arbitral tribunal can be seized) between Argentina and Chile – by virtue of the MFN clause contained in the Germany–Argentina BIT. Argentina objected to Siemens' failure to exhaust an 18-month time period set out in the Germany–Argentina BIT for recourse to local courts, prior to turning to international arbitration. The arbitral tribunal determined that the relevant MFN clause allowed the investor to choose more favourable dispute settlement provisions from various other agreements.[27]

10. Salini v. Jordan (2004). The Italian investor invoked the MFN clause in the BIT between Jordan and Italy in order to benefit from more favourable dispute settlement provisions in the BITs with the US and the UK. In the view of the claimants, the US and UK treaties contained a dispute settlement clause "which is more favourable than that contained in Article 9 of the Jordan–Italy BIT", by virtue of its supposed inclusion of contractual breaches. The relevant MFN clause was silent on the question of the application of MFN to the dispute settlement process;

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[25]ICSID Case No. ARB/AF/00/2, *Technicas Medioambientales Tecmed S.A. v. Mexico*, Award, 29 May 2003, para. 69.

[26]ICSID Case No. ARB/01/7, *MTD Equity Sdn. Bhd. and MTD Chile S.A. v. Republic of Chile*, Award, 25 May 2004, para. 103; see the comments by L. Peterson, Malaysian firm wins BIT case against Chile; "wide scope" of MFN clause looms large, INVEST-SD: Investment Law and Policy Weekly News Bulletin, 23 August 2004, published by the International Institute for Sustainable Development, available online at http://www.iisd.org/investment. The annulment decision regarding this award is of minor importance with regard to the findings on MFN; see Decision on Annulment, 21 March 2007. para. 64.

[27]ICSID Case No. ARB/02/8, *Siemens A.G. v. The Argentine Republic*, Decision on Jurisdiction, 3 August 2004.

accordingly, the tribunal rejected the claimants' contention that the MFN clause should be interpreted so as to apply to procedural matters.[28]

11. Lucchetti v. Peru (2005). The claim concerned how the Respondent State, Peru, had applied the fair and equitable treatment standard, national treatment and most-favoured-nation treatment. According to the claimant, Peru had breached all of its treatment obligations provided in the 2000 BIT between Chile and Peru.[29] The ICSID Tribunal did not address the issue as it declined jurisdiction.

12. Plama v. Bulgaria (2005). The tribunal refused to permit the Cypriot investor to invoke the MFN clause contained in the BIT between Bulgaria and Cyprus in order to borrow the arbitration clause found in another investment treaty by Bulgaria, which would have paved the way for arbitration under a different set of rules and over a much broader range of claims.[30]

13. CMS v. Argentina (2005). The investor relied on the most-favoured-nation treatment clause included in the 1991 BIT between the United States and Argentina to maintain that the liability standards (no exceptions) incorporated in other BITs concluded by Argentina should apply. The Tribunal rejected this assertion since it was "not convinced that the clause [had] any role to play in this case". The Tribunal established that such an assertion would in any event fail under the *ejusdem generis* rule.[31]

14. Impregilo S.p.A. v. Pakistan (2005). The Italian investor claimed that by applying the MFN clause in the 1997 Italy and Pakistan BIT, it was entitled to request ICSID arbitration in relation to contractual claims covered under the so-called "umbrella clauses", such as contained in the 1995 Switzerland and Pakistan BIT. The Italy–Pakistan BIT did not provide for the coverage of purely contractual claims as investment claims. Although the Tribunal ultimately held that the claims were not claims against Pakistan as a party to the agreement but against a separate entity, it did not exclude the possibility of invoking the umbrella clause on the basis of the MFN clause: "even assuming *arguendo* that Pakistan, through the MFN clause and the Swiss–Pakistan BIT, has guaranteed the observance of the contractual commitments into which it has entered together with Italian investors, such a guarantee would not cover the present Contracts – since they are agreements into which it has not entered".[32]

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[28] ICSID Case No. ARB/02/13, *Salini Costruttori S.p.A and Italstrade S.p.A v. The Hashemite Kingdom of Jordan*, Decision on Jurisdiction, 29 November 2004.

[29] ICSID Case No. ARB/03/4, *Empresas Lucchetti, S.A. and Lucchetti Peru, S.A. v. Republic of Peru*, Decision on Jurisdiction, 7 February 2005, para. 23.

[30] ICSID Case No. ARB/03/24, *Plama Consortium Ltd. v. Bulgaria*, Decision on Jurisdiction, 8 February 2005. See also Acconci, Most-Favoured Nation Treatment and International Law on Foreign Investment, in: Muchlinski/Ortino/Schreuer (eds.), *The Oxford Handbook of International Investment Law*, 2008, pp. 363–407, Sect. 5.3.

[31] ICSID Case No. ARB/01/8, *CMS Gas Transmission Co. v. Argentina*, Award of 20 April 2005, para. 377. On the *ejusdem generis* principle, see next section.

[32] ICSID Case No. ARB/03/3, *Impregilo S.p.A. v. Pakistan*, Decision on Jurisdiction of 22 April 2005, para. 223.

15. Camuzzi v. Argentina (2005). In this case, Argentina did not object at all to the claimant's attempt to refer to the MFN clause included in the 1990 BIT between Argentina and the Belgo-Luxembourg Economic Union (the basic treaty) in order to borrow a more favourable dispute settlement clause (no waiting period) provided by the 1991 US–Argentina BIT. In view of Argentina's missing objection, the ICSID Tribunal did not "decide on the relevance of that clause" in the case. However, for the sake of clarity, the Tribunal specified that Argentina had probably considered the "18 months in domestic courts" requirement met, since Camuzzi had "submitted the dispute to [its] national courts" which had left it unresolved.[33]

16. Gas Natural v. Argentina (2005). An investor invoked the MFN clause contained in the 1991 Agreement between Argentina and Spain in order to borrow the allegedly more favourable dispute settlement provisions in several BITs concluded by Argentina with third states. The *Gas Natural* tribunal followed the *Maffezini* approach stating that there was "no 'public policy' reason not to give effect to the most-favoured-nation provision with respect to the right to proceed directly to international arbitration"[34] because the applicable MFN clause related to "all matters" and thus covered dispute settlement. In the tribunal's view "assurance of independent international arbitration is an important — perhaps the most important — element in investor protection".[35]

17. Bayindir v. Pakistan (2005). The 1995 BIT between Turkey and Pakistan did not expressly include a fair and equitable treatment clause. The investor asserted that he was entitled to such a treatment as provided in other treaties entered into by Pakistan through the MFN clause. The ICSID Tribunal accepted jurisdiction with regard to this request as other BITs concluded by Pakistan contained "an explicit fair and equitable treatment clause".[36] The claimant had also contended a direct violation of the most-favoured-nation clause included in the Turkey and Pakistan BIT as Pakistan had engaged in a selective tendering process allegedly intended to squeeze Bayindir out of the market. In this respect the Tribunal equally confirmed its jurisdiction.[37]

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[33]ICSID Case No. ARB/03/2, *Camuzzi International S.A. v. Argentina*, Decision on Objections to Jurisdiction of 11 May 2005, para. 121. See, for details, Acconci, Most-Favoured Nation Treatment and International Law on Foreign Investment, in: Muchlinski/Ortino/Schreuer (eds.), *The Oxford Handbook of International Investment Law*, 2008, pp. 363–407, Sect. 5.1.

[34]ICSID Case No. ARB/03/10, *Gas Natural SDG, S.A. v. Argentina*, Decision on Preliminary Questions on Jurisdiction, 17 June 2005, para. 28. See on this case, among others, Reinisch, *Maffezini v. Spain* Case, in: *Encyclopaedia of Public International Law — EPIL*, forthcoming 2010.

[35]*Ibid*., para. 49.

[36]ICSID Case No. ARB/03/29, *Bayindir Insaat Turizm Ticaret Ve Sanayi A.Ş. v. Pakistan*, Decision on Jurisdiction of 14 November 2005, para. 231.

[37]*Ibid*. Para. 206 reads: "The mere fact that Bayindir had always been subject to exactly the same legal and regulatory framework as everybody else in Pakistan does not necessarily mean that it was actually treated in the same way as local (or third countries) investors. In other words, as is evident from the broad wording of Article II (2) of the BIT, the treatment the investor is offered under the MFN clause is not limited to 'regulatory treatment'". Para 223 reads: "The fact remains that, taken

18. Continental Casualty v. Argentina (2006). Argentina objected to ICSID jurisdiction based on the MFN clause in the 1991 BIT between Argentina and the United States. As the claimant only used this provision in order to get better substantive treatment (the treatment granted to investors as to the remittance of capital transfers) and not procedural improvements, the ICSID Tribunal accepted jurisdiction in view of possibly applying the MFN clause with regard to the allegedly discriminatory treatment relating to to the remittance of capital transfers.[38]

19. National Grid Transco plc v. Argentina (2006). In this case again, the 18-month waiting period before an arbitral tribunal can be seized (as contained in the 1990 UK–Argentina BIT) was removed by an UNCITRAL tribunal by allowing the investor from the United Kingdom to rely on the more favourable provision in the Argentina–US BIT.[39]

20. Telenor v. Hungary (2006). The investor referred to the MFN clause included in the 1991 Norway–Hungary BIT and asked for the incorporation of more favourable dispute settlement provisions in other agreements concluded by Hungary which allowed for a more generous jurisdiction of an ICSID tribunal (not limited to expropriation claims as in the 1991 Norway–Hungary BIT). The tribunal refused such incorporation.[40]

21. Suez, Sociedad General de Aguas de Barcelona S.A., and Vivendi Universal S.A. v. Argentina and *AWG Group Ltd. v. Argentina* (2006). In this case, immediate access to an ICSID arbitral tribunal for British and Spanish investors was achieved through the most-favoured-nation clauses included in the basic treaties (the 1990 Argentina and the United Kingdom BIT and the 1991 Argentina and Spain BIT). The dispute settlement clause of the 1991 Argentina and France BIT, according to which no prior litigation in local courts was necessary, was borrowed again as being a more favourable treatment.[41]

22. Berschader v. Russia (2006). An arbitral tribunal at the Stockholm Arbitration Institute declined jurisdiction to hear a claim by two Belgian businessmen brought pursuant to the USSR–Belgium bilateral investment treaty. The tribunal noted that the relevant dispute settlement provision in the BIT originally concluded between the USSR and Belgium was rather narrow, and permitted

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together, Bayindir's allegations in respect of the selective tender, and that the expulsion was due to Pakistan's decision to favor a local contractor, and that the local contractor was awarded longer completion time-limits, if proven, are clearly capable of founding a MFN claim".

[38] ICSID Case No. ARB/03/9, *Continental Casualty Co. v. Argentina*, Decision on Jurisdiction of 22 February 2006.

[39] UNCITRAL, *National Grid plc v. The Argentine Republic*, Decision on Jurisdiction, 20 June 2006, para. 53 ff.

[40] ICSID Case No. ARB/04/15, *Telenor Mobile Communications A.S. v. Hungary*, Award of 22 June 2006. See on this issue also Reinisch, International Centre for Settlement of Investment Disputes (ICSID), The Global Community: Yearbook of International Law and Jurisprudence 2006 (2007), 1806–1807.

[41] ICSID Case No. ARB/03/19, *Suez, Sociedad General de Aguas de Barcelona S.A., and Vivendi Universal S.A. v. The Argentine Republic*, and UNCITRAL, *AWG Group Ltd. v. The Argentine Republic*, Decision on Jurisdiction, 3 August 2006.

investor–state arbitration only in case of disputes over the amount of compensation owing in the event of an expropriation or nationalization. By a majority of two-to-one the tribunal refused to allow the Belgian investors to invoke the Most-Favoured-Nation (MFN) clause in this agreement in an effort to "borrow" more favourable dispute settlement rules found in more recent bilateral investment treaties signed by Russia.[42]

23. Champion Trading Company, Ameritrade International, Inc., James T. Wahba, John B. Wahba, Timothy T. Wahba v. Egypt (2006). The tribunal came to the conclusion that the investor was not "in a like situation" to another investor with regard to whom he had invoked a violation of the MFN standard.[43]

24. Parkerings-Compagniet AS v. Lithuania (2007). In this case the claimants invoked their right to obtain MFN treatment in view of an alleged more favorable treatment of a competitor by the Lithuanian authorities. The treatment related to the denied renewal of a permit for environmental reasons and the impact on the local community. The tribunal did not deny that the MFN clause as such was applicable but came to the conclusion that the situation referred to was not governed by "like circumstances and thus the differential treatment seemed justified and was not contrary to the MFN clause."[44]

25. Société Générale v. Dominican Republic (2008). The claimant argued that the MFN provision of the France–Dominican Republic BIT should entitle the French firm to the more-favourable definition of investments in Central American Free Trade Agreement (CAFTA). However, the tribunal rejected this effort, holding that the MFN clause only extended to "treatment" accorded to investments, not to the definition of investment itself. In addition, the tribunal also accepted the DR Government's view that an exclusion clause in the BIT prevented the MFN clause from reaching into a free trade agreement such as the CAFTA.[45]

26. RosInvestCo UK Ltd. v. The Russian Federation (2007). A tribunal upheld jurisdiction in this case by allowing a British investor to invoke a wider dispute settlement clause from the BIT between Denmark and Russia. The UK–Soviet Union BIT precluded an examination of whether the claimant had, in fact, suffered expropriation as it limited investor–state arbitration to disputes over the amount of

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[42]SCC Case No. 080/2004 (Belgium/Russia BIT), *Berschader v. Russia*, Award, 21 April 2006. See also Peterson, Investment Treaty News (ITN), 23 August 2006 (available online at http://www.iisd.org/pdf/2006/itn_aug23_2006.pdf, (last visited 4 January 2009).

[43]ICSID Case No. ARB/02/9 (United States/Egypt BIT), *Champion Trading Company, Ameritrade International, Inc., James T. Wahba, John B. Wahba, Timothy T. Wahba v. Egypt*, Award, 27 October 2006. See also Reinisch, International Centre for Settlement of Investment Disputes (ICSID), The Global Community: Yearbook of International Law and Jurisprudence 2007 (2008), at III.4.

[44]ICSID Case No. ARB/05/8 (Norway/Lithuania BIT) *Parkerings-Compagniet AS* v. *Lithuania*, Award, 11 September 2007. For comments see Vis-Dunbar and Peterson, Lithuania victorious in dispute with Norwegian parking lot business, Investment Treaty News, September 28, 2007, 3.

[45]UNCITRAL, LCIA Case No. UN7927 (France/Dominican Republic BIT), *Société Générale v. Dominican Republic*, Preliminary Objections to Jurisdiction, 19 September 2008. See Peterson, Investment Arbitration Reporter, Vol. 1, No. 12, 9 October 2008.

compensation or any other matter consequential of expropriation but which contained an MFN clause.[46] The tribunal expressly left open the question whether an arbitration clause as such could be incorporated through reliance on an MFN clause.[47]

27. L.E.S.I. S.p.A. et ASTALDI S.p.A. v. Algeria (2008). The claimant invoked the "fair and equitable treatment" clause not contained in the Italy–Algeria Agreement from another BIT, thanks to the MFN clause contained in this latter agreement. The tribunal accepted this argument but came to the conclusion that the standard imported this way was not violated.[48]

28. Wintershall Aktiengesellschaft v. Argentine Republic (2008). In this decision an ICSID tribunal ruled that a German investor could not invoke the MFN provision of the Germany–Argentina bilateral investment treaty in order to evade a treaty requirement that claims be pursued for 18 months in the Argentine courts before being subjected to international arbitration by invoking a dispute settlement provision without such a waiting period in the Argentina–US BIT. The same provision was interpreted differently in the case *Siemens* v. *Argentina*.[49]

Specific Issues Addressed in Investor–State Arbitration

The Ejusdem Generis Principle

The dynamic nature of the MFN clause is intended to operate only in situations where a treatment occurs in "like situations" or "like circumstances".[50] One can see it as a normal limitation of any non-discrimination rule as it exists in most if not all legal systems. When it comes to the application of the MFN clause in the basic treaty to invoke the applicability of a specific treatment provision in a third-party treaty this principle is normally referred to as the "*ejusdem* (or *eiusdem*) *generis* principle". It is normally understood to mean that the third-party treaty must, in principle, regulate the same subject-matter as the basic treaty, otherwise the specific treatment standard would be taken out of its context and thus not be accorded in "like circumstances" or in "like situations". No other rights can be claimed under a most-favoured-nation clause than those falling within the limits of the

[46] SCC Case No. Arb. V079/2005, *RosInvestCo UK Ltd. v. The Russian Federation*, Award on Jurisdiction, 28 October 2007.

[47] Para. 129.

[48] ICSID Case No. ARB/05/3 (Italy/Algeria BIT), *L.E.S.I. S.p.A. et ASTALDI S.p.A. v. Algeria*, Award, 12 November 2008.

[49] ICSID Case No. ARB/04/14 (Germany/Argentina BIT), *Wintershall Aktiengesellschaft v. Argentine Republic*, Award, 8 December 2008.

[50] For a typical example of the comparison of two situations, see ICSID Case No. ARB/05/8 (Norway/Lithuania BIT), *Parkerings-Compagniet AS v. Lithuania*, Award, 11 September 2007.

subject-matter of the clause. Furthermore one can extend this principle to the "persons and things" covered by the standard which must be of the same category.[51]

So far, ascertaining the application of this principle has not given rise to controversial issues within investment cases. In reality, the *ejusdem generis* principle has been extensively discussed only by the ICSID Tribunals of the *Maffezini* and *Suez* cases.[52] More recently the *Wintershall* Tribunal also referred to it.[53] This can be explained by the fact that investors have normally invoked rules contained in third-party BITs under the MFN clause of a BIT (basic treaty). Even where the treaty does not specify that the MFN principle applies only to "like circumstances" or in "like situations", it can be considered as an inherent principle underlying the MFN principle.[54]

An interesting example of a situation other than domestic where this question was discussed is a legal opinion by the Swiss Directorate of Public International Law, a unit of the Swiss Department of Foreign Affairs of 1994.[55] In this case, a plaintiff invoked under the MFN clause contained in Article 4 of the Convention on Establishment and Legal Protection of 1927[56] the procedural rights contained in the Convention of 16 September 1988 on jurisdiction and the enforcement of

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[51]Ustor, Most Favoured Nation Clause, in: Encyclopaedia of Public International Law 3 (1997), p. 472. See also The Anglo–Iranian Oil Company (Jurisdiction) Case (United Kingdom vs Iran), 22 July 1952, ICJ Reports, 1952, p. 109 and Article 9 and 10 of the Draft Articles on Most-Favoured-Nation Clauses (1978), International Law Commission, as available online at http://untreaty.un.org/ilc/texts/instruments/english/draft%20articles/1_3_1978.pdf (last visited on 4 January 2009).

[52]See Acconci, Most-Favoured Nation Treatment and International Law on Foreign Investment, in: Muchlinski/Ortino/Schreuer (eds.), *The Oxford Handbook of International Investment Law*, 2008, pp. 363–407. See, on the application of this principle with regard to the *Maffezini* and *Plama* cases, also McLachlan, Shore and Weiniger, *International Investment Arbitration – Substantive Principles*, 2007, pp. 254–257.

[53]ICSID Case No. ARB/04/14 (Germany/Argentina BIT), *Wintershall Aktiengesellschaft v. Argentine Republic*, Award, 8 December 2008. They refer to historic examples at Para 101: "[A]n interesting application of this principle has been mentioned by Prof. George Schwazenberger in an Article in the British Yearbook on International Law 1945 ("The Most-Favoured-Nation Standard in British State Practice", para. 96 at p. 108, footnote 6) It is the decision of the Umpire of the British–Venezuelan Mixed Claims Commission in the case of *The Aroa Mines* under the Protocol of February 13, 1903. The Umpire held that the relevant MFN Clause on which Great Britain relied and which extended to the *administration of Justice* only applied to rights before national courts "but not, as Great Britain had maintained, to the proceedings of the International Mixed Claims Commission, a restricted interpretation of an MFN Clause" (emphasis in original).

[54]See also with regard to the specific case of Swiss BITs: Schmid, *Swiss Investment Protection Agreements: Most-Favoured-Nation Treatment and Umbrella Clauses*, 2007, p. 43.

[55]Direction du droit international public, Avis du 11 mars 1994; reprinted in French in "Pratique suisse 1994, N° 4.2" in: Revue suisse de droit international et de droit européen (1995), pp. 25 ff.; also reprinted in: Jurisprudence des autorités administratives de la Confédération (JAAC) no. 59.155; available online as http://www.vpb.admin.ch/deutsch/doc/59/59.155.html (last visited on 4 January 2009).

[56]Convention d'établissement et de protection juridique que la Suisse et la Grèce du 30 novembre 1927.

judgments in civil and commercial matters (so-called Lugano Convention).[57] The authority denied such a right, invoking the *ejusdem generis* principle as the two treaties did not have "the same objective".

Nevertheless, even where a Party invokes the clauses of another BIT through the MFN clause in a different BIT, this principle may play an important role. The *Wintershall* Tribunal most recently held that a correct interpretation of the term "treatment"[58] was related to the concept of "ejusdem generis":

> The question whether Article 3 [MFN Treatment] could apply to the dispute resolution clause in Article 10 [and specifically to the 18-month requirement stipulated in paragraph (2) thereof] has to be answered in the negative — not because 'treatment' in Article 3 may not include 'protection' of an investment by the investor adopting ICSID arbitration, but primarily because of the significance that has been attached by the Contracting States to the 18-month requirement in Article 10(2): it is part and parcel of Argentina's integrated 'offer' for ICSID arbitration. This 'offer' must be accepted by the investor on the same terms. Besides, it is well-established, in this branch of the law, that a most-favoured-nation clause can only attract matters belonging to the same category of subject as that to which the clause itself relates – the issue being determined in accordance with the intention of the Contracting Parties, deduced from a reasonable interpretation of the Treaty. But what is the category of subject (the *genus*) to which the 'treatment' mentioned in Article 3 relates? That is not mentioned in Article 3 — it can only be ascertained upon reading Article 3 along with Article 4 [Treatment].[59]

Explicit Descriptions of the Scope

Some MFN clauses are very general in scope. A typical example is the clause in the Agreement between Spain and Argentina, which was at stake in the *Maffezini* decision. Article IV (2) of the Argentina–Spain BIT[60] is relatively open or unspecific with regard to the exact scope of the MFN clause:

In *all matters subject to this Agreement*, this *treatment* shall not be less favourable than that extended by each Party to the investments made in its territory by investors of a third country.[61]

Certain MFN clauses go further in their explicitness and define the types of situations in which the treatment is subject to the MFN standard. Article 1103 (Most-Favored-Nation Treatment) of the North American Free Trade Agreement

[57] At the time of the dispute, Greece was not yet a Party to this Convention.

[58] See next paragraph on the explicit description of the scope of an MFN clause.

[59] Para. 162.

[60] Signed in Buenos Aires on 3 October 1991; available in Spanish by UNCTAD on its "Investment Instruments Online" site: http://www.unctadxi.org/templates/DocSearch_779.aspx (last visited on 4 January 2009).

[61] English translation of the Spanish original ("En todas las material regidas por el presente Acuerdo, este tratamiento no será menos favorable que el otorgado por cada Parte a los inversiones realizadas en su territorio por inversores de un tercer país").

(NAFTA) (which resembles very much Article 4 of the 2004 US Model BIT[62]) reads:

1. Each Party shall accord to investors of another Party treatment no less favorable than that it accords, in like circumstances, to investors of any other Party or of a non-Party *with respect to the establishment, acquisition, expansion, management, conduct, operation, and sale or other disposition of investments*.
2. Each Party shall accord to investments of investors of another Party treatment no less favourable than that it accords, in like circumstances, to investments of investors of any other Party or of a non-Party *with respect to the establishment, acquisition, expansion, management, conduct, operation, and sale or other disposition of investments*. [Emphasis added.]

This MFN treatment clause is particular – in comparison to those clauses concluded especially by most European states (at least until recently) – in so far as it includes besides the "management, conduct, operation, and sale or other disposition of investments" also the "establishment, acquisition, expansion" and thus extends MFN treatment to market access or establishment, i.e. rights normally related to the pre-establishment phase of foreign direct investment. While traditionally only the United States and Canada regularly included such market access rights, it is now very common for many states to include them into the general scope of the treatment standards of an agreement.[63]

Similarly, Article 40 Paragraph 1 (National Treatment and Most-Favoured-Nation Treatment) of the Investment Chapter in the EFTA–Singapore Free Trade Agreement reads:

Each Party shall accord to investors and investments of investors of another Party, *in relation to the establishment, acquisition, expansion, management, conduct, operation and disposal of investments*, treatment that is no less favourable than that which it accords *in like situations* to its own investors and their investments or to investors and their investments of any other State, whichever is more favourable. [emphasis added]

[62]Text made available online by the US Secretary of State at http://www.ustr.gov/assets/Trade_Sectors/Investment/Model_BIT/asset_upload_file847_6897.pdf (last visited on 4 January 2009).

[63]See, for many examples from Canadian and US practice, Acconci, Most-Favoured Nation Treatment and International Law on Foreign Investment, in: Muchlinski/Ortino/Schreuer (eds.), *The Oxford Handbook of International Investment Law, 2008*, pp. 363–407, Sect. 3.1. with reference, e.g. to Canada–Latvia (1995), Article II (3); Canada–South Africa (1995), Article II (3); US–Nicaragua (1995), Article II (1); Canada–Egypt (1996), Article II (3); Canada–Panama (1996), Article II (3); Canada–Venezuela (1996), Article II (3); Canada–Thailand (1997), Article II (3); US–Azerbaijan (1997), Article II (1); US–Jordan (1997), Article II (1); US–Bahrain (1999), Article 2 (1); US–El Salvador (1999), Article II (1). See also the 2004 Canadian Model BIT, Article 4, and the 2004 US Model BIT, Article 4. All made available by UNCTAD on its "Investment Instruments Online" site, http://www.unctadxi.org/templates/DocSearch_779.aspx (last visited on 4 January 2009). See also Salacuse, Do BITs Really Work? An Evaluation of Bilateral Investment Treaties and Their Grand Bargain, Harvard International Law Journal 46 (2005) p. 67 (93–94).

Here again we see that the extension of the MFN clause is limited to certain operations (including pre-establishment rights) and only applies in "like situations". Similarly NAFTA speaks of "like circumstances". Other variations of the MFN clause may not specify at all to what kinds of treatment they apply, i.e. specific standards, treatment in general or any provision of the treaty. Article 3 (first part) of the Treaty between the Federal Republic of Germany and the Co-operative Republic of Guyana concerning the Encouragement and Reciprocal Protection of Investments of 6 December 1989[64] reads:

Neither Contracting Party shall subject investments in its territory owned or controlled by nationals or companies of the other Contracting Party to *treatment* less favourable than it accords to investments of its own nationals or companies of any third State.

Neither Contracting Party shall subject nationals or companies of the other Contracting Party, as regards their *activity in connection with investments in its territory, to treatment less favourable* than it accords to its own nationals or companies of any third State. . . . [emphasis added]

More specifically when it comes to the treatment of investors, Article 4 of the 1995 Swiss Model BIT[65] provides:

1. Each Contracting Party shall in its territory accord investments or returns of investors of the other Contracting Party *treatment not less favourable* than that which it accords to investments or returns of its own investors or to investments or returns of investors of any third State, whichever is more favourable to the investor concerned.
2. Each Contracting Party shall in its territory accord investors of the other Contracting Party, as regards the management, maintenance, use, enjoyment or disposal of their investments, treatment not less favourable than that which it accords to its own investors or investors of any third State, whichever is more favourable to the investor concerned.

Similarly during the negotiations for a Central America–Dominican Republic–United States Free Trade Agreement (CAFTA) in 2004, the parties had included at some point a footnote in the draft text with the following text:

> [t]he Most-Favored-Nation Treatment Article of this Agreement is expressly limited in its scope to matters 'with respect to the establishment, acquisition, expansion, management, conduct operation and sale or other dispositions of investments.' The Parties share the understanding and intent that this clause does not encompass international dispute resolution mechanisms such as those contained in Section C of this chapter, and therefore could not reasonably lead to a conclusion similar to that of the *Maffezini* case.

[64]As made available by UNCTAD on its "Investment Instruments Online" site, http://www.unctadxi.org/templates/DocSearch_779.aspx (last visited on 4 January 2009).

[65]As made available by UNCTAD on its "Investment Instruments Online" site, http://www.unctadxi.org/templates/DocSearch_779.aspx (last visited on 4 January 2009).

The footnote was to be eliminated before the conclusion of the negotiations but its insertion in 2004 was specifically intended to make it part of the negotiating history. To the United States this approach obviously seems to be a way to prevent a "Maffezini-like" interpretation of the MFN clauses contained in its agreements without leading to an unwanted watering-down of the provision.[66]

Furthermore, on 30 May 2006 the European Commission (DG Trade) presented an Issue Paper for the attention of the EC's so-called 133 Committee in view of its future competence to negotiate investment treaties on behalf of the European Community, thus taking over this competence from the Member States, as envisaged in the most recent proposals for treaty amendments. In this paper the Commission suggested with regard to the inclusion of an appropriate MFN clause in future agreements:

> The scope of application of the MFN clause is focused and limited to establishment, thus clearly signalling that it could not extend to BIT provisions on expropriation and dispute settlement.
>
> It appears necessary to exclude from the benefit of this clause most deep-integration agreements the EU concludes (i.e. to exclude granting to third countries the advantages resulting from — for instance — the EU–Balkans Stabilisation and Association Agreements that could lead at a later stage to EU accession). To that aim, the classical regional economic integration organisation (REIO) clause needs to be adjusted to avoid a carve-out from the scope of MFN treatment of any FTA, which would be counter-productive.
>
> Here again, this approach is fully consistent with WTO commitments of the EU under the GATS, since the latter contains an MFN provision of general application. It is also consistent with existing EU agreements with third countries that already contain an MFN provision (examples: Article 30 of the EU–Jordan Association Agreement; Article 48 of the Agreement EU-FYROM).[67]

Finally, Switzerland has very recently partly changed its practice regarding the language related to MFN treatments in its BITs in what seems a clear reaction to the *Maffezini* case law. In the agreement with Colombia signed on 17 May 2006,[68] the parties have included an Annex which reads:

[66]See also Peterson, Investment Law and Policy Weekly News Bulletin, 6 February 2004, available online at www.iisd.org/pdf/2004/investment_investsd_feb6_2004.pdf (last visited on *4 January 2009*) and American Society of International Law, International Law In Brief, 6 February 2004, available online at http://www.asil.org/ilib/ilib0703.htm (last visited on 4 January 2009).

[67]The text was made available online at www.iisd.org/pdf/2006/tas_upgrading_eu.pdf (last visited 4 January 2009); see on this issue also Vis-Dunbar/Peterson, European Commission makes another play for power to negotiate investment pacts, *Investment Treaty News (ITN)*, 9 July 2006, para. 6; available online at http://www.investmenttreatynews.org/content/archives.aspx (last visited on 4 January 2009).

[68]Swiss Federal Council, Despatch to the Swiss Parliament regarding the Agreements on the Promotion and Protection of Investments with Serbia and Montenegro, Guyana, Azerbaijan, Saudi Arabia and Colombia, September 22, 2006, Official Gazette (Bundesblatt) (2006) 8455 ff., 8460 available online in German at http://www.admin.ch/ch/d/ff/2006/8455.pdf (last visited on 4 January 2009).

> For greater certainty, it is further understood that the most favourable nation treatment (. . .) does not encompass mechanisms for the settlement of investment disputes provided for in other international agreements concluded by the Party concerned.[69]

Specifically Negotiated Provisions

The use of the MFN Clause to invoke the applicability of treaty norms between one Party of the Treaty at stake and a third State is subject to the condition that the two treaties do create *like circumstances*, i.e. they must regulate the same subject matter.[70] In the *Tecmed* arbitral award,[71] the arbitral tribunal held that the MFN clause could not be used to invoke those provisions of a Treaty with a third State that were clearly the result of a particular negotiating situation with this third State and thus constituted part of a specific "package deal" made up of specific rights and obligations ("...core matters that must be deemed to be specifically negotiated by the Contracting Parties"...).[72]

In the view of the *Tecmed* arbitral tribunal, the very nature of these provisions makes them unfit for being invoked by third states under an MFN clause.[73] The provision providing for retroactive application of a BIT to investments made before the entry into force of the BIT was considered to be such a clause that had only been granted to the respective treaty partner in view of the specific negotiating situation and could thus not be invoked by an investor under another BIT.

Already the *Maffezini* Tribunal had held that "the beneficiary of the [MFN] clause should not be able to override *public policy considerations* that the contracting parties might have envisaged as fundamental conditions for their acceptance of the agreement in question".[74] According to the tribunal this would apply, for instance:

(a) Where a State has conditioned its consent to arbitration on the exhaustion of local remedies;
(b) Where a BIT contains a "fork-in-the-road" clause according to which a choice between domestic or international courts or tribunals becomes irreversible once made;

[69]Protocol to the BIT (note 68) with Colombia *ad* Article 4 para. 2.

[70]See also Herdegen, *Internationales Wirtschaftsrecht*, (6th ed.) 2007, p. 221.

[71]ICSID Case No. ARB/AF/00/2, *Technicas Medioambientales Tecmed S.A. v. Mexico*, Award, 29 May 2003.

[72]ICSID Case No. ARB/AF/00/2, *Technicas Medioambientales Tecmed S.A. v. Mexico*, Award, 29 May 2003, para. 69.

[73]See also Herdegen, *Internationales Wirtschaftsrecht*, (6th ed.) 2007, p. 221.

[74]ICSID Case No. ARB/97/7, *Maffezini v. Spain*, Decision on Jurisdiction, 24 January 2000, para. 62.

(c) Where a particular forum such as ICSID or NAFTA has been chosen;
(d) If the parties have agreed to a highly institutionalized system of arbitration that incorporates precise rules of procedure, such as NAFTA.[75]

However, the *Maffezini* Tribunal considered a mere requirement to first resort to domestic courts during a period of 18 months did not reflect a fundamental question of public policy which would have limited the scope of the MFN clause.[76]

This argument was also important in the most recent *Wintershall* arbitral award. Here the 18-month time limit was considered an important element of the consent to arbitration given by the State Parties.[77]

Relevance for Procedural Provision in General

Over all, the main question in the *Maffezini*[78] arbitral award and later similar decisions remained whether the MFN clause applied only to substantive rules (treatment provisions) or also to procedural rules, such as the rules relating to dispute settlement or application *ratione temporis* (retrospective application) or *ratione materiae* (umbrella clauses) under a BIT.[79]

Those authors and arbitrators opposed to applying the MFN clause to procedural guarantees, in particular dispute settlement, mostly consider such an application contrary to the intention of the Contracting Parties.[80] In the Plasma v. Bulgaria case, the arbitral tribunal stated accordingly:

> [A]n MFN provision in a basic treaty does not incorporate by reference dispute settlement provisions in whole or in part set forth in another treaty, unless the MFN provision in the basic treaty leaves no doubt that the Contracting Parties intended to incorporate them[81]

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75 ICSID Case No. ARB/97/7, *Maffezini v. Spain*, Decision on Jurisdiction, 24 January 2000, para. 63.

76 See Reinisch, Maffezini v. Spain Case, in: *Encyclopaedia of Public International Law — EPIL*, forthcoming 2010.

77 ICSID Case No. ARB/04/14 (Germany/Argentina BIT), *Wintershall Aktiengesellschaft v. Argentine Republic*, Award, 8 December 2008.

78 ICSID Case No. ARB/97/7, *Maffezini v. Spain*, Decision on Jurisdiction, 24 January 2000, paras. 53 ff.

79 The question as to whether the MFN treatment obligation applied also to procedural standards besides substantive treatment provisions has also arisen in the framework of trade, more specifically in relation to the GATT of 1947 in the case *United States — Section No. 337 of the Tariff Act of 1930*, see below Section IV.

80 See Herdegen, Internationales Wirtschaftsrecht, (6th ed.) 2007, p. 221 with reference to the arbitral awards in ICSID Case No. ARB/02/13, *Salini Costruttori S.p.A and Italstrade S.p.A* v. *The Hashemite Kingdom of Jordan*, Decision on Jurisdiction, 29 November 2004, paras. 102 ff. and ICSID Case No. ARB/03/24, *Plama Consortium Ltd.* v. *Bulgaria*, Decision on Jurisdiction, 8 February 2005, para. 223. Most recently also in ICSID Case No. ARB/04/14 (Germany/Argentina BIT), *Wintershall Aktiengesellschaft v. Argentine Republic*, Award, 8 December 2008.

81 ICSID Case No. ARB/03/24, *Plama Consortium Ltd. v. Bulgaria*, Decision on Jurisdiction, 8 February 2005, para. 223.

Also the recent steps by Canada, the US and the EC to limit the scope of their MFN clauses included in BITs seem to hint in this direction.[82] At the same time, many arbitrators and authors seem to consider such limitation unnecessary or at least not supported by the treaty language used in the past. The *Maffezini* tribunal openly rejected Spain's argument that "matters" can only be understood to refer to substantive matters or material aspects of the treatment granted to investors and not to procedural or jurisdictional questions. Relying on international precedents and considering the broad wording of the MFN clause which refers to "all matters subject to this Agreement", the tribunal emphasised that dispute settlement provisions in BITs were "essential to the protection of the rights envisaged under the pertinent treaties; they are also closely linked to the material aspects of the treatment accorded".[83] Similarly Gaillard considers it logical to include dispute settlement provisions among the types of treatment subject to MFN.[84] Also several other authors seem favourable to including procedural rules as long as this seems openly excluded by the wording of a treaty or is evident from the context when interpreting the treaty at stake.[85]

It is interesting to observe that generally arbitral tribunals were only willing to let the claimant borrow more favourable dispute settlement provisions in cases involving BITs concluded by Argentina and on the question of a mandatory waiting period. This approach developed in Maffezini was even expanded in *Siemens* v. *Argentina* (2004) where again the waiting period of 18 months was equally avoided in this way. Other cases affirming the possibility of getting rid of a waiting period through importation of a different dispute settlement provision not containing this requirement into a BIT are *Gas Natural* v. *Argentina* (2005), *Camuzzi* v. *Argentina* (2005),[86] *National Grid plc* v. *Argentina* (2006),[87] as well as in *Suez,*

[82]See section immediately before this one.

[83]ICSID Case No. ARB/97/7, *Maffezini v. Spain*, Decision on Jurisdiction, 24 January 2000, para. 55 as summarized by Reinisch, Maffezini v. Spain Case, *Encyclopaedia of Public International Law — EPIL*, forthcoming 2010.

[84]See Gaillard, Chronique des sentences arbitrales, Journal du Droit International 132 (2005), pp. 135 ff. (163): "Lorsque la clause est rédigée en des termes très généraux, tout laisse à penser que l'intention des rédacteurs du traité était bien de lui permettre de jouer à l'égard de tous les bénéfices que l'Etat d'accueil serait susceptible d'accorder aux ressortissants d'Etats tiers. Or force est de constater que l'accès à un mécanisme efficace et neutre de règlement des différends . . . est bien l'un des bénéfices les plus importants, sinon le plus important, susceptible de résulter du droit contemporain de la protection des investissements". Gaillard, Establishing Jurisdiction through a Most-Favored-Nation Clause, New York Law Journal 203 (2005), p. 105.

[85]See also Bernardini, Investment Arbitration under the ICSID Convention and BITs, in: Aksen et al. (eds.), *Liber Amicorum in Honour of Robert Briner*, 2005, pp. 95 ff.; Schreuer, *The Dynamic Evolution of the ICSID System*, 2006, p. 9. See also Schmid, *Swiss Investment Protection Agreements: Most-Favoured-Nation Treatment and Umbrella Clauses*, 2007, p. 43 and p. 46.

[86]ICSID Case No. ARB/03/2, *Camuzzi International S.A. v. Argentina*, Decision on Objections to Jurisdiction of 11 May 2005, para. 121. See for details Acconci, Most-Favoured Nation Treatment and International Law on Foreign Investment, in: Muchlinski/Ortino/Schreuer (eds.), *The Oxford Handbook of International Investment Law*, 2008, pp. 363–407, Sect. 5.1.

[87]UNCITRAL, *National Grid plc v. The Argentine Republic*, Decision on Jurisdiction, 20 June 2006, para. 53 ff.

Sociedad General de Aguas de Barcelona S.A., and Vivendi Universal S.A. and *AWG Group Ltd. v. Argentina* (2006).[88] All these cases involve the non-compliance with the waiting periods provided in some of Argentina's BITs. Only in *Wintershall Aktiengesellschaft v. Argentine Republic* (2008) did the ICSID tribunal deny the implicit waiver of the 18-month waiting period by reliance on the MFN clause.[89]

In *Salini* v. *Jordan* (2004),[90] in *Plama* v. *Bulgaria* (2005),[91] in *Telenor* v. *Hungary* (2006), and *Berschader* v. *Russia* (2006),[92] however, the respective ICSID tribunals came to the conclusion that the applicable MFN clauses did lend themselves to widening the substantive scope of the dispute settlement method specifically chosen in a selected BIT.[93] Only in *RosInvestCo UK Ltd. v. The Russian Federation* (2007)[94] did the tribunal uphold jurisdiction in this case by allowing a British investor to invoke a dispute settlement clause with a wider substantive scope. This seems so far the only existing decision where a tribunal accepted the import of a procedural aspect of a dispute settlement provision other than the waiting period.

Summary Analysis

In recent years arbitrators and commentators have been focusing on the question whether the MFN treatment clause of BITs applies to all types of treatment or whether it is limited to certain kinds of treatment. For some the case law of various arbitral tribunals diverges heavily. Others have tried to distinguish between the different arbitral awards and to develop a coherent theory taking into account the wording and context of specific MFN clauses. These theories which try to establish under what circumstances MFN treatment should have a broad scope (possibly including consent to arbitration, procedural aspects of dispute settlement etc.), and when MFN does not apply do not, however, seem extremely convincing. Therefore more and more States seem to prefer a clear exclusion of procedural provisions, especially dispute settlement. They do so by stating the exception in an appropriate way in the text or the negotiating history of the newer agreements.

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[88]ICSID Case No. ARB/03/19, *Suez*, *Sociedad General de Aguas de Barcelona S.A., and Vivendi Universal S.A. v. The Argentine Republic*, and UNCITRAL, *AWG Group Ltd. v. The Argentine Republic*, Decision on Jurisdiction, 3 August 2006.

[89]ICSID Case No. ARB/04/14 (Germany/Argentina BIT), *Wintershall Aktiengesellschaft v. Argentine Republic*, Award, 8 December 2008.

[90]ICSID Case No. ARB/02/13, *Salini Costruttori S.p.A and Italstrade S.p.A* v. *The Hashemite Kingdom of Jordan*, Decision on Jurisdiction, 29 November 2004.

[91]ICSID Case No. ARB/03/24, *Plama Consortium Ltd. v. Bulgaria*, Decision on Jurisdiction, 8 February 2005.

[92]SCC Case No. 080/2004 (Belgium/Russia BIT), *Berschader v. Russia*, Award, 21 April 2006.

[93]See Reinisch, Maffezini v. Spain Case, in: *Encyclopaedia of Public International Law — EPIL*, forthcoming 2010.

[94]SCC Case No. Arb. V079/2005, *RosInvestCo UK Ltd. v. The Russian Federation*, Award on Jurisdiction, 28 October 2007.

Application to Like Circumstance

The case law relating to the mere application of the MFN standard to the treatment of arbitrators in "like circumstances" or "like situations" (without reference to another BIT) are rather rare and do not seem to cause major problems. In both *Champion Trading Company, Ameritrade International, Inc., James T. Wahba, John B. Wahba, Timothy T. Wahba v. Egypt* (2006)[95] and *Parkerings-Compagniet AS v. Lithuania* (2007)[96] the tribunals accepted the applicability of the MFN clause but came to the conclusion that the investors were not "in a like situation" or that the situation was not governed by "like circumstances" and thus the differential treatment seemed justified and was not contrary to the MFN clause."[97]

Borrowing Substantive Treatment Standards

To invoke treatment standards from another BIT can be more difficult. Here the question as to whether a differently worded standard in another agreement results in more favorable treatment can be controversial.[98] To invoke specific substantive standards such as "fair and equitable treatment", "full protection and security", the prohibition of "unreasonable and discriminatory measures", the "obligation to grant necessary permits"[99] or "the remittance of capital transfers"[100] in the absence of such standards or clearly less advantageous provisions in the agreement containing the MFN clause, however, seems relatively easier.[101] This can also be said for the

[95]ICSID Case No. ARB/02/9 (United States/Egypt BIT), *Champion Trading Company, Ameritrade International, Inc., James T. Wahba, John B. Wahba, Timothy T. Wahba v. Egypt*, Award, 27 October 2006.

[96]ICSID Case No. ARB/05/8 (Norway/Lithuania BIT), *Parkerings-Compagniet AS v. Lithuania*, Award, 11 September 2007.

[97]In ICSID Case No. ARB/03/29, *Bayindir Insaat Turizm Ticaret Ve Sanayi A.Ş. v. Pakistan*, Decision on Jurisdiction of 14 November 2005; the applicability of the MFN clause to alleged discrimination in a tendering procedure was not ruled out.

[98]ICSID Case No. ARB/87/3, *AAPL v. Sri Lanka*, Award of 27 June 1990, para. 54.

[99]ICSID Case No. ARB/01/7, *MTD Equity Sdn. Bhd. and MTD Chile S.A.* v. *Republic of Chile*, Award, 25 May 2004, para. 103.

[100]ICSID Case No. ARB/03/9, *Continental Casualty Co. v. Argentina*, Decision on Jurisdiction of 22 February 2006.

[101]ICSID Case No. ARB (AF)/00/1 (NAFTA), *ADF Group Inc. v. United States*, Award, 9 January 2003, paras. 193ff; ICSID Case No. ARB/01/7, *MTD Equity Sdn. Bhd. and MTD Chile S.A. v. Republic of Chile*, Award, 25 May 2004, para. 103; ICSID Case No. ARB/03/29, *Bayindir Insaat Turizm Ticaret Ve Sanayi A.Ş. v. Pakistan*, Decision on Jurisdiction of 14 November 2005; ICSID Case No. ARB/03/9, *Continental Casualty Co. v. Argentina*, Decision on Jurisdiction of 22 February 2006; ICSID Case No. ARB/05/3 (Italy/Algeria BIT), *L.E.S.I. S.p.A. et ASTALDI S.p.A. v. Algeria*, Award, 12 November 2008.

importation of the inclusion of contractual clauses through so-called “umbrella clauses”.[102]

Borrowing Provisions Defining the Scope of an Agreement

However, specific exceptions, expressly contained in the agreement containing the MFN clause, seem less likely to be avoided by reference to another BIT not containing them in view of the *ejusdem generis* rule.[103] When it comes to the definitions of “investment” and “investors” certain tribunals have refused to regard such issues as an aspect of treatment,[104] which does not necessarily imply that future tribunals will admit borrowing such provisions in cases where the MFN clause is worded more openly. At least one tribunal, however, has denied the possibility of importing the retroactive application of substantive standards as contained in a treaty with a third party “because it deem[ed] that matters relating to the application over time of the Agreement [. . .] due to their significance and importance, go to the core of matters that must be deemed to be specifically negotiated by the Contracting Parties”.[105]

Borrowing Dispute Settlement Provisions

Most decisions on the MFN clause definitely relate to the question whether more favourable dispute settlement provisions can be borrowed. Here the *Maffezini* award of 2004[106] is at the beginning of an ongoing debate by allowing – in view of the text of the MFN clause concerned and with certain caveats – such an importation in the case at stake (waiver of 18-month waiting period). It was followed in cases against Argentina with regard to the mandatory waiting period by an important number of tribunals. The only true exception is the recent *Wintershall Aktiengesellschaft v. Argentine Republic* (2008), where the ICSID tribunal

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[102]ICSID Case No. ARB/01/7, *MTD Equity Sdn. Bhd. and MTD Chile S.A. v. Republic of Chile*, Award, 25 May 2004, para. 103, and ICSID Case No. ARB/03/3, *Impregilo S.p.A. v. Pakistan*, Decision on Jurisdiction of 22 April 2005, para. 223.

[103]ICSID Case No. ARB/01/8, *CMS Gas Transmission Co. v. Argentina*, Award of 20 April 2005, para. 377, and UNCITRAL, LCIA Case No. UN7927 (France/Dominican Republic BIT), *Société Générale v. Dominican Republic*, Preliminary Objections to Jurisdiction, 19 September 2008.

[104]UNCITRAL, LCIA Case No. UN7927 (France/Dominican Republic BIT), *Société Générale v. Dominican Republic*, Preliminary Objections to Jurisdiction, 19 September 2008.

[105]ICSID Case No. ARB/AF/00/2, *Technicas Medioambientales Tecmed S.A.* v. *Mexico*, Award, 29 May 2003, para. 69.

[106]ICSID Case No. ARB/97/7, *Maffezini v. Spain*, Decision on Jurisdiction, 24 January 2000, paras. 53 ff.

denied the implicit waiver of the 18-month waiting period by reliance on the MFN clause.[107]

However, when it comes to widening the scope of dispute settlement provisions the awards analyzed in this contribution have all rejected the borrowing of a wider scope from a different BIT, just as arbitral tribunals have normally rejected the widening of the scope of a BIT in general by relying on an MFN clause. Here, the decision in *RosInvestCo UK Ltd. v. The Russian Federation* (2007)[108] seems to be the notable exception.

It seems clear from the analysis just undertaken that it is in particular the questions relating to the applicability of the MFN clause to the dispute settlement clauses contained in BITs with third parties that still needs clarification whereas the other aspects treated in this article seem rather governed by a coherent case law so far. This is not to say that the distinction which has been developed in practice by arbitral tribunals is perfectly logical and coherent. Possibly the view expressed by certain authors who argue that either all aspects of dispute settlement[109] or none should be subject to the MFN clause will influence further developments in this field.

[107]ICSID Case No. ARB/04/14 (Germany/Argentina BIT), *Wintershall Aktiengesellschaft v. Argentine Republic*, Award, 8 December 2008.

[108]SCC Case No. Arb. V079/2005, *RosInvestCo UK Ltd. v. The Russian Federation*, Award on Jurisdiction, 28 October 2007.

[109]See Gaillard, Chronique des sentences arbitrales, Journal du Droit International 132 (2005) pp. 135 ff. (163): "Lorsque la clause est rédigée en des termes très généraux, tout laisse à penser que l'intention des rédacteurs du traité était bien de lui permettre de jouer à l'égard de tous les bénéfices que l'Etat d'accueil serait susceptible d'accorder aux ressortissants d'Etats tiers. Or force est de constater que l'accès à un mécanisme efficace et neutre de règlement des différends . . . est bien l'un des bénéfices les plus importants, sinon le plus important, susceptible de résulter du droit contemporain de la protection des investissements"; Gaillard, Establishing Jurisdiction through a Most-Favored-Nation Clause, New York Law Journal 233 (2005), p. 105; Bernardini, Investment Arbitration under the ICSID Convention and BITs, in: Aksen et al. (eds.), *Liber Amicorum in Honour of Robert Briner*, 2005, p. 95; Schreuer, *The Dynamic Evolution of the ICSID System*, 2006, p. 9; Schmid, *Swiss Investment Protection Agreements: Most-Favoured-Nation Treatment and Umbrella Clauses*, 2007, p. 43.

Foreign Investment in Germany: Restrictions Based on Public Security Concerns and Their Compatibility with EU Law

Till Müller-Ibold

Introduction

On February 13, 2009, the German Bundestag enacted revisions to German foreign trade laws, which provide for broad powers of the German federal government to block foreign investments in Germany, if such investments would threaten German national security[1] (the "new German legislation").

The new law had been a matter of significant public debate. Supporters of the law (and of even stronger legislation) expressed concern about the absence of appropriate procedures to deal with investment by large foreign buyers, and in particular by foreign sovereign wealth funds (state-owned investment vehicles), buying up industries critical to national security. Those opposed, or desiring more limited powers of intervention, pointed to the fact that foreign direct investment is crucial for the development of the German economy, and that nothing should be done to discourage such investment (particularly in times of economic crisis).

The new law, and the projects for such a law discussed in the run-up to the adoption of the final text, was not only the subject of political debate. Issues were

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[1] 13. Gesetz zur Änderung des Außenwirtschaftsgesetzes (AWG) und der Außenwirtschaftsverordnung, BGBl. 2009 I, p. 770 [13th act amending the *Außenwirtschaftsgesetz* (Foreign Trade and Payments Act, AWG) and the *Außenwirtschaftsverordnung* (Foreign Trade and Payments Regulation, AWV)] (the draft and the government explanatory memorandum were published in BT Drs. 16/10730).

C. Herrmann and J.P. Terhechte (eds.), *European Yearbook of International Economic Law 2010*, European Yearbook of International Economic Law,
DOI 10.1007/978-3-540-78883-6_5,

also raised by legal scholars, who have expressed concerns as regards the compatibility of the new law, in particular, with EU law.[2]

This article is neither attempting to settle the political debate, nor to resolve the legal arguments. Rather, the objective is to describe the law and the legal difficulties that may arise in connection with its application, against the background of the rules applicable in other jurisdictions and, in particular, against the background of the strictures imposed by EU law.

The Global Context: Comparable Legislation in Other Jurisdictions

The new German legislation was not adopted in a vacuum. Rather, the German legislature was able to consider the rules applicable in a number of other "developed" OECD countries, which had adopted similar regimes earlier. Moreover, there is a legislative trend towards the adoption of such restrictive rules.[3] It is perhaps useful as background to briefly consider the rules that are in place in some jurisdictions that are traditionally considered in Germany when guidance is sought from foreign legislation.[4]

United States

The *Exon-Florio* law in the United States was supposedly a template for the German legislation. It is notoriously known for the row over the contemplated but eventually abandoned acquisition of terminal operations at six US ports by a United Arab Emirates company. The law was introduced in 1988 and last revised in October 2007.[5] *Exon-Florio* envisages a two-stage procedure: the Committee on Foreign Investment of the United States (which is composed of representatives of US government agencies and departments) may review proposed transactions with regard to national security concerns. The committee may then refer the matter to the

[2]See, inter alia, Nettesheim, Unternehmensübernahmen durch Staatsfonds: Europarechtliche Vorgaben und Schranken, ZHR 172 (2008), p. 729; Weller, Ausländische Staatsfonds zwischen Fusionskontrolle, Außenwirtschaftsrecht und Grundfreiheiten, ZIP (2008), p. 857; Krolop, Schutz vor Staatsfonds und anderen ausländischen Kapitalmarktakteuren unter Ausblendung des Kapitalmarktrechts? ZRP (2008), p. 40.

[3]See also Nettesheim, Unternehmensübernahmen, op.cit., ZHR 172 (2008), p. 729 (734).

[4]Other comparable regimes not covered in this article exist, e.g., in the United Kingdom, Hungary, Poland and Lithuania;, some examples are also noted by Nettesheim, op. cit.

[5]See section 721 of the Defense Production Act of 1950, 50 U.S.C. App. 2170, as amended by the Foreign Investment and National Security Act of 2007, available at http://www.treas.gov/offices/international-affairs/cfius/.

President who has the power to block the contemplated transaction or order divestment of an acquisition already consummated. The President is allowed to do so if there is "credible evidence" that leads him to believe that "the foreign interest exercising control might take action that threatens to impair the national security" and if other laws do not provide sufficient protection.[6] The amended law gives a list of non-exhaustive factors to consider, such as implications of the deal for national defense, proliferation of weapons, terrorism, important infrastructures including major energy assets, and foreign policy.[7]

Canada

The *Investment Canada Act* provides for review of foreign investment if either a financial threshold is met or if the target business is related to Canada's "cultural heritage or national identity."[8] Several factors linked to national industrial, economic and cultural policies have to be taken into account during the review process, but the government has not formally voided any proposed acquisition since the law's enactment in 1985.[9] This may change when the new national security test is eventually introduced, as proposed by the government in February 2009.

Spain

The Spanish law 19/2003 enables the government to restrict capital movements inter alia on the grounds of public policy, public security and public health.[10] The royal decree 664/1999 and the order of the Ministry of the Economy of May 28, 2001 spell out the procedure:[11] If a ministerial department becomes aware of foreign investments that could affect public policy, public order or public health, it must solicit (together with the Ministry of the Economy and other ministerial bodies) the council of ministers to take a decision on the issue. The council of ministers may then suspend the liberalized regime and introduce a system of control for certain investments. As a result, investors would have to notify the transaction and submit detailed information about it. Six months after the notification the

[6]See section 721(d)(4) of the Defense Production Act of 1950, 50 U.S.C. App. 2170, as amended by the Foreign Investment and National Security Act of 2007.

[7]See section 721(f) of the Defense Production Act of 1950, 50 U.S.C. App. 2170, as amended by the Foreign Investment and National Security Act of 2007.

[8]Lalonde, Vand. J. Transnat'l L. 41 (2008), p. 1475 (1486).

[9]Lalonde, Vand. J. Transnat'l L. 41 (2008), p. 1475 (1488).

[10]Artículo 7 de la ley 19/2003 de 4 de julio 2003.

[11]Artículo 10(1) del real decreto 664/1999 de 23 de abril 1999; artículos 10 y 11 del orden de 28 mayo de 2001.

transaction would be automatically authorized if no prior decision had been taken. Up to now, the council of ministers has suspended the liberalized regime only for foreign investments related to national defense. The European Commission ("Commission") has so far not objected to these rules.

Spain maintains, in addition, certain sector-specific rules (for example as regards investments in the energy sector). These rules have repeatedly led to objections by the European Commission. The Commission has taken legal action, and the Court of Justice has repeatedly held, that the Spanish rules relating to the energy sector infringed the EC Treaty, in particular the rules on freedom of establishment and free movement of capital.[12]

France

France has revised its authorization procedure for foreign investment in certain sectors of activities that affect public policy, public security or national defense.[13] The regime of prior authorization applies when stakes of at least 33.33% are acquired in a company established in France that is active in sectors such as gambling, private security services, information technology security, cryptology or the production of bugging devices, arms, explosives or other products likely to be used for terrorist activities. The scope of the authorization procedure is less extensive for investments originating from the EU, Iceland, Norway and Liechtenstein. Moreover, a transaction can only be prohibited or modified if the investor is suspected of infringing criminal law, or if capacity, research, know-how or security of supply of a particular industry are not guaranteed, or public services or production of military goods are not ensured.

The Commission considers the third-country provisions to be authorized by Article 57 EC, which allows restrictions on the free movement of capital between Member States and third countries that existed on or before December 31, 1993. On the other hand, the Commission was critical of the possibility that the procedure foreseen for third-country investments could create a restriction on investments by companies that are legally established in the European Union and have shareholders established in third countries.[14] After sending its reasoned opinion the Commission, however, seems to have put the infringement proceedings on hold.

[12]See Case C-463/00 *Commission v Spain* [2003] ECR I-4581, Case C-274/06 *Commission v Spain* [2008] ECR I-26, and Case C-207/07, *Commission v Spain* (ENDESA) [2008] ECR I-0000 (judgment of July 17, 2008).

[13]Art. L151-3 du Code monétaire et financier législatif; art. R153-1 to 11 du Code monétaire et financier règlement; for the discussion of the former regime, see below at Part IV.

[14]Commission press release from October 12, 2006, IP/06/1353.

European Union

In 2008 the Commission published a policy document setting out the Commission's approach to investment by sovereign wealth funds ("SWFs").[15] While the Commission's comments deal expressly with SWFs only, the Commission addresses the concerns that have prompted certain Member States to place limitations on investments from third countries more generally.

The Commission notes, with regard to the EU legal framework:

> that the principles of free movement of capital between Member States, and between Member States and third countries stipulated in Article 56 EC apply, but that the free movement of capital is not absolute. As a fundamental principle of the Treaty, it may be regulated in two respects at the European level under Article 57(2) EC. First, the Community may adopt by qualified majority measures on the movement of capital from third countries involving direct investment. Second, it is not excluded that the Community can introduce — by a unanimous decision — measures that restrict direct investments.[16]

However, the Commission does not favor regulatory intervention at the EU level.[17] Rather it proposes the adoption of a code of conduct for sovereign wealth funds.

As regards national legislation, the Commission recognizes the right of Member States to have on their statute books national instruments which could be used to control and condition SWF investments, while emphasizing also the limits of this right. According to the Commission, such national legislation is permitted:

> as long as those measures are compatible with the Treaty, are proportionate and non-discriminatory, and do not contradict international obligations. The European Court of Justice has provided further guidance on how Member States can take these national measures in full compatibility with the Treaty, stressing that purely economic grounds can never justify obstacles prohibited by the Treaty.[18] The Court has also provided criteria to assess the proportionality of authorization systems: these must aim at the protection of a legitimate general interest, and foresee strict time limits for the exercise of opposition

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[15]Commission Communication, *A common approach to Sovereign Wealth Funds*, February 27, 2008, COM(2008) 115 final.

[16]Commission Communication, *A common approach to Sovereign Wealth Funds*, February 27, 2008, COM(2008) 115 final, at 3.1.

[17]A limited exception was expected in the form of the so-called "Gazprom Clause," which would have limited (without express reference to Gazprom) investments by grid operators from non-EU countries into grid operators within the EU, in the absence of an EU-to-government agreement providing for such investments; see Common Position (EC) No 8/2009 adopted by the Council on January 9, 2009 with a view to the adoption of Directive 2009/. . ./EC of the European Parliament and of the Council of . . . concerning common rules for the internal market in electricity and repealing Directive 2003/54/EC, OJ 2009/C 70 E/02 (not adopted in this version). On this provision, see Reinisch, pp. 53 et seq. in this volume.

[18]In addition, as required by Article 58(3) EC, the measures taken by Member States shall not constitute a means of arbitrary discrimination or a disguised restriction on the free movement of capital, Article 56 EC.

powers; assets or management decisions targeted must be specifically listed; and the system's objective and stable criteria must be subject to an effective review by the courts.[19]

The Commission rightly notes that the EU Merger Regulation[20] prevents Member States from addressing in such legislation perceived anti-competitive effects of such investments. The "one stop shop" approach, on which the Merger Regulation is based, ensures, in cases where a proposed acquisition or other "concentration" has a "community dimension" (as defined under the Merger Regulation), that the Commission retains exclusive competence to deal with such competition concerns.

The New German Investment Restrictions

Outline of the Legal Framework

Germany has for many years regulated foreign trade. The German rules are enshrined in the *Außenwirtschaftsgesetz* ("AWG," Foreign Trade and Payments Act) and in the *Außenwirtschaftsverordnung* ("AWV," Foreign Trade and Payments Ordinance), based on the authority to issue such legislative measures provided for in § 27 AWG. A significant part of the AWG and AWV are no longer autonomous German rules, but simply reflect and implement EU law (in particular EU export and import restrictions, as well as EU sanctions). The AWG serves, in this regard, as a basis for imposing criminal sanctions for non-compliance with the EU rules (as the EU lacks the power to enact criminal sanctions itself).

Nevertheless there are autonomous German rules. The AWG permitted the German government even prior to its recent amendment to impose certain restrictions on transactions that could affect Germany's external security and military interests.[21] Transactions concerning the acquisition of companies active in the manufacture of weaponry, ammunition, other war material and cryptographic systems are subject to government intervention, and these rules will continue to apply.

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[19]Commission Communication, *A common approach to Sovereign Wealth Funds*, February 27, 2008, COM(2008) 115 final, at 3.1., referring to the ECJ Judgment of June 4, 2002, case C-503/99, *Commission v Belgium*, paras. 48–52.

[20]Council Regulation (EC) No 139/2004 of January 20, 2004 on the control of concentrations between undertakings (EC Merger Regulation), OJ L 24, January 29, 2004, p. 1.

[21]Section 7(1)(1)–(3) and section 7(2) AWG.

The 2009 Amendment

The Substantive Rules

The new legislation provides for broader control of transactions that involve the transfer of stakes in German companies to an investor established outside of the European Union[22] or European Free Trade Area (EFTA, i.e., Switzerland, Norway, Iceland and Liechtenstein). The German government has the right to block or modify any such transaction on the grounds of public policy or public order.[23] The new section 7(1)(4) AWG provides: "Transactions and practices in foreign trade can be restricted (. . .) in order to safeguard public policy or public security in the German Federal Republic within the meaning of Article 46 and 58(1) of the EC Treaty."

Section 7(2)(6) AWG specifies that such restrictions can be imposed, in particular, as regards:

> contractual arrangements (Rechtsgeschäfte) concerning the acquisition of German ("Gebietsansässige") companies or of shares in such companies, by an acquirer established outside the European Union ("gemeinschaftsfremder Erwerber"), if public order or security, as defined in Section 1(4), are put in jeopardy as a result of such acquisition and provided that there is a real and sufficiently grave threat affecting one of the fundamental interests of society ("Grundinteresse der Gesellschaft").

A further sentence makes clear that acquirers established in the EFTA States (i.e., Switzerland, Liechtenstein, Iceland and Norway) are to be treated as if they were established within the EU.[24]

The nature of the threats to "public order and security" ("öffentliche Ordnung oder Sicherheit") is not further clarified. The government, when submitting the law to parliament, emphasized the exceptional character of the rules, and argued that the term "öffentliche Ordnung oder Sicherheit" should be construed narrowly (in line with similar EU law terms), in an apparent attempt to differentiate the language used from the term "öffentliche Sicherheit und Ordnung," which is a standard

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[22]The definition of the term "gemeinschaftsansässig" (person established in the Community) and "gemeinschaftsfremd" (a person not established in the Community) follows, pursuant to Sec. 4 (1) (6) and (8) AWG, the definition provided in EU Council Regulation (EEC) No 2913/92 of October 12, 1992 establishing the Community Customs Code, Article 4 (2): "'Persons established in the Community' means: — in the case of a natural person, any person who is normally resident there, [and] — in the case of a legal person or an association of persons, any person that has in the Community its registered office, central headquarters or a permanent business establishment."

[23]As regards the substantive and procedural rules applicable see Traugott/Strümpel, Die Novelle des Außenwirtschaftsgesetzes, Neue Regeln für den Erwerb deutscher Unternehmen durch ausländische Investoren, AG (2009), p. 186; Leuering/Rubner, Neuer Rahmen für Unternehmenserwerbe, NJW Spezial (2009), p. 175.

[24]In the following text, we will refer to shareholders, acquirers, and other persons established outside the EU and the EFTA States as "third-country" shareholders, acquirers and persons respectively.

phrase in German administrative law (allowing for public law intervention), and which has a very broad meaning.[25] In the present context, some initial guidance is provided by reference to Articles 46 and 58 EC. Articles 46 and 58 EC provide for exceptions to the freedom of establishment and the free movement of capital as guaranteed by the EC Treaty. Exceptions must, according to a general rule of interpretation applicable in Germany and under EU law, be narrowly construed.[26] Second, the specific reference to "a real and sufficiently grave threat affecting one of the fundamental interests of society" suggests that prohibitions (or other restrictive orders) will be possible in exceptional circumstances only and will not be available in those additional circumstances that would fall within the broad concept of "öffentliche Sicherheit und Ordnung" as normally understood in German administrative law. Relevant issues, according to the explanation provided by the government to parliament, would include the need to ensure that the population has access to basic needs in times of crisis (such as telecommunications and electricity).

In principle, therefore, a company established within the EU acquiring a German target would not be subject to an investigation, although the AWG provides that investigations remain possible in case of "artificial arrangements" or "circumvention of the control regime."[27]

However, a new Section 53 of the AWV provides further details, which will, in many cases, lead to the application of the new rules even if the direct acquirer is a German or EU-based undertaking. Section 53(1) provides that the German Ministry of the economy can investigate any direct or indirect participation of third-country acquirers in German companies, in those cases where third-country shareholders hold at least 25% of the shares of the target and if the direct or indirect shareholding of the third-country acquirer would exceed 25% post transaction. Shares are considered to be indirectly held if the acquirer holds 25% or more of the shares in the company holding the shares directly.[28] If shares of the acquirer are part of a share pooling arrangement, by which the acquirer and other shareholders have

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[25]The term "öffentliche Sicherheit und Ordnung" is a very broad and far reaching concept under German general public law, cf. for example § 1, 3 PolG Baden–Württemberg, § 8 PolG North Rhine–Westphalia, § 11 SOG Lower Saxony, § 9(1)(1) POG Rhineland–Palatinate, § 3 SOG Hamburg.

[26]Grabitz/Hilf, *Kommentar I, Das Recht der Europäischen Union*, Art. 30 EC, para. 3; Case C-113/80 Commission v Ireland [1981] ECR 1625, 1637, para. 9; Callies/Ruffert, *Das Verfassungsrecht der europäischen Union*, 2007, Art. 57 EC, para. 2; Callies/Ruffert, *Das Verfassungsrecht der europäischen Union*, 2007, Art. 46 EC, para. 1; Case C-348/96 Calfa [1999], ECR I-11, para. 23, Stelkens/Bonk/Sachs, *Verwaltungsverfahrensgesetz*, 2008, § 28 VwVfG, para. 47; *BGH* NVwZ (2002), p. 509 (510).

[27]Section 53(1)(6) AWV.

[28]Section 53(1)(3) AWV; interestingly, the definition of indirect holding does not expressly include situations in which the acquirer A holds 50% of the shares in B, which holds 50% in C, which holds 50% in the target D. The apparent definition of indirect shareholding in section 53(1)(3) provides for only one intermediate undertaking between the acquirer and the target. This may be a drafting error.

agreed to vote their shares jointly, the other shares in the voting agreement are also deemed to be shares of the third-country acquirer.[29]

The rules make clear that the question of whether a (legal or natural) person is established inside the EU or in a third country depends on the actual effective establishment and legal seat.[30] Branch offices or simple business establishments without legal personality share (for the purposes of the specific rules discussed here) the legal status of the legal entity they represent (i.e., a branch of a third-country acquirer remains a third country entity).[31] By contrast, subsidiaries of a third-country acquirer, which are properly established in another Member State of the EU would not have "third country" status, but would be deemed a company established within the EU. Nevertheless, any acquisition "through" or "by" such a subsidiary would be considered an "indirect" acquisition by a third-country entity, as outlined above.

Any transaction that is subject to investigation can be prohibited, or other (less intrusive) instructions can be issued, if the Ministry comes to the conclusion that the transaction poses a sufficiently serious threat to public order or security. In such a case, the contractual arrangement is deemed to be dissolved. For that purpose, section 31(3) AWG provides that any transaction that can be investigated pursuant to section 7(2)(6) AWG will be deemed to have been concluded with a condition subsequent, such condition being triggered by the government's decision to prohibit the transaction.[32] In order to ensure effective implementation of any prohibition, the Ministry can order, in addition, that the affected shares may not be voted generally or in respect of specific issues and it may nominate a trustee to oversee the reversal of the prohibited transaction.[33]

The Procedural Rules

The new legislation provides for an ex officio procedure. When the Government submitted the draft law to parliament it requested additional staff to enable it to monitor the markets for those cases in which a sufficiently serious threat to public order and security might present itself.

Hence, there is *no obligation to notify* any acquisition that may fall within the definition of a transaction that can be investigated. Nevertheless, that acquirer may make a *voluntary notification* to the Ministry of the Economy and apply for a certificate confirming that the transaction will not pose a threat to public order and security.[34] The law provides for no specific deadline within which the government

[29] Section 53(1)(4) AWV.

[30] See also Dorsch, Zollrecht, Kommentar, Art. 4 Community Customs Code, para. 7.

[31] Section 53(1)(5) AWV.

[32] Section 53(1)(1) AWV, section 31(3) AWG.

[33] Section 53(4) AWV.

[34] Section 53(3) AWV.

would have to decide on such a request. If "complete information" is provided to the government (as in the case of the normal ex officio procedure, see below), the 2-month period for taking a decision should apply by analogy.

Investigations pursuant to Section 7(5) AWG are dealt with by the federal Ministry of the Economy. The ministry may initiate an investigation within 3 months of signature of an acquisition agreement. The reference to "schuldrechtliche Vertrag über den Erwerb der Stimmrechte" (contractual arrangements concerning the promise of the acquisition of voting rights) makes it clear that the signing (and not the closing) of a transaction triggers the 3-month period. By contrast, the signing of preliminary agreements, such as a memorandum of understanding, should not trigger the period. Voluntary notifications may be made prior to the signing of documents, but the Government will in all likelihood require that the underlying transaction can be described in sufficient detail to allow for its full assessment.

Once an investigation is formally opened, the investor is obliged to provide "complete documentation" of the case.[35] The Ministry of the economy will publish instructions in the Federal Register (*Bundesanzeiger*) identifying what exactly it needs in terms of "complete documentation."[36] Once such complete documentation is submitted, the investigation must be completed within 2 months.[37]

The general procedural rules applicable to the Federal Administration, and enshrined in the "Administrative Procedure Act" (*Verwaltungsverfahrensgesetz*[38]), apply. Legal redress against the decisions to investigate, to modify or to block a transaction is available for the parties concerned; they can appeal such a decision to the administrative court (*Verwaltungsgericht*) Berlin.

The Strictures of EU Law

A number of commentators have raised concerns as regards the compatibility of the new German legislation with EU law. Indeed, the compatibility of the restrictions with the fundamental freedoms of the Treaty and with existing legislation under the EC Treaty requires closer analysis.

Concerns Under EU Law

The compatibility concerns can be grouped into three categories. First, the "fundamental" freedoms, in particular Articles 43 and 56 EC, require in principle that restrictions of the kind imposed in the new German legislation be justified by concrete reasons of

[35] Section 53(2)(1) AWV.

[36] Section 53(2)(2) AWV.

[37] Section 53(2)(4) AWV.

[38] Verwaltungsverfahrensgesetz, BGBl. 2004 I, p. 718.

public security. The scope of application of these rules as regards the transactions covered by the German legislation will be considered in more detail below.

Second, the EU Merger control regime is based on a "one-stop shop" approach. Therefore, Member States cannot call into question a Commission decision authorizing a transaction by reference to concerns, which the Commission has to consider as part of its decision-making process.[39] While the German government can consider genuine public security concerns, it would be prevented from considering the competitive effects of a transaction, even under the heading "public security concerns." For example, the protection of a national champion against unwelcome competition from a third-country investor is likely to be a matter which the German government would not be able to consider under the new legislation.[40]

Finally, the Community itself is competent to legislate in this context. Article 57 (2) EC enables the Council of Ministers to adopt measures on the movement of capital with relation to third countries. Moreover, under the Lisbon Treaty Article 207(1) of the Treaty on the Functioning of the European Union provides an exclusive competence of the Union to legislate on matters of "foreign direct investments."[41]

Reminder: The Scope of Application of the Legislation

It is clear from the very wording of the legislation that the typical situation envisaged by the legislature is the acquisition of the voting rights in a company resident in Germany by a third-country investor.

However, the scope of application of the control regime is significantly broader in two important aspects. First, it is not necessary to buy the whole of the company, or a controlling stake (>50%); rather, acquisition of a 25% share in the target is sufficient. The threshold was apparently based on the assumption that 25% of the voting rights are likely to put the investor in a position where he is able to block

[39]The Merger Regulation (Council Regulation (EC) No 139/2004 of January 20, 2004 on the control of concentrations between undertakings) OJ 2004 L 24/1 (as amended)) specifically provides for the exclusivity of the Commission's analysis in *Article 21 — Application of the Regulation and jurisdiction:*"1. This Regulation alone shall apply to concentrations as defined in Article 3(. . .).2. Subject to review by the Court of Justice, the Commission shall have sole jurisdiction to take the decisions provided for in this Regulation.3. No Member State shall apply its national legislation on competition to any concentration that has a Community dimension. (. . .) 4. Notwithstanding paragraphs 2 and 3, Member States may take appropriate measures to protect legitimate interests *other than those taken into consideration by this Regulation* and compatible with the general principles and other provisions of Community law. Public security, plurality of the media and prudential rules shall be regarded as legitimate interests within the meaning of the first subparagraph" [emphasis supplied].

[40]See, for example, ECJ, C-207/07, Commission v Spain (ENDESA), 2008 ECR I-0000 (judgment of July 17, 2008).

[41]On this competence, see Bungenberg, pp. 123 et seq. in this volume.

certain business decisions. The threshold mirrors German merger control provisions.[42]

Moreover, the legislation is not limited to third-country investment. The law also encompasses indirect acquisitions, i.e., situations in which the buyer does not buy the German target directly, but buys the shares in another company which happens to be a shareholder of the German "target." It is sufficient that the third-country investor holds only 25% of the voting rights in the intermediate company, if that intermediate company in turn holds at least 25% of the target.[43] It is not entirely clear whether in such a case the 25% threshold is measured by reference to the aggregate indirect shareholding in the German target (in which case a 25% holding of 25%, i.e., 6.25% should not be sufficient), or if a consecutive chain of 25% holdings triggers the application of the control regime.

As a result, transactions completely taking place outside of Germany may fall into the scope of application of the new control regime. A Chinese company buying a US entity that happens to hold more than 25% in a German company would be subject to investigation, as would the acquisition of a Dutch company (with a majority owned subsidiary in Germany) be subject to investigation if it is bought by a US corporation. More importantly, EU internal acquisitions of a German target would be subject to the new German legislation as well, for example if a UK company in which third-country shareholders (say from the United States) hold a minority stake of 25% or more bought a 25% stake in a German company.

Fundamental Freedoms

Application of the Fundamental Freedoms to Investment Restrictions of the Kind Envisaged by the New German Legislation

The Scope of Application

Article 43 of the EC Treaty provides that "restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State shall be prohibited. Such prohibition shall also apply to restrictions on the setting-up of agencies, branches or subsidiaries by nationals of any Member State established in the territory of any Member State."[44] Article 56 EC prohibits "all restrictions on the movement of capital between Member States *and between Member States and third countries*" [emphasis supplied]. Direct investment in a company by means of

[42]Section 37(1)(3)(b) of the German Act Against Restraints of Competition (GWB).

[43]Section 53(1)(3) AWV.

[44]This applies also to companies, pursuant to Article 48 EC: "Companies or firms formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the Community shall, for the purposes of this Chapter, be treated in the same way as natural persons who are nationals of Member States."

shareholding with the view to effectively participate in the management and control of a company,[45] as well as the acquisition of shares with the intention of making financial investment (a portfolio investment),[46] are capital movements and fall within the scope of Article 56 EC.

Generally, the fundamental freedoms provided for in the EC Treaty apply only inside the European Union.[47] Hence, these rules do not protect investors established in third countries. However, free movement of capital is ensured by the EC Treaty even in relation to third countries. It is recognized, in principle, that Article 56 EC creates directly applicable rights also for third country nationals, which Member States' courts must enforce also as regards capital flows from third countries into the EU (and from the EU to any third country).[48]

Hence, both Articles 43 and 56 EC protect in principle investments in Germany, and the limitation of the right to invest in German companies of the kind imposed by the new German legislation.

The Lex Specialis Question

It has been argued that Article 43, on the freedom of establishment, is really the more specific rule that should be the only rule applying to investments of 25% or more. Supporters refer, inter alia, to Article 58(2) EC, which states that "the provisions of this Chapter [on free movement of capital] shall be without prejudice to the applicability of restrictions on the right of establishment which are compatible with this Treaty." The argument suggests, in particular, that because Article 43 applies only to investors established in an EU Member State, investors from third countries would not benefit from the free movement of capital rules in this regard, in so far as any restrictions are compatible with the freedom of establishment rules under the Treaty.

The case law of the European Court of Justice is not entirely clear in this regard. One line of cases, relating to difficulties for the exercise of the freedom of establishment resulting from national tax legislation (direct taxation), seems to suggest that whether Article 43 or Article 56 EC applies depends on the *purpose* (*objet*; *Gegenstand*) of the legislation. If it primarily concerns the establishment of a business activity it would be dealt with under Article 43, and if it deals mainly with

[45]See, for example, Case C-367/98 *Commission v Portugal* [2002] ECR I-4731, para. 38; Case C-483/99 *Commission v France* [2002] ECR I-4781, para. 37; Case C-503/99 *Commission v Belgium* [2002] ECR I-4809, para. 38; Joined Cases c-463/04 and C-464/04 *Federconsumatori* [2007] ECR I-10419, para. 20.

[46]See, for example, Joined Cases C-282/04 and 283/04 *Commission v Netherlands* [2006] ECR I-9141, para. 19.

[47]See Case C-452/04 *Fidium Finanz* [2006] ECR I-9521, para. 25 on the free movement of services; Case C-492/04 *Lasertec* [2007] ECR I-3775, para. 27 on the freedom of establishment.

[48]Case C-101/05 *Skatteverket v A* [2007] ECR I-11531, para. 27; see also Cases C-163/94, C-165/94 and C-250/94 *Sanz de Lera* [1995] ECR I-4821, paras. 43 and 47.

capital transfer it would be dealt with under Article 56.[49] This analytical approach can be traced back to Advocate General Alber in his opinion in *Baars*, which suggested that only the directly affected freedom should be considered. He advocated the application of the free movement of establishment when the investment at issue enabled the investor to "exercise real influence over the company's business decisions."[50] The ECJ has referred to this wording and developed it into a formula which it has often repeated in that line of cases: "According to consistent case law, in a case concerning a shareholding which gives its holder *definite influence* over the company's decisions and allows that holder to determine the company's activities, it is the provisions of the EC Treaty on the freedom of establishment that are to be applied"[51] [emphasis supplied].

The ECJ usually continues to say that any restrictive effects on the free movement of capital resulting from the restriction on the freedom of establishment "would be the unavoidable consequence of such an obstacle to the freedom of establishment as there might be, and do not therefore justify an independent examination of that legislation from the point of view of Article 56 EC."[52]

It is important to underline, though, that this line of cases relates to situations where the restrictions in question existed between Member States. The Court did not address the question of whether Article 56 would be excluded in cases where Article 43 could not apply because the restriction in question affected only third countries. The language used by the Court ("do not therefore justify an independent examination of that legislation from the point of view of Article 56 EC") does not suggest an exclusion of Article 56 if Article 43 is not applicable as a result of its limited (territorial) scope of application.

Moreover, the Court, in a different line of cases, has applied Article 43 and 56 concurrently. In the so-called "golden share" case law (relating to Member States maintaining special voting rights in certain companies), the Court arguably did not suggest a *lex specialis*-relationship between freedom of establishment and free movement of capital. In all these cases the Court measured national restrictions

[49]Case C-157/05 *Holböck* [2007] ECR I-4051, para. 22, citing for this proposition Case C-196/04 *Cadbury Schweppes and Cadbury Schweppes Overseas* [2006] ECR I-7995, paras. 31–33; Case C-452/04 *Fidium Finanz* [2006] ECR I-9521, paras. 34 and 44–49; Case C-374/04 *Test Claimants in Class IV of the ACT Group Litigation* [2006] ECR I-11673, paras. 37 and 38; Case C-446/04 *Test Claimants in the FII Group Litigation* [2006] ECR I-11753, para. 36; and Case C-524/04 *Test Claimants in the Thin Cap Group Litigation* [2007] ECR I-2107, paras. 26–34.

[50]Alber AG in Case C-251/98 *Baars* [2000] ECR I-2787, para. 33.

[51]See, for example, Case C-251/98 *Baars* [2000] ECR I-2787, paras. 21 and 22; Case C-208/00 *Überseering* [2000] ECR I-9919, para. 77; Case C-436/00 *X and Y* [2002] ECR I-10829, paras. 37 and 66 to 68; Case C-196/04 *Cadbury Schweppes* [2006] ECR I-7995, para. 31; Case C-374/04 *Test Claimants in Class IV of the ACT Group Litigation* [2006] ECR I-11673, para. 39; Case C-231/05 *Oy AA* [2007] ECR I-6373, para. 20.

[52]Case C-231/05 *Oy AA* [2007] ECR I-6373; Case C-196/04 *Cadbury Schweppes* [2006] ECR I-7995, para. 33; Case C-524/04 *Test Claimants in the Thin Cap Group Litigation* [2007] ECR I-2107, para. 34.

solely against the yardstick of Article 56 EC.[53] In *Volkswagen*, the ECJ considered the application of Article 43 EC and the "definite influence"-test.[54] The case concerned, "at least in part, the situation of a possible takeover of Volkswagen by a shareholder seeking to exercise a controlling influence over the undertaking."[55] But as the Commission did not advance any argument based on the freedom of establishment, the ECJ decided to apply only Article 56 EC. Similarly, in *Commission v Netherlands,* the Court mentioned Article 43 EC and the "definite influence"-test but held, after examining the case under Article 56 EC, that restrictions on the freedom of establishment "are a direct consequence of the obstacles to the free movement of capital," so that "there is no need for a separate examination" in light of Article 43 EC.[56]

In a more recent decision the Court even relied exclusively on Article 56. In *Commission v Spain* a Spanish law required public entities and companies to notify the acquisition of any controlling or significant stakes (at least 3% of the capital or voting rights) in Spanish energy companies.[57] The Court analyzed the case only under Article 56 EC and held that the requirement infringed Article 56 and could not be justified. In its subsequent judgment in the ENDESA matter (again, *Commission v Spain*) the ECJ held that a revised Spanish legislation was incompatible with both Articles 56 and 43.[58]

It would seem difficult to claim on the basis of the somewhat inconsistent case law that Article 43 excludes the application of Article 56, because Article 43 is "*lex specialis*." The Court simply seems to say that it is not necessary, in cases where both rules apply, to review the measure on the basis of both rules (which are, in fact, quite similar in substance, except for the territorial reach). It is worth noting that the Court does not seem to consider Article 58(2) EC to be a basis for exclusion of Article 56 EC either.

Conclusion

Against this background the better arguments suggest that the new German legislation restricts the free movement of capital in the sense of Article 56 EC, and does so

[53]See, for example, Case C-54/99 *Association Église de scientologie de Paris* [2000] ECR I-1335; Case C-367/98 *Commission v Portugal* [2002] ECR I-4731; Case C-483/99 *Commission v France* [2002] ECR I-4781; Case C-503/99 *Commission v Belgium* [2002] ECR I-4809; Case C-463/00 *Commission v Spain* [2003] ECR I-4581; Case C-274/06 *Commission v Spain* [2008] ECR I-26.

[54]Case C-112/05 *Commission v Germany (Volkswagen)* [2007] I-8995, paras. 13–16.

[55]Case C-112/05 *Commission v Germany (Volkswagen)* [2007] I-8995, paras. 14.

[56]Joined Cases C-282/04 and C-283/04 *Commission v Netherlands*, para. 42; see also Case C-463/00 *Commission v Spain* [2003] ECR I-4581, para. 86; Case C-367/98 *Commission v Portugal* [2002] ECR I-4731, para. 56; Case C-483/99 *Commission v France (Elf Aquitaine)* [2002] ECR I-4781, para. 56.

[57]Case C-274/06 *Commission v Spain* [2008] ECR I-26, para. 2 (summary publication; the full text is available from the website of the Court).

[58]Case C-207/07, *Commission v Spain* (ENDESA) [2008] ECR I-0000 (judgment of July 17, 2008).

irrespective of whether the investor is established in another Member State or in a third country. Moreover, and as regards acquisitions by (or through) investors established within another Member State, the freedom of establishment (Article 43 EC) is restricted, if and to the extent that the investor wishes to acquire control or "definite influence" over the target.

One other element needs to be emphasized. Even to the extent that Article 56 EC would not be applied to investors from third countries, such limitation would only relate to "true" third-country investors. EU law is not affected by the rule in §53 AWV, according to which an investment by a legal entity established in another Member State is deemed to be made by a third-country investor, if such a third-country investor holds more than 25% of the shares in such a Community investor. For purposes of Community law, and the application of the freedom of establishment and free movement of capital rules, all that matters in the effective place of business of the investor: if the investor is established within the EU, it is protected by the fundamental freedoms.[59]

Justification on the Grounds of Public Policy or Public Security?

Not all restrictions of the four fundamental freedoms under the EC Treaty are automatically illegal. Certain restrictions can be justified, in particular on grounds of public security. The German legislation relies explicitly on reasons of public policy or public security, and even makes specific reference[60] to Articles 46(1) and 58(1)(b) EC,[61] the requirements of which would have to be fulfilled in order to justify government action under the new German legislation.

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[59] Only in the case of concrete indications of circumvention in a specific case would it be possible to look through the Community entity acting as an investor. This risk is addressed in Section 53(1)(6) AWV, and not by the 25% rule, which does not require any indication of circumvention in a particular case. The ECJ has accepted that "a national measure restricting freedom of establishment may be justified where it specifically relates to wholly artificial arrangements aimed at circumventing the application of the legislation of the Member State concerned". See Case C-524/04 *Test Claimants* [2007] ECR I-2107, para. 72; Case C-201/05 *Test Claimants*, para. 76; Case C-196/04 *Cadbury Schweppes* [2006] ECR I-7995, para. 51, referring to Case C-264/96 *ICI* [1998] ECR I-4695, paragraph 26; Case C-324/00 *Lankhorst-Hohorst* [2002] ECR I-11779, paragraph 37; Case C-9/02 *De Lasteyrie du Saillant* [2004] ECR I-2409, paragraph 50; Case C-446/03 *Marks & Spencer* [2005] ECR I-10837, paragraph 57.

[60] See above, section 7(1)(4) AWG.

[61] These rules are the legal basis of public security exceptions, and read as follows:Article 46 (1): *The provisions of this Chapter and measures taken in pursuance thereof shall not prejudice the applicability of provisions laid down by law, regulation or administrative action providing for special treatment for foreign nationals on grounds of public policy, public security or public health.*Article 58 (1): *The provisions of Article 56 shall be without prejudice to the right of Member States: (a) (...); (b) to take all requisite measures to prevent (...) or to take measures which are justified on grounds of public policy or public security.*

Requirements for Proper Reliance on Public Security

The European Court of Justice has identified a number of criteria for the application of the public security justification. In addition to the requirement that there be a sufficiently serious public security objective, the Court has identified a number of procedural requirements, required for public security justifications. A brief summary of three cases will identify the Court's main concerns.

In the matter *Association Église de scientologie de Paris*, Scientology challenged a French system of prior ministerial authorization for foreign investment that allegedly represented a threat to public policy or public security.[62] This regime was the predecessor of the one described above, and it did not yet provide any explanation on the term "threat to public policy or public security." The ECJ held that the freedom of capital was restricted by such a regime.[63] The Court noted that the terms "public policy" and "public security" in the French law were used "without any more detailed definition. Thus, the investors concerned are given no indication whatever as to the specific circumstances in which prior authorization is required."[64] This led the Court to hold: "Such lack of precision does not enable individuals to be apprised of the extent of their rights and obligations deriving from Article [56] of the Treaty. That being so, the system established is contrary to the principle of legal certainty."[65]

In the second case, Commission v Belgium,[66] Belgium had passed a law requiring that advance notice must be given to the government of any transfer, use as security or change in the strategic assets of two companies, SNTC (*Société nationale de transport par canalizations*) and Distrigaz. Within 21 days after receiving notice of the operation in question, the minister was entitled to oppose such operations if he considered that they adversely affected the national interest in the energy sector. The Court decided that the inherent limitation on the free movement of capital could be justified, because the regime at issue was one of opposition, not prior authorization; strict time-limits were in place; governmental intervention was limited to decisions on strategic assets; power to intervene was confined to concrete threats to the energy policy's objectives; effective review by the courts was available.[67]

The third case, Commission v Spain, dealt with a Spanish law according to which certain entities were required to notify the acquisition of any controlling or significant stakes (at least 3% of the capital or voting rights) in energy companies of national importance.[68] The Spanish government was empowered to withdraw or

[62]Case C-54/99 *Association Église de scientologie de Paris* [2000] ECR I-1335.

[63]Case C-54/99 *Association Église de scientologie de Paris* [2000] ECR I-1335, para. 17.

[64]Case C-54/99 *Association Église de scientologie de Paris* [2000] ECR I-1335, para. 21, see also Case C-463/00 *Commission v Spain* [2003] ECR I-4581, para. 74.

[65]Case C-54/99 *Association Église de scientologie de Paris* [2000] ECR I-1335, para. 22.

[66]Case C-503/99 *Commission v Belgium* [2002] I-4809.

[67]Case C-503/99 *Commission v Belgium* [2002] I-4809, para. 49–53.

[68]Case C-274/06 *Commission v Spain* [2008] ECR I-26; summary publication, the full text is available on the web-site of the Court; see also Case C-463/00 *Commission v Spain* [2003] ECR I-4581.

modify any voting rights of the new stakeholder within a 2-month time period. It had to take into account any significant risks or negative effects the new investment would create for the energy company. The investor was to be examined with regard to its transparency, independence, risk management, business plan, its ability to secure energy supply, respect public service obligations and protect the general interest and energy policy.[69] The Court held that this restriction of the free movement of capital could not be justified, even though the Court confirmed that safeguarding of energy supply is a valid objective of justification.[70] The Court held, however, that restricting voting rights only at the time of acquisition did not prevent voting rights from being exercised later in a harmful way. The system was therefore inadequate to pursue the alleged aim of safeguarding energy security. On the other hand the Court noted that the legislation went too far in providing for the possible withdrawal or modification of all voting rights and not only those related to energy security. The ECJ also noted that the Spanish law left a significant margin of discretion to the government.[71]

The Court thus appears to require a significant level of predictability, both as regards the kind of security concerns at issue and the assessment criteria for State intervention. Moreover, the procedure favored is a regime not linked to an acquisition but linked to the harmful exercise of control and with limited discretion for the government.

Immunity Because of Incorporation of Treaty Requirements by Reference?

The new German legislation is difficult to reconcile with these requirements. The new legislation provides no real guidance as to the kind of security concerns the legislation is aimed at (except for some references, in the *actes préparatoires*, to energy and communications). The new legislation does not identify assessment criteria (other than by reference to the public security rules under the EC Treaty). The discretion of the government appears to be broad and the procedure, rather than individual harmful decisions, controls the acquisition.

What distinguishes the German legislation from all the cases discussed above is its explicit reference to Articles 46(2) and 58(1)(b) EC. Moreover, Section 7(2)(6) AWG replicates the exact wording of a judgment of the Court of Justice by providing that restrictions can only be imposed if "a genuine and sufficiently serious threat affects one of the fundamental interests of society."[72] The apparent,

[69]Case C-274/06 *Commission v Spain*, ibid. para. 2.

[70]Case C-274/06 *Commission v Spain*, ibid. para. 38.

[71]Case C-274/06 *Commission v Spain*, ibid. para. 44–50.

[72]See, for example, Case C-161/07 *Commission v Austria*, judgment of December 22, 2008 (not yet reported), para. 35: "As the Court has pointed out on numerous occasions, the concept of public policy first comes into play where a genuine and sufficiently serious threat affects one of the fundamental interests of society."

and in principle laudable, objective is to make it abundantly clear that the new German legislation is intended to comply fully with Community law.

Nevertheless, it is doubtful whether the incorporation by (explicit) reference is sufficient to satisfy the Court. The Court based its decision in *Commission v Spain* on the consideration that national legislation must be predictable not only to sophisticated legal scholars but also to those who are actually affected by it. Investors concerned must be given "indication of the specific, objective circumstances in which . . . approval will be granted or withheld."[73] They must be able "to be apprised of their rights and obligations deriving from Article 56 EC."[74] The Court also criticized that "the administrative authorities have in this sphere a particularly broad discretion which represents a serious threat to the free movement of capital and may end by negating it completely."[75]

The difficulty for the German approach is that it does not address the underlying concerns of the Court. By incorporating the EU law limitations by reference, the law becomes neither more transparent nor predictable. The discretion of the administration remains wide. The limitations on the free movement of capital and the freedom of establishment remain vague. That is the central concern of the Court, which is not addressed by incorporating this concern by reference.

Resulting Concerns as Regards the New German Legislation

The new German legislation is likely to restrict the free movement of capital and the freedom of establishment. It is clearly intended, in principle, to apply only in cases where its application can be justified pursuant to the public security justification under Articles 46(2) and 58(1)(b) EC. But in the absence of binding guidance, both for the investor and for the administration, as to when a sufficiently serious public security concern is likely to exist, the legislation is not easily reconcilable with the transparency and legal certainty requirements which the European Court of Justice has generally required in its case law.

There remain, however, some arguments in support of the new German legislation. In *Skatteverket*, the ECJ recognized that "case law, which relates to restrictions on the exercise of freedom of movement within the Community, cannot be transposed in its entirety to movements of capital between Member States and third countries, since such movements take place in a different legal context."[76] The Court noted, in addition, that "relations between Member States take place against a common legal background, characterized by the existence of Community

[73]Case C-463/00 *Commission v Spain* [2003] ECR I-4581, para. 74.

[74]Case C-463/00 *Commission v Spain* [2003] ECR I-4581, para. 75.

[75]Case C-463/00 *Commission v Spain* [2003] ECR I-4581, para. 76.

[76]Case C-101/05 *Skatteverket v A* [2007] ECR I-11531, para. 60; see also Case C-446/04 *Test Claimants in FII Group Litigation* [2006] ECR I-11753, para. 171; Kokott AG in Case C-319/02 *Manninen* [2006] ECR I-11753, para. 79; Stix Hackl in Case C-452/04 *Fidium Finanz* [2006] ECR I-9524, para. 171.

legislation [and] reciprocal obligations of mutual assistance."[77] These thoughts may allow the Court, at least as regards "true" third-country investors, to show more flexibility compared to its case law focusing on intra-EU cases.

Moreover, and as outlined above, the history and purpose of the legislation allow only a narrow interpretation. The possibility of such narrow, autonomous interpretation, coupled with the express acknowledgment of the limitations under EU law, should give investors some guidance as to the limited and exceptional nature of this rule. It is perhaps still unlikely that this guidance will satisfy the Court's requirements, but its existence makes it more difficult to predict the final verdict.

The Application of the Law in Practice

The future of the new German legislation will depend in no small measure on the way it is now implemented and enforced. In the current climate of economic uncertainty, investors are likely to be welcome, and investment restrictions will be the rare exception rather than the rule.

If and when the new legislation is applied in practice, much will depend on the transparency of the process and the absence of suggestions of ulterior motives (such as the protection of a national champion). The more well-reasoned case law (whether through ex-officio proceedings or voluntary notification) is developed, the more it will be possible to consider the system as providing for transparency and legal certainty, the two elements which are particularly questionable under the rules recently adopted.

[77]Case C-101/05 *Skatteverket v A* [2007] ECR I-11531, para. 61; see also Bot AG in Case C-101/05 *Skatteverket v A* [2007] ECR I-11531, para. 145.

Going Global? The EU Common Commercial Policy After Lisbon

Marc Bungenberg

Introduction

The EU is competing with the other economic superpowers for the biggest influence in world economic affairs; the BRIC countries (Brazil, Russia, India, China) are challenging the existing economic order, and add with their own interests a further complication of matters. A multilateral approach seems most unlikely. A coalition between the USA and the EU to influence the world economic order in a democratic and western market economy driven way — even if this model is envisaged by political scientists and economists — is wishful thinking. Such an EU–USA economic cooperation is not mentioned in the 2006 Commission Communication on "Global Europe, Competing in the World." Bergsten recently proposed that China and the USA should as a new "G2" work together on and be responsible for the new world order, putting the EU — still an economic superpower but without a clear voice — aside.[1] Thus, in political reality the USA and the EU, even though economically highly interdependent, are both acting independently from each other. By more and more favoring preferential trade agreements (PTAs[2]) they set up their trade agreement networks in a manner comparable to superhubs in air transport.[3] A competition between the EU, the USA, China and the other emerging markets for their position in the new economic order of the twenty-first century therefore is the challenge the actors have to adapt to. With the Treaty of Lisbon,[4] the

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[1]Bergsten, A Partnership of Equals, Foreign Affairs 87 (2008) 4, p. 57.

[2]See, on the general usage of the term PTA instead of FTA (free-trade agreement) and RTA (regional trade agreement), Bhagwati, *Termites in the Trading System,* 2008, p. XI.

[3]On the USA and the EU as superhubs, see Lloyd/MacLaren, The EU's New Trade Strategy and Regionalisation in the World Economy, Aussenwirtschaft 61 (2006) 4, p. 423.

[4]O.J. 2007 C 306/1 et seq.

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EU is seeking — once again — to become a major player in this arena, since before as well as after the entry into force of the Treaty the Common Commercial Policy (CCP) determines the legal basis for Europe's place in its global economic relations.

The Common Commercial Policy has been and still is one of the most dynamic fields of EU external relations. Since the entry into force of the EEC Treaty in 1958, the scope of the Common Commercial Policy has already changed several times to adapt to the new realities of international trade and economic relations.[5] This paper will examine the future changes that the Lisbon Treaty would bring about in this area. The core question to answer is whether the Lisbon Treaty offers an improvement compared to the complex and insufficient current situation.[6] After the external challenges the EU is facing today in the competition of systems, and the current problems and major changes with the Treaty of Lisbon in this sector are briefly pointed out, the following sections discuss the "Lisbon modifications" of the CCP and their consequences, especially in their international law context.

External Challenges to the European Union

The outcome of the Doha Round will not constitute a new dimension of multilateralism.[7] Since the failure of the Cancun Conference in 2004,[8] the USA has already given priority to bilateral and regional trade negotiations in preference to the WTO.[9] Therefore, the struggle for agreements on raw materials and the general competition of systems between the EU and other major players in the world economy with upcoming markets in the second world will reach a new definition of importance in the future.[10] The offers global players can make to emerging

[5]For an overview, see Chaisse, Adapting the European Community Legal Structures to the International Trade, EBLR (2006), p. 1615 et seq.; Krenzler/Pitschas, Die Gemeinsame Handelspolitik im Verfassungsvertrag — ein Schritt in die richtige Richtung, in: Herrmann/Krenzler/Streinz (eds.), *Die Außenhandelspolitik im Vertrag über eine Verfassung für Europa*, 2005, p. 5 sec.

[6]For an overview, see Cremona, The External Dimension of the Single Market, in: Bernard/Scott (eds.), *The Law of the Single European Market — Unpacking the Premises*, 2002, p. 351 et seq.

[7]See on this, for example, Sally, The End of the Road for the WTO? A snapshot of international trade policy after Cancun, World Economics 5 (2004) 1, p. 1 et seq; see also Cremona, p. 2, in this volume.

[8]Especially on this, see for example Bhagwati, Don't Cry for Cancún, Foreign Affairs (2004), p. 52 et seq.; Hauser, Die WTO nach Cancun, Aussenwirtschaft 58 (2003), p. 459 et seq.

[9]Sally, The End of the Road for the WTO? A snapshot of international trade policy after Cancun, World Economics 5 (2004) 1, p. 1 et seq. (6).

[10]On this, see Communication from the Commission, *Global Europe: Competing in the World*, COM (2006) 567 final.

economies will be relevant for tomorrow's economic world order.[11] Economic growth, employment and prosperity can only be achieved if the EU itself is competitive on the international level, which from a legal point of view is primarily determined by its constitutional basis and options.

If the EU and its member states want to succeed in a competition of systems between Europe, China, Japan and the USA — and probably in the near future also India and Brazil — the EU has to adjust to the challenges of globalization. Nation states, as well as regional areas of integration, have to react to the situation that capital and establishments of firms can without any obstacles freely cross borders, invest internationally and buy raw materials for private production as well as for public needs on international markets.[12] More intensive global competition of systems means that all entities which are part of this competition have to make best use of their resources — one of these resources which states and supranational organizations have is economic law. In the context of globalizing markets, economic law is to be regarded as an economic good.[13] External trade law, the legal possibility and capacity to conclude international trade and cooperation agreements, as well as international investment protection law, are economic goods which have to be adapted and adjusted to the challenges of globalization in the best possible way.

Thus, to be successful in competing with other economic superpowers in the long run, the EU has to have an improved legal setting for its international operations as well as for its internal reactions to external disturbances such as dumping or other unfair trade practices. The EU Commission has pointed out these objectives explicitly in its Communication on "Global Europe Competing in the World."[14] The Declaration of Laeken of December 2001[15] pointed out a need for reforms in the legal basis of the external relations facing Europe's new role in a globalized world. The "Declaration of Globalisation" adopted six years later by the European Council[16] focuses directly on the function of the Lisbon Treaty, stating "The Lisbon Treaty, in setting a reformed and lasting institutional framework, improves our capacity to fulfill our responsibilities, respecting the core principles enshrined in the Berlin declaration. It will bring increased consistency to our external action." The Treaty of Lisbon would give a new basis for the EU's possibilities of positioning itself in the world order of the twenty-first century. In the Common Commercial Policy, the Lisbon Treaty leads to a shift of paradigms in different aspects:

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[11]Elaborating on this, see Khanna, *The Second World, Empires and Influence of the New Global Order*, 2008; Huliaras/Magliveras, In Search of a Policy: EU and US Reactions to Growing Chinese Presence in Africa, EFA Rev. 13 (2008) pp. 399–420.

[12]Meessen, *Economic Law in Globalizing Markets*, 2004, pp. 8 et seq.

[13]See on this Meessen/Bungenberg/Puttler (eds.), *Economic Law as an Economic Good,* 2009.

[14]Communication from the Commission, *Global Europe: Competing in the World,* COM (2006) 567 final.

[15]Conclusions, European Council (Laeken) 14/15 March 2001.

[16]European Council, Presidency Conclusions — Annex on "EU Declaration on Globalisation," 14 December 2007.

competences, democratic deficit and the role of the European Parliament, as well as the politicization of the CCP. The question is whether the Lisbon Treaty is answering to the challenges of globalization described above in an adequate way.[17]

Current Problems and Overview of the Lisbon Treaty Modifications in the CCP

The CCP very often is seen as the external face of the single market; Eeckhout stated, that if the Common Market were a building, the CCP would be its facade.[18] It is characterized — just like the entire domain of international trade regulation — by an intense dynamic.[19] In Opinion 1/78, the ECJ already ruled that the CCP had to be dynamically interpreted, so as not to "cause disturbances in intra-Community trade."[20] With the foundation of the WTO in 1994 and new developments in international economic law, deficits in the CCP became visible.[21]

Until recently, the problem of acting in the WTO with one voice, the question of direct applicability of WTO law and the power of the EU to conclude new multilateral trade agreements in this regard, along with the currently insufficient participation of the European Parliament, were the main topics in the area of the CCP. The problem of integrating human rights questions, social standards and sustainable development is also seen to be of growing importance. Today — at a time when multilateralism is in crisis and the Doha Round might not be a success — the challenge for the EU will be to negotiate and conclude far-reaching free trade and economic partnership agreements which contain rules on investment protection. The EU also needs to be able to give appropriate unilateral answers to unfair trade practices. The new generation of EU Free Trade Agreements — starting with the EU–Chile and EU–Mexico Agreements — can be characterized as a WTO-plus approach that is not covered by the legal basis of Article 133 EC Treaty any more because of the political topics included.[22]

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[17] See on this question also Wouters/Coppens/De Meester, External Relations after the Lisbon Treaty, in: Griller/Ziller (eds.), *The Lisbon Treaty*, 2009, p. 143 et seq.

[18] Eeckhout, *The European Internal Market and International Trade*, 1994, p. 344; see also Herrmann, Die Außenhandelsdimension des Binnenmarktes im Verfassungsentwurf, in Hatje/Terhechte (eds.), Das Binnenmarktziel in der europäischen Verfassung, EuR Beiheft 3/2004, pp. 175 et seq.

[19] See on this Tietje, Die Außenwirtschaftsverfassung der EU nach dem Vertrag von Lissabon, Beiträge zum Transnationalen Wirtschaftsrecht 83 (2009), p. 5, http://www.wirtschaftsrecht.uni-halle.de/InstitutWirtschaftsrecht/html/publikationen.html.

[20] ECJ, Opinion 1/78, (1979) ECR, 2871, para. 45.

[21] ECJ, Opinion 1/94, (1994) ECR I, p. 5267.

[22] Tietje, Die Außenwirtschaftsverfassung der EU nach dem Vertrag von Lissabon, Beiträge zum Transnationalen Wirtschaftsrecht 83 (2009), p. 5, http://www.wirtschaftsrecht.uni-halle.de/InstitutWirtschaftsrecht/html/publikationen.html.

In the intergovernmental conferences of Maastricht, Amsterdam and Nice an extension of Community competences had already been discussed, but the outcome of the Amsterdam modification of the then Article 113 and the Nice modification of Article 133 were more than disappointing.[23] At the Maastricht conference in 1992, the Commission proposed for the first time that services and trade-related intellectual property rights should explicitly be included in the EC external competences;[24] this was rejected. Furthermore, the ECJ gave his Opinion on the foundation of the WTO,[25] complicating the issue by ruling that in the area of services and intellectual property rights the EC has no exclusive competences.[26]

Systematically, the Lisbon Treaty restructures the external policies and integrates the CCP, development cooperation and economic, financial and technical cooperation with third countries as part five of the Treaty on the Functioning of the European Union (TFEU). Only the Common Foreign and Security Policy keeps its predominant but also isolated position in the Treaty on the European Union[27] and still remains intergovernmental. The European Union will finally be accorded legal personality[28] and its three pillars are merged. The Lisbon Treaty declares all matters concerning external commercial policy an exclusive competence of the European Union.[29] At the same time, the CCP is extended explicitly to "… the conclusion of … trade agreements relating to trade in … services, and the commercial aspects of intellectual property, foreign direct investment, the achievement of uniformity in measures of liberalization, export policy and measures to protect trade such as those to be taken in the event of dumping or subsidies." In contrast to the role of the European Parliament today, in which it is more or less excluded from any participation in the exercise of the CCP, it will then be the new — dominating — actor in the field of EU external relations. And it intends to enforce the principles of the new Article 21 EU Treaty. Article 21 EU Treaty names several objectives by which the EU will then be bound in the field of its external relations — including the entire area of the CCP. This Article thereby embodies a new principle of consistency between different areas of external action, on the one hand, and between these areas and "other policies" — namely its internal action — on the

[23]On this, see Herrmann, Common Commercial Policy after Nice: Sisyphus would have done a better job, CMLRev. 39 (2002) 1, p. 7 et seq.

[24]Maresceau, The Concept "Common Commercial Policy" and the difficult Road to Maastricht, in: Maresceau (ed.), *The European Community's Commercial Policy after 1992: The Legal Dimension*, 1993, pp. 3–19.

[25]ECJ, Opinion 1/94, *WTO-Opinion*, (1994) ECR I, p. 5267.

[26]For a critical analysis of Opinion 1/94, see: Bourgeois, The EC in the WTO and Advisory Opinion 1/94: An Echternach Procession, CMLRev. 32 (1995), p. 763; Hilf, The ECJ's Opinion 1/94 on the WTO, No surprise but Wise? EJIL 6 (1995), p. 245; Pescatore, Opinion 1/94 on Conclusion of the WTO Agreement: Is There an Escape from a Programmed Disaster? CMLRev. 36 (1999), p. 401 et seq.

[27]Articles 23–46 EU Treaty.

[28]Article 47 EU Treaty.

[29]Article 3 TFEU.

other. In the following, a new conjunction of the CCP with other political objectives of the EU such as environmental protection and human rights will be analyzed. The changes in EU investment law seem even more important than those in the traditional external trade law. These points will be more thoroughly analyzed.

More Politics, Please: Says the Treaty…

The entire Common Commercial Policy will be "politicized." EU trade and investment policy is brought under the same external action heading as other elements of EU external policy, and is therefore to be conducted within the context of the framework of the general principles and objectives of the Union's external action.[30] Article 205 TFEU explicitly states that the CCP "shall be guided by the principles, pursue the objectives and be conducted in accordance with the general provisions" laid down in Article 21 EU Treaty. These broadly drafted principles and objectives include the support for democracy, the rule of law and human rights, along with more specific aims such as sustainable economic, environmental and social development, as well as the integration of all countries into the world economy, good global governance and improvement of the sustainable management of global resources. They lack any prioritization. The binding linkage of the CCP to these principles and objectives points out that the EU does not only have a liberalization agenda, but that other objectives must also be taken into account in the negotiation of bilateral trade and investment agreements.[31] For the first time, these values will have to be applied in the CCP.[32] Vedder interprets these principles and objectives as a model for a future world order and as a clear task for a value-oriented bi- and multilateral EU "Weltordnungspolitik."[33] While these represent, of course, positive developments and attract applause by specific groups, it is imaginable from an economic point of view that this linkage limits the capacity and flexibility of the EU in comparison to other entities.

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[30] Articles 205 and 207 TFEU.

[31] Cremona, A Constitutional Basis for Effective External Action? An Assessment of the Provisions on EU External Action in the Constitutional Treaty, EUI Working Papers Law No. 2006/30, p. 30, para. 52.

[32] Tietje, Die Außenwirtschaftsverfassung der EU nach dem Vertrag von Lissabon, Beiträge zum Transnationalen Wirtschaftsrecht 83, (2009), p. 19, http://www.wirtschaftsrecht.uni-halle.de/InstitutWirtschaftsrecht/html/publikationen.html.

[33] Vedder, Ziele der Gemeinsamen Handelspolitik und Ziele des auswärtigen Handelns, in: Herrmann/Krenzler/Streinz (eds.), *Die Außenwirtschaftspolitik der Europäischen Union nach dem Verfassungsvertrag*, 2005, p. 43 et seq. (47).

A New Role for the European Parliament

The constitutional convention already provided for a broad debate regarding the democratic accountability of also the EU trade policy.[34] Up to now, the European Parliament has had no formal role during the negotiations of an international agreement in the area of the CCP;[35] even a consultation of the European Parliament is currently not mentioned in European Primary Law. The Lisbon Treaty would significantly strengthen the role of the European Parliament in this field. In general, the Parliament will need to be consulted before an agreement is concluded,[36] and even parliamentary consent is required de facto in almost all cases of new agreements,[37] but there are no powers for the European Parliament to change or modify the results of a (terminated) negotiation.[38] The Commission will be legally obliged to provide the European Parliament with information on the conduct of the negotiations, and to report regularly to the Parliament's International Trade Committee (INTA). The INTA is seeking a means of establishing preconditions for granting Parliament's consent for trade agreements through a revision of the Framework Agreement between the Parliament and the Commission.[39]

Furthermore, regulations implementing EU trade policy agreements will be adopted in the "ordinary legislative procedures" (Article 207(2) TFEU). The European Parliament will have shared powers with the Council to adopt the basic regulations on anti-dumping, anti-subsidies, trade barriers, rules of origin, etc. Because the EU trade policy is to be conducted within the "context of the framework of principles and objectives of the Union's external action", (Article 207(1) TFEU) it is even more likely to be politicized.

The European Parliament is fully aware of its new "superpowers" resulting from these institutional changes. In 2006 already, it announced it would give its consent only to agreements containing a human rights clause.[40] The European Parliament

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[34]Krajewski, External Trade Law and the Constitution Treaty: Towards a Federal and More Democratic Common Commercial Policy? CMLRev. (2005), p. 91 et seq.

[35]Wouters/Coppens/De Meester, External Relations after the Lisbon Treaty, in: Griller/Ziller (eds.), *The Lisbon Treaty*, 2009, p. 143 (p. 183 and 185).

[36]Cremona, The Draft Constitutional Treaty: External Relations and External Actions, CMLRev. (2003), p. 1347 et seq. (1364).

[37]See Article 218 par. 6 TFEU; see on this European Parliament, Opinion of the Committee on International Trade of 14 January 2008, Doc.-No. 2007/2286 (INI), pt. 3 f); on the similar provision in the Constitutional Treaty see for example Monar, Die Gemeinsame Handelspolitik der Europäischen Union im EU-Verfassungsentwurf, Aussenwirtschaft 60 (2005), p. 99 et seq. (111).

[38]European Parliament, Opinion of the Committee on International Trade of 14 January 2008, Doc.-No. 2007/2286 (INI), point 6 et seq.

[39]See Woolcock, The potential impact of the Lisbon Treaty on EU External Trade policy, SIEPS – European Policy Analysis 3/2008, p. 5; European Parliament 2008/2063(INI) of 27 May 2008.

[40]Resolution of the European Parliament of 14 December 2006, EP-Doc. A 6–4/2006. On this topic in general, see Bartels, *Human Rights Conditionality in the EU's International Agreements*, 2005.

calls on the Commission to include far-reaching social and environmental clauses and standards in bilateral and regional trade agreements, and emphasizes that no free trade agreement should be signed without a partnership and cooperation agreement. It also stresses the explicit requirement that the CCP shall serve the principles and objectives of the EU's external action — support for democracy and the rule of law as well as the promotion of sustainable development. Recently, the European Parliament has declared — before the Lisbon Treaty is even in force — that it would give its consent necessary under the Lisbon Treaty to the conclusion of a free-trade agreement between the EC and the Gulf Cooperation Council[41] only if those objectives laid down in Article 21 EU Treaty (Lisbon version) are sufficiently taken into account.[42]

Taken together, it is this increased role of the European Parliament connected with the politicization of the entire Common Commercial Policy which constitutes a great potential impact of the Lisbon Treaty on EU external trade policy.[43]

Today's Complex Situation of Distribution of Competences and New "Lisbon Competences" in the Field of External Trade Relations

The necessity of completing the internal market was the driving force for extending the CCP throughout the entire existence of the EEC/EC. It urged the Community to take action in this field, mainly by providing for common rules for imports and exports and by harmonizing standards throughout the Community.[44] The ECJ found that the traditional CCP — meaning then the trade in goods — has been the Community's exclusive competence. In Opinion 1/75,[45] the Court ruled that Member States could not legislate in an area which would affect the operation of the CCP, even if the Community had not yet taken any action.

The international development of trade relations led to multiple fields of economic activity going far beyond the reduction of tariffs, in seeking liberalization of agricultural trade and attacking barriers to investment and to trade in services. The WTO Agreement provided a new institutionalized framework for these developments; in addition to regulating trade in goods[46] it established international rules on

[41]Negotiations started in 1991, see OJ 1990 C 231/216.

[42]See Resolution of 24 April 2008.

[43]See on this also Woolcock, The potential impact of the Lisbon Treaty on EU External Trade policy, SIEPS – European Policy Analysis 3/2008, p. 1.

[44]See Cremona, The External Dimension of the Single Market, in: Bernard/Scott (eds.), *The Law of the Single European Market – Unpacking the Premises*, 2002, p. 354 seq. (359).

[45]ECJ, Opinion 1/75, (1975) ECR, p. 1355.

[46]General Agreement on Tariffs and Trade, OJ 1994 L 336/11.

trade in services (GATS)[47] as the most dynamic economic sector, as well as on trade-related intellectual property rights (TRIPS).[48] Within this context the ECJ gave its Opinion 1/94,[49] having to decide whether the EC had exclusive competence to conclude the WTO Agreements. The ECJ did not argue about the EC's exclusive powers with regard to trade in goods, but dealt at length with the Community powers in the field of services and intellectual property rights. On the one hand, the ECJ reaffirmed the dynamic character of the CCP as declared in Opinion 1/78,[50] but on the other hand it rejected the Commission's view that GATS and TRIPS fell in their entirety under the scope of the CCP, or that they were covered by implied exclusive powers.[51] Hence the Court held that the competence for the conclusion of the WTO Agreement was shared between the EC and the Member States. This "WTO Opinion" — as it is widely known — constituted a benchmark for the future development of the CCP. It signaled that the CCP and Article 133 EC Treaty could not be expanded to a general common economic policy, but that it should be balanced with the internal aspect of services and intellectual property regulation.[52] In reaction to Opinion 1/94,[53] the scope of the CCP was amended by the Amsterdam Treaty[54] and the Treaty of Nice.[55] The latter expanded the extension of the CCP into the fields of trade in services and trade-related aspects of intellectual property rights. The result was an "extremely complicated wording"[56] and an unreadable, unsystematic and complex system of competence rules.[57]

After the entry into force of the Lisbon Treaty, the CCP would cover trade in goods and services, commercial aspects of intellectual property and foreign direct investment. The only remaining speciality with regard to trade in services is reflected in the voting rules in the Council. Article 207(4) TFEU provides for unanimity in the negotiations and conclusion of agreements in the field of culture

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[47]General Agreement on Trade in Services, OJ 1994 L 336/190.

[48]Agreement on Trade Related Aspects of Intellectual Property Rights, OJ 1994 L336/213.

[49]ECJ Opinion 1/94, *WTO-Opinion*, (1994) ECR I, p. 5267.

[50]ECJ, Opinion 1/78, (1979) ECR, p. 2871, para. 45.

[51]ECJ, Opinion 1/94, WTO, (1994) ECR I, p. 5267, paras. 36–105.

[52]Dimopoulus, The Common Commercial Policy after Lisbon: Establishing Parallelism between Internal and External Economic Relations? Croatian Yearbook of European Law and Policy 4 (2008), p. 101 et seq. [at pt. 2 (a) (i)].

[53]Eeckhout, *External Relations of the European Union – Legal and Constitutional Foundations*, 2004, p. 57.

[54]For a discussion of the Amsterdam amendments of Article 133 EC Treaty see: Cremona, External economic relations and the Amsterdam Treaty, in: O'Keefe/Twomey, *Legal Issues of the Amsterdam Treaty*, 1999, pp. 225–247; Krenzler/de Fonseca-Wollheim, Die Reichweite der Gemeinsamen Handelspolitik nach dem Vertrag von Amsterdam, EuR 1998, p. 226.

[55]See on this Herrmann, Vom misslungenen Versuch der Neufassung der gemeinsamen Handelspolitik durch den Vertrag von Nizza, EuZW (2001), p. 269.

[56]See AG Kokott, Opinion delivered on 26 March 2009, C-13/07, *Commission vs Council*, point 1.

[57]On the difficulties in interpreting Art. 133(5) and 133(6) EC Treaty see AG Kokott, Opinion delivered on 26 March 2009, C-13/07, *Commission vs Council*.

and audiovisual services, where the agreements risk prejudicing the Union's linguistic and cultural diversity. There are similar unanimity rules for social, education and health services. Furthermore, transport policy is covered by special provisions of the TFEU.[58] As a result of this explicit shift of competences, international agreements on trade in services will not have to be concluded any more by both EU and Member States as mixed agreements; thus, national parliaments are not involved in the ratification process any more.[59] Out of this aspect (and the new EU competence for foreign direct investment) multiple questions of international and European law arise.

Is There Still a Necessity to Conclude Mixed Agreements?

Under the current legal situation resulting from the WTO Opinion 1/94 and the modifications resulting from the Treaty of Nice, some services fall under shared competences and therefore make mixed agreements a necessity.[60] A mixed agreement has to follow the national ratification track, and any Member State not content with the provisions of a chapter can veto the agreement in its entirety.[61]

The Lisbon Treaty will extend the scope of exclusive competences in the CCP to all kinds of services, and thereby significantly reduce the need of further mixed agreements.[62] This extension with regard to trade in services and with regard to commercial aspects of intellectual property rights will thus exclude the Member States from adopting international agreements, given that the nature of the Union's competence is exclusive.[63] As Wouters/Coppens/De Meeser indicate, the intention of the drafters is to bring the WTO agreements and negotiations within the exclusive competence of the Union. This confirms that "trade in services" must be understood in its broad meaning given in the GATS (encompassing the four modes of supply).[64]

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[58] See Part III Title VI TFEU.

[59] See Woolcock, The potential impact of the Lisbon Treaty on EU External Trade policy, SIEPS — European Policy Analysis 3/2008, p. 3.

[60] Herrmann, Vom misslungenen Versuch der Neufassung der gemeinsamen Handelspolitik durch den Vertrag von Nizza, EuZW (2001), p. 269 (272).

[61] On the complexity of mixed agreements, see Bungenberg, Mixed Agreements im Gemeinschaftsrecht und nationalen Recht, in: Zehetner (ed.), *FS H.-E. Folz*, 2003, p. 13 et seq.; Rosas, The European Union and Mixed Agreements, in: Dashwood/Hillion (eds.), *The General Law of the E.C. External Relations*, 2000, p. 200 et seq.; Leal-Arcas, The European Community and Mixed Agreements, EFAR 6 (2001) p. 483 et seq.

[62] Woolcock, The potential impact of the Lisbon Treaty on EU External Trade policy, SIEPS — European Policy Analysis 3/2008, p. 3 et seq.

[63] Wouters/Coppens/De Meester, External Relations after the Lisbon Treaty, in: Griller/Ziller (eds.), *The Lisbon Treaty*, 2009, p. 143 et seq. (at p. 170).

[64] Wouters/Coppens/De Meester, External Relations after the Lisbon Treaty, in: Griller/Ziller (eds.), *The Lisbon Treaty*, 2009, p. 143 et seq. (at p. 171).

However, this does not at all mean that mixed agreements will not be concluded any more. Agreements that cover policies outside the scope of the CCP with no exclusive EU competence, as well as trade deals extending beyond the harmonization possible at intra-EU level (in such fields as occupation, social policy, health, industry or culture) would "after Lisbon" still qualify as mixed agreements.[65] The new generation of EU free-trade agreements[66] that will be concluded with India,[67] the Mercosur[68] and South Korea[69] will be such mixed agreements due to their complexity and wide range of policies covered. This means mixed agreements are still possible in general — it comes down to a question of preference: Member States' participation on the one hand, or a quicker and probably more efficient EU decision-making on the other hand. In the following, a closer look at the consequences for the membership of EU Member States in the WTO will be taken.

EU Member States and Their Future Participation in the WTO

As discussed above, the EC has at present no exclusive competence for the whole body of agreements under the WTO. Thus, the EC and its 27 Member States have a parallel membership in the WTO.[70] After the entry into force of the Lisbon Treaty all matters regulated under WTO law would lie within the exclusive competence of the EC. At least two far-reaching consequences will have to be discussed. A delicate question from the political point of view is whether, after the entry into force of the Lisbon Treaty, the EU Member States would still have the competence to sign an Agreement within the framework of the WTO concluding the Doha Round. Another problem resulting from the first point will be whether there is a need for the EU Member States to be members of the WTO parallel to the EU at all in the future.

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[65]See also Wouters/Coppens/De Meester, External Relations after the Lisbon Treaty, in: Griller/Ziller (eds.), *The Lisbon Treaty*, 2009, p. 143 et seq. (at p. 180).

[66]On this in general see Woolcock, *European Union Policy towards Free Trade Agreements,* ECIPE Working Paper 3/2007.

[67]Negotiations started on 28 June 2007.

[68]Negotiating directive for an association agreement 13 September 1999; negotiations ongoing.

[69]Negotiating Directive for the negotiation of a Free Trade Agreement with the Republic of South Korea adopted by the Council on 23 April 2007. FTA: Negotiations launched on 6 May 2007 in Seoul, concluded October 2009. 1st Round 7–11 May 2007 in Seoul, 7th Round 13–15 May 2008 in Brussels. Negotiation directive for the negotiation of the update of the existing 2001 Framework Agreement adopted by the Council in May 2008. Framework Agreement: 1st Round 17–18 June 2008 in Brussels.

[70]See Article XI WTO Agreement; elaborating in detail on the problems of parallel membership, see Herrmann, Rechtsprobleme der parallelen Mitgliedschaft von Völkerrechtssubjekten in Internationalen Organisationen: Eine Untersuchung am Beispiel der Mitgliedschaft der EG und ihrer Mitgliedstaaten in der WTO, in: Bauschke (ed.), *Pluralität des Rechts*, 2003, p. 139 et seq.

If the Lisbon Treaty enters into force before the ratification of a Doha Agreement, and the Doha Round subjects are not extended at the very last minute, it would be the EU alone having to conclude the Doha Round Agreement.[71] After the 2008 struggles between President Sarkozy and former External Trade Commissioner Mandelson[72] one can question whether any EU Member State would want to ratify this Agreement. The distribution of external competences has always been and will remain a highly controversial topic between Council and Commission. Whereas the Commission will most likely argue for exclusive powers of the EU the Council will take the opposite view.[73]

The second problem to discuss is whether the EU Member States can stay in the WTO as full members — or if they have to withdraw from the Organization, in the case that they do not ratify the Doha Agreement on their own. Complications arise from a WTO law as well as from an EU law perspective. From a WTO law perspective, to modify the WTO Agreements at least a two-thirds majority is necessary.[74] To reach this two-thirds majority will be difficult if 27 Member States of the WTO, as a result of the EU's internal distribution of competences, are not allowed to ratify the Agreement amending the WTO Agreements.

In addition, EU law has to be analyzed to find out if it contains an obligation for the Member States to withdraw from the WTO. This could originate from Articles 307 (applied analogically) and 10 EC Treaty, which are also integral parts of the Lisbon Treaty (see Article 351 TFEU and Article 4(3) EU Treaty). It can be argued that EU Member States have to adjust their international law obligations to the distribution of competences between themselves and the EU — in those areas in which the competences have been transferred to the EU level, the EU Member States therefore have to terminate their international treaty obligations.

After a withdrawal of the EU Member States from the WTO, which from a WTO law perspective is possible,[75] the EU would lose its voting weight. Today, the European Communities when exercising their right to vote have a number of votes equal to the number of their Member States. Thus, the influence of the EC

[71]On this point, see Herrmann, Das Auswärtige Handeln der EU, in: Streinz/Ohler/Herrmann (eds.), *Der Vertrag von Lissabon zur Reform der EU*, 2008, p. 128; Leal-Arcas, Will EU Member States Play Any Role at the WTO after the EU Reform Treaty? http://www.icl-law-journal.com, 1 (2007) 2, p. 75 et seq.

[72]On this, see Press Release Commission, 7 July 2008; also see for example NZZ of 2 July 2008 ("Streit zwischen Sarkozy und EU-Kommissar Mandelson").

[73]At the moment, an action for annulment of the Council and Member States decision establishing the Community' and Member States' position within the WTO General Council on the accession of Vietnam is pending at the ECJ, C-13/07, OJ EU 2007 C-56, p. 22.

[74]Article X:3 and 4 WTO Agreement. On future problems relating to Article X WTO-Agreement, see also Herrmann, Die Außenhandelsdimension des Binnenmarktes im Verfassungsentwurf, in: Hatje/Terhechte (eds.), Das Binnenmarktziel in der europäischen Verfassung, EuR Beiheft 3/2004, p. 175 et seq. (198).

[75]Article XV WTO Agreement.

might fall behind today's status quo.[76] But already today, decisions in the WTO are taken by consensus, so this decline of voting power is of no practical relevance. Furthermore, a withdrawal of the EC/EU Member States firstly corresponds to the factual situation that in reality the EU is one coherent economic area, at least from an outsider's point of view;[77] secondly, the USA, China or India only have one vote as well, and thirdly a transparent distribution of powers between the EU and the Member States level is in the interest of the EU's contracting and trading partners.

Consequences in the Area of Foreign Direct Investments

The Lisbon Treaty includes a new and (explicitly) exclusive competence on foreign direct investment in the chapter on the CCP. As will be shown, even after the Lisbon modifications the EU investment policy and its legal fundament do not deliver the necessary basis for acting efficiently in the global arena of the twenty-first century. "After Lisbon" the EU will still have to conclude mixed agreements and only exceptionally will be able to conclude "pure" EU investment agreements. De lege lata the EU is facing major constitutional deficits as a result of competences in investment matters being divided up between the EU and its Member States.[78] In order to put the EU in a position to compete with the other economic superpowers, the competences of the Common Commercial Policy will have to be extended once more to all kinds and aspects of foreign investments de lege ferenda. Lately, the EU has been making efforts in developing its own foreign investment promotion and protection policy, and even though before the entry into force of the Lisbon Treaty the EC competences for doing so are still limited, the Commission is nevertheless already tending towards taking a broad approach on this issue.[79] The question arises whether, as a result of the new EU competence, 1300 bilateral investment treaties (BITs) of the 27 EU Member States (out of today's around 2600 BITs worldwide) will have to be terminated.

[76] Kokott, Article 302, in: Streinz (ed.), *EU-/EGV Kommentar*, 2003, Article 302 EC Treaty, para. 34.

[77] See for example McNamara, The EU Reform Treaty: A Threat to the Transatlantic Alliance, The Heritage Foundation, Backgrounder No. 2109, 20 February 2008, http://www.heritage.org/Research/Europe/bg2109.cfm.

[78] Karl, The Competence for Foreign Direct Investment — New Powers for the European Union? JWT&I 5 (2006) 3, p. 413 et seq. (415).

[79] On this, Maydell, The European Community's Minimum Platform on Investment or the Trojan Horse of Investment Competence, in: Reinisch/Knahr (eds.), *International Investment Law in Context*, 2007, p. 73 et seq.

Background of the New EU Investment Policy

Rules on investment promotion and protection can stimulate trade relations and have an influence on the quality of investments.[80] Limits on the ability of foreign governments to interfere with foreign investor operations reduce the political risk associated with an investment, which should result in greater levels of investment in a given economy.[81] The growth rates of investment[82] have caused increased attempts to "internationalize" investment law via international investor protection regulations. A first proposal of a multilateral framework for investments in the Havana Charter failed to enter into force in 1948. Further efforts to put in place a multilateral agreement on investment, first in the OECD and then in the WTO, were not successful. The failed OECD project was mainly aimed at adding a general right to invest to the protection of existing investment[83] — which was also one of the reasons for its failure.[84] The same is true for the WTO approach. The American and European interest in securing a predictable international environment for their companies meant in particular that the issue was highlighted in the Doha Development Declaration of 2001.[85] This stated that "transparent, stable and predictable conditions" assist in encouraging foreign direct investment and expand trade, and thereby also acknowledged the link between trade and investment.[86] The US Trade Representative pressed for a broad agreement covering the widest possible forms of investment.[87] The EU had more reluctantly proposed that the admission of pre-establishment measures should follow the GATS-type approach based on positive lists ("bottom up"), whereas the USA followed a negative list approach ("top

[80]Lesher/Miroudot, *The Economic Impact on Investment Provisions in Regional Trade Agreements*, OECD Trade Policy Working Paper No. 36/2006; Dolzer, Auslandsinvestitionen, Wachstum und Armutsbekämpfung: Zur Ordnung des Völkerrechts, in: Dolzer/Herdegen/Vogel, *Auslandsinvestitionen,* 2006, p. 13 et seq. (18); questioning this Salacuse/Sullivan, Do BITs really work?: An Evaluation of Bilateral Investment Treaties and Their Grand Bargain, Harvard International Law Journal 46 (2005), p. 67 et seq.; Neumayer/Spess, Do Bilateral Investment Treaties Increase Foreign Direct Investment to Developing Countries? World Development 33 (2005), p. 1567 et seq.

[81]McGuire/Smith, *The European Union and the United States – Competition and Convergence in the Global Arena,* 2008, p. 142.

[82]See on this UNCTAD, World Investment Report, 2005, p. 6 et seq.

[83]See Chapter III Art. 1 MAI Negotiating Text, http://www1.oecd.org/daf/mai/pdf/ng/ng987r1e.pdf.

[84]Gugler/Tomsik, *The North American and European Approaches in the International Investment Agreements*, NCCR Working Paper No. 2006/04, p. 4.

[85]WT/MIN(01)/DEC/1 of 20 November 2001, point 20.

[86]McGuire/Smith, *The European Union and the United States – Competition and Convergence in the Global Arena*, 2008, p. 121.

[87]Bora, Investment Issues in the WTO, in: Hocking/McGuire (eds.), *Trade Politics*, (2nd ed.) 2004, p. 208 et seq.

down").[88] The failure of the Cancun Ministerial Conference in 2004[89] eliminated the Singapore issues from the Doha Agenda;[90] in the absence of multilateral investment rules, the main actors in the global arena have given priority to bilateral and regional trade negotiations.[91] Instead of multilaterally binding rules on the foreign investment game, a patchwork of bilateral, plurilateral and regional treaties has developed.

Rules on investment are part of an improved body of economic law in the competition of systems. As shown above, the EU is aware that it has to have an improved legal setting for its international operations. It has to react to make use of upcoming opportunities,[92] but until recently has not shown the same interest in investment promotion and protection. In 2006 the EU Commission observed that "in comparison to NAFTA countries' agreements, EU agreements and achievements in the area of investment lag behind because of their narrow content. As a result, European Investors are discriminated vis-à-vis their foreign competitors and the EU is loosing market shares."[93] Therefore, the EU Commission, even before the entry into force of the Lisbon Treaty, is already taking a new approach and is setting up a new EU investment policy. This has already started with the EU–Chile Agreement,[94] the EU's ambitious of setting up an EU investment platform and the inclusion of investment chapters in currently negotiated EU PTAs. A further step in the development of an EU investment policy is provided for by the Lisbon Treaty.

EU Internal Investment Protection and Relationships Between EU Member States

Most of the "Intra-EU BITs" — BITs concluded between Member States — were concluded before these states acceded to the EU. Only two of approximately 150

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[88]Gugler/Tomsik, *The North American and European Approaches in the International Investment Agreements*, NCCR Working Paper No. 2006/04, p. 12; WTO Doc. WT/WTGTI/W121, Concept Paper on Modalities of Pre-Establishment (Communication from the EC and its Members).

[89]See for example Baghwati, Don't Cry for Cancún, Foreign Affairs 83 (2004), p. 52 et seq.

[90]"July package" of 31 July 2005, WT/L/579.

[91]See Woolcock, *European Union Policy towards Free Trade Agreements*, ECIPE Working Paper No. 03/2007.

[92]See on this Communication from the Commission, *Global Europe: Competing in the World*, COM (2006) 567 final.

[93]Commission, *Upgrading the EU Investment Policy*, Note for the attention of the 133 Committee, Brussels, 30 May 2006.

[94]O.J. 2002 L-352, signed on 18 November 2002.

intra-EU BITs in force[95] have been concluded between "old Member States," namely Germany on the one hand and Greece and Portugal on the other hand; no claim is known of under these Treaties.[96] Intra-EU BITs partly overlap in their guarantees with the basic freedoms of the internal market,[97] the protection of fundamental rights in community law[98] and the ECHR.[99] Nevertheless, the dimension of protection is one of the main differences between protection via EU law and under a BIT. The latter in general provides direct access to international arbitral bodies for the investor,[100] whereas under EU law the investor has to deal with Member States' courts in all cases where measures affecting investments originate from EU Member States.

In cases of non-conformity between BITs and the above-mentioned guarantees the question arises as to which source of law prevails. The European Commission is of the opinion that EC law prevails over the non-conforming BIT norms from the date of accession of new states.[101] Arbitral tribunals may hold a different view on the question of jurisdiction as well as on the applicable law in cases of conflicts,[102] however; also, it is argued that in no way may the EC restrict the possibility of investor–state arbitration.[103] Nevertheless, even an effective prevalence of EC law does not entail at the same moment the automatic termination of the BITs.[104] In addition, almost all BITs contain post-termination protection periods.

The Commission has asked the Member States to terminate the intra EU Member States' BITs; up to now the Member States have not done so. If further intra-EU BIT investment disputes arise before the termination of those BITs it is not

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[95]Note of the Commission from November 2006, Internal Market and Services DG, sent to the Economic and Financial Committee; excerpts of this note in *Eastern Sugar vs Czech Republic*, Partial Award, 27 March 2007 (UNCITRAL Arbitration, Stockholm Chamber of Commerce) (Netherlands/Czech Republic BIT), p. 27.

[96]Van Aaken, Fragmentation of International Law: The Case of International Investment Protection, Finnish Yearbook of Int'l Law (2008), p. 93, at p. 121.

[97]ECJ, C-524/04 — *Test Claimants*, (2007) ECR I, p. 2107; ECJ, C-196/04 — *Cadbury Schweppes*, (2006), ECR I, p. 7995.

[98]ECJ, 4/73 — *Nold*, (1974) ECR, p. 491; ECJ C-84/95 — *Bosphorus*, (1996) ECR I, p. 3953.

[99]Söderlund, Intra-EU Investment Protection and the EC Treaty, JIA 24 (2007), p. 455.

[100]Van Aaken, Fragmentation of International Law: The Case of International Investment Protection, Finnish Yearbook of Int'l Law (2008), p. 93, at p. 123.

[101]See Letter of 13 January 2006, from Schaub, Internal Market and Services, to Zelinka, Czech Deputy Minister of Finance, excerpts of this letter in *Eastern Sugar vs Czech Republic*, Partial Award, 27 March 2007 (UNCITRAL Arbitration, Stockholm Chamber of Commerce) (Netherlands/Czech Republic BIT), p. 24 et seq.

[102]See on this, for example, *Eastern Sugar vs Czech Republic*, Partial Award, 27 March 2007 (UNCITRAL Arbitration, Stockholm Chamber of Commerce) (Netherlands/Czech Republic BIT).

[103]Söderlund, Intra-EU Investment Protection and the EC Treaty, JIA 24 (2007), p. 455 (456 et seq.).

[104]Report of the ILA 2008, Committee on Foreign Investment; for ECJ Jurisdiction on state-to-state dispute settlement, see Case C-459/03 – *MOX Plant decision (Commission v. Ireland)*, (2006) ECR I, p. 4635.

likely that arbitral tribunals will defer the case to the ECJ,[105] even if deciding a dispute contrary to EC law might cause difficulties regarding the enforceability of the arbitral award within the EU under the New York Convention.

The External Dimension of EU Investment Policy

Global Europe: A New Approach

Inspired by the already struggling Doha Round negotiations, the EU announced that it would seek to conclude new PTAs in 2006.[106] Today, the EU is negotiating with the Gulf Cooperation Council, South Korea, ASEAN, India and Mercosur. The EU partnership agreements with Russia and China have expired. Successor Agreements are still being sought. Negotiations on a "Club Med" will probably start soon.[107] Obviously, the EU has given up its moratorium on negotiating new PTAs with emerging economies playing a "catch up" game, after China, Japan, Korea, Australia, New Zealand and the USA started enforcing their PTA relationships.[108] But nevertheless there is still doubt with regard to the effectiveness of today's EU external investment protection attempts (EU investment policy effectiveness) when compared to the modalities of US investment protection. These doubts result mainly from the limited EU competences for external action, and from the uncertainty as to what extent the Member States still possess the competence to conclude international investment agreements with non EU-Member States.[109]

Neither in the field of capital movement nor in matters relating to establishment have the internal EC competences been exercised widely enough to harmonize an entire policy.[110] Therefore, the ECJ has excluded investment policy from the scope

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[105]See ILA, Committee on Foreign Investment, Conference Report 2008; Burgstaller, European Law and Investment Treaties, JIA 26 (2009), p. 181, at p. 193.

[106]See on this Abbott, EU Trade Policy — Approaching a Crossroads, Chatham House briefing paper, June 2008; Woolcock, *European Union policy towards Free trade Agreements*, ECIPE Working Paper No. 3/2007.

[107]See the Joint Declaration of the Paris Summit for the Mediterranean of 13 July 2008.

[108]On this for example Bhagwati, *Termites in the Trading System,* 2008; Sally, *Trade Policy, New Century: The WTO, FTAs and Asia Rising*, 2008.

[109]Maydell, The European Community's Minimum Platform on Investment or the Trojan Horse of Investment Competence, in: Reinisch/Knahr (eds.), *International Investment Law in Context*, 2007, p. 73 et seq.; see on this Ceyssens, Towards a Common Foreign Investment Policy? – Foreign Investment in the European Constitution, Legal Issues of Economic Integration (2005), p. 259 et seq.; Karl, The Competence for Foreign Direct Investment — New Powers for the European Union? JWT&I 5 (2006) 3, p. 413 et seq.; Mola, Which Role for the EU in the Development of International Investment Law? Society of International Economic Law, Online Proceedings Working Paper No. 26/08 http://www.ssrn.com/link/SIEL-Inaugural-Conference.html.

[110]ILA, Committee on Foreign Investment, Conference Report 2008, p. 8; for further details, see Eeckhout, *External Relations of the European Union*, 2004, p. 58 et seq.

of the CCP for an EU responsibility, and competences for external relations in investment matters follow out of internal measures (*in foro interno, in foro externo*).[111] Before the entry into force of the Lisbon Treaty, the CCP and the fundamental freedoms thus do not provide for exclusive competences in this area.[112] Nevertheless, the fundamental freedoms of the EC Treaty lead to community competences, allowing for the conclusion of international agreements on market access.[113] Therefore, EU Member States do not have the right to conclude BITs on the establishment of foreign investments any more. For this reason, national BITs are limited in their scope to post-investment establishment only, while EU agreements would have to cover the pre-establishment phase.

Even if there is no exclusive EU-external competence in this policy yet, an analysis of current EU PTAs shows a new concern about investment policy within the EU Commission. The EU–Chile Agreement[114] provides for a general right of establishment and full national treatment at the pre- and post-establishment phase for both natural and legal persons, as well as a consent to state-to-state dispute settlement arbitration. The EU Commission is continuing with ambitions to set up an EU investment platform and including investment chapters in new EU PTAs.[115] The ongoing EU–India negotiations for example contain an entire chapter on investment.[116] The Commission states that it has no plans to install any sort of arbitration mechanisms into present BITs.[117] The EU's official position before the entry into force of the Treaty of Lisbon is such that the EU PTAs will not be designed to replace Member States' BITs. Still, the Commission's politics in this respect point in a different direction as well.

By proposing a "Minimum Platform on Investment", the Commission has sent a signal that it wants to acquire all the competences needed to negotiate investment agreements. In November 2006 the Council of the European Union adopted the "Minimum Platform on Investment" for EU PTAs with third countries.[118] This "MPoI" serves — comparable to national Model BITs — as a standardized

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[111]ECJ, 22/70 — *ERTA (Commission vs Council)*, (1971) ECR, 263; on this doctrine see for example Emiliou, Competence between the EC and its Member States, in: Emiliou/O'Keeffe (eds.), *The European Union and World Trade Law*, 1996, p. 38 et seq.

[112]ECJ, Opinion 2/92 — *OECD National Treatment Instruments,* (1994) ECR I, p. 5267; see on this Ceyssens, Towards a Common Foreign Investment Policy?, Legal Issues of Economic Integration (2005), p. 259, at p. 260.

[113]Maydell, The European Community's Minimum Platform on Investment or the Trojan Horse of Investment Competence, in: Reinisch/Knahr (eds.), *International Investment Law in Context*, 2007, p. 73 et seq., and p. 81 et seq.

[114]O.J. 2002 L-352, signed on 18 November 2002.

[115]See Woolcock, *European Union policy towards Free Trade Agreements*, ECIPE Working Paper No. 3/2007, p. 8 et seq.

[116]See EU Commission, September 2007, on EU–India FTA http://www.euindiachambers.com/Events/euindiafta.pdf.

[117]EU Commission, *Upgrading the EU Investment Policy*, Note of 30 May 2006 for the attention of the 133 Committee, Brussels.

[118]Council of the European Union, 15375/06 of 27 November 2006.

negotiation proposal for ongoing and future free trade agreement negotiations with third countries. Its purpose is to preserve the Commission and Member States from having to agree on an investment chapter every time a potential PTA is under negotiation.[119]

Will the implementation of this approach (also called an EU "power-grab"[120]) make existing BITs illegal?[121] The Member States are — because of Article 307 EC Treaty applied analogically — obliged to adapt their BITs to EU law.[122] This might lead to an obligation to terminate those BITs. In decisions of March 2009 in infringement proceedings against Austria,[123] Sweden[124] and Finland[125] before the ECJ, the Court declared — by obviously relying on the principle of effectiveness ("effet utile") — that certain provisions in BITs of these EU Member States with third countries violate EU law. Once more, the ECJ seeks to minimize as far as possible the breach to the integrity of the Community's legal order caused by pre-existing international obligations. The Court does in general neither leave any room to maneuver nor allow exemptions from the treaty obligations. It has held that Article 307 EC Treaty is of general scope, and applies to any international agreement which is capable of affecting the EC Treaty.[126] The obligation under Article 307 EC Treaty is an expression of the duty of loyal cooperation formulated in Article 10 EC Treaty.[127] It is this duty which explains why Member States are obliged to amend agreements that are incompatible with the Treaty,[128] even though such agreements are recognized as fully valid from an international as well as European law perspective.[129] The ECJ has stressed that incompatibilities with the EC Treaty are not limited to the decided cases, and that Member States are obliged to take all appropriate measures to eliminate incompatibilities with the EC Treaty.[130]

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[119]Maydell, The European Community's Minimum Platform on Investment or the Trojan Horse of Investment Competence, in: Reinisch/Knahr (eds.), *International Investment Law in Context*, 2007, p. 73 et seq. (75).

[120]Eriksson, Financial Times of 12 March 2008.

[121]See on this Ceyssens, Towards a Common Foreign Investment Policy? – Foreign Investment in the European Constitution, Legal Issues of Economic Integration (2005), p. 259 seq.

[122]On the application of Article 307 EC Treaty analog to these constellations in general see Terhechte, Art. 307, in: Schwarze (ed.), *EU-Kommentar*, 2008, pt. 15.

[123]Case C-205/06, *Commission vs Austria*.

[124]Case C-249/06, *Commission vs Sweden*.

[125]Case C-118/07, *Commission vs Finland*.

[126]Case 812/79, *Attorney General vs Burgoa*, 1980 E.C.R. 2787, at para. 6.

[127]See the Opinion of Advocate General Tizzano in Case C-216/01 — *Budvar*, (2003) ECR I, p. 13617, point 150; Opinion of AG Maduro, Case C-402/05 — *Kadi*, point 32; Opinion of Advocate General Maduro delivered on 10 July 2008, Case C-205/06 — *Commission vs Austria* and Case C-249/06 – *Commission vs Sweden*, point 33.

[128]ECJ, C-249/06, Dec. of 3 March 2009 – *Commission vs Sweden*, pt. 45.

[129]Opinion of AG Maduro in Case C-205/06, *Commission vs Austria*, point 33.

[130]ECJ, Judgments of 3 March 2009, C-249/06 *Commission vs Sweden*; C-205/06 *Commission vs Austria*.

Article 307 par. 2 EC Treaty includes Member States' obligations to denounce incompatible pre-accession agreements. It remains to be seen whether the Commission challenges other Member rates' BITs as well. Before the ECJ decisions against Sweden and Austria were delivered, the Commission had already announced it would consider its options in the light of these rulings.[131] It is most likely that the Commission will institute new infringement proceedings under Article 226 EC Treaty.

Lisbon Treaty Modifications with Regard to Investments

The division of competences between Member States and the EU makes the negotiation and conclusion of new trade and investment agreements difficult not only for the EU itself but also for (potential) third parties, since the ratification process is burdensome — 27 States plus the contracting partners can veto the negotiated agreement. Following the approach provided for in the (abandoned) Constitutional Treaty, the Treaty of Lisbon therefore provides for an explicit and exclusive competence of the Union in matters concerning "foreign direct investment" as part of the CCP (Article 207 TFEU). Undoubtedly the EU competences in the area of investment policy will therefore be extended.

The reason for this far-reaching transfer of competences for aspects of foreign direct investments is the intention to strengthen the EU as an actor in bi- and multilateral negotiations on investment policy.[132] Its negotiating powers are stronger than those of individual Member States, and therefore there might be a better chance to obtain (more) favorable conditions for EU investors in third countries.[133] The EU would be putting itself at a disadvantage if it did not seek to improve investment conditions, since this topic is becoming more relevant in the negotiation process of the new generation of free trade agreements, as highlighted above.[134] The Commission stresses: "Future FTAs should also include new provisions for investment, …. A new, ambitious model EU investment agreement should be developed in close coordination with Member States. It could be usefully complemented by a dialogue on investment promotion and facilitation."[135] The EU with its new competences will then be able to negotiate investment treaties with market

[131] See Annual EFC Report 2007, point 18.

[132] *European Commission*, Draft Articles Concerning External Action, CONV 685/03, 23 April 2003.

[133] Karl, The Competence for Foreign Direct Investment — New Powers for the European Union? JWT&I 5 (2006) 3, p. 413 et seq. (425); see on the effectiveness of the EU Member States as members of the EU, the latter with a collective weight behind it Mandelson, *The European Union in the Global Age*, 2007, p. 15 et seq., http://www.policy-network.net.

[134] See on this Woolcock, The potential impact of the Lisbon Treaty on EU External Trade policy, SIEPS — European Policy Analysis 3/2008, p. 8 et seq.

[135] European Commission Staff Working Document SEC (2006) 1230, p. 18.

access provisions as well as pre-establishment treatment more forcefully, and thereby be able to narrow down the existing differences between the BITs of the EU and NAFTA countries.[136]

Scope of the Investment Policy Competences After "Lisbon"

After the entry into force of the Lisbon Treaty, the EU would possess the exclusive competence in the field of foreign direct investments.[137] However, the scope of application of this competence is not yet clear. Most BITs use the much broader term "investment" or the narrower terms "establishment" and "enterprise."[138] The interpretation given to the term "foreign direct investment" by the IMF, reflecting the objective of obtaining a lasting interest by a resident entity in one economy in an enterprise resident in another economy[139] as well as in Community law in the capital directive,[140] does not provide an answer to what kind of policy instruments the EU would have at its disposal.

To assess the future scope of "foreign direct investment" in the CCP it is partly — very restrictively — argued that the Lisbon Treaty only includes investment liberalization.[141] This would cover a competence for internal and external regulation of market access, providing pre-establishment and national treatment. Investment protection or/and the question of standards of expropriation/protection of property on the other hand would remain entirely within the scope of the Member States' BITs.[142] Some commentators argue in the opposite direction; the EU shall in the future be able to conclude agreements that include comprehensive investment rules similar to those included in US free-trade agreements. This competence would then have to cover market access, pre- and post-establishment standards of treatment, performance requirements, investor–state dispute settlement provisions and even the question of protection in terms of the conditions under which expropriation takes place, notwithstanding that the conditions for expropriation are already to a

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[136] See ILA Report (footnote 104).

[137] See Article 2 EU Treaty. According to the definition given to "exclusive competence" by Article 2 EU Treaty (Lisbon version) "only the Union may legislate and adopt legally binding acts, the Member States being able to do so themselves only if so empowered by the Union or for the implementation of Union acts."

[138] Karl, The Competence for Foreign Direct Investment – New Powers for the European Union? JWT&I 5 (2006), p. 413 et seq. (420).

[139] IMF Balance of Payments Manual, 1993.

[140] Directive 88/361/EEC, 1988 O.J. L-187/5.

[141] See for example Leczeykiewicz, German Law Journal 6 (2005), p. 1675 (1677); Krajewski, External Trade Law and the Constitution Treaty: Towards a Federal and More Democratic Common Commercial Policy? CMLRev. (2005), p. 91 et seq. (112).

[142] See also Tietje, Die Außenwirtschaftsverfassung der EU nach dem Vertrag von Lissabon, Beiträge zum Transnationalen Wirtschaftsrecht 83, (2009), p. 14, http://www.wirtschaftsrecht.uni-halle.de/InstitutWirtschaftsrecht/html/publikationen.html.

large degree determined by customary international law and the general principles of community law.[143]

The wording of Article 207 TFEU does not contain any explicit limitation; for reasons of efficiency and practicability (effet utile) the EU should possess the competence for all possible aspects of (foreign direct) investment promotion and protection.[144] Furthermore, the entire CCP has been expanded beyond trade by the inclusion of foreign direct investments as well as intellectual property rights, which are themselves strongly related to property protection.[145] In addition, Article 345 TFEU (current Article 295 EC Treaty) does not exclude the extension of the new competences to the standards of protection; it does not preserve exclusive powers for Member States to determine expropriation and has been interpreted narrowly so far. Its scope only concerns the right of Member States to nationalize private property or to privatize public property.[146] The narrow scope of application has also been recognized in the field of intellectual property rights and protection, where the Court found that the regulation of intellectual property rights concerning not only their existence can be adopted at Community level.[147] Article 345 TFEU reserves for Member States only the power to decide whether and when expropriation occurs and not the conditions under which it takes place. The latter is the subject of foreign investment regulation, and does not fall within the scope of Article 345 TFEU but within the scope of regulation of Article 207 TFEU.

A broad scope of application of Article 207 TFEU also leads to the conclusion that the widely discussed sovereign wealth funds and their engagements in the EU will not be the object of national regulation any more. Investments of sovereign wealth funds from abroad would be covered by the CCP if they were to be determined as foreign direct investments and thus fall within the exclusive sphere of the EU — from a legal point of view, not even Sarkozy would be allowed then to set up a protectionist regime here.[148] Only the extension of the scope of application of the CCP to portfolio investments[149] and other forms of investment (for

[143]ECJ, 4/73 — Nold, (1974) ECR, 491; ECJ, C-84/95 — *Bosphorus*, (1996) ECR I, 3953.

[144]Karl, The Competence for Foreign Direct Investment — New Powers for the European Union? JWT&I 5(2006) 3, p. 413 et seq. (p. 422).

[145]Dimopoulus, The Common Commercial Policy after Lisbon: Establishing Parallelism between Internal and External Economic Relations? Croatian Yearbook of European Law and Policy 4 (2008), p. 101 et seq. (text at footnote 46); see also Karl, The Competence for Foreign Direct Investment — New Powers for the European Union? JWT&I 5(2006) 3, p. 413 et seq. (421); Ceyssens, Towards a Common Foreign Investment Policy? — Foreign Investment in the European Constitution, Legal Issues of Economic Integration (2005), p. 259 seq. (278).

[146]ICJ, Case 182/83 – *Fearon*, (1984) ECR, p. 3677.

[147]Dimopoulus, The Common Commercial Policy after Lisbon: Establishing Parallelism between Internal and External Economic Relations? Croatian Yearbook of European Law and Policy 4 (2008), p. 101 et seq. (text at footnote 47).

[148]See on this The Economist of 25 Oct. 2008, p. 16 (The State as Owner — Re bonjour, Monsieur Colbert), p. 33 (Nicolas Sarkozy — The President who Loved Summits), p. 34 (France tests a Different Type of National Champion).

[149]See below p. 147.

example intellectual property rights) cannot be covered by the notion "foreign direct investment."

Future of Existing Member States BITs and Question of their Termination

As already mentioned, Germany has concluded almost 140 BITs with non-EU countries, Great Britain more than 120, France almost 100 and Austria 50.[150] As has been shown, the exclusive power to conclude international treaties in the field of foreign direct investments will be transferred to the EU level. As a direct consequence, EU Member States will not be allowed to conclude new BITs by themselves any more.[151] The discussion on the legal status of the existing agreements of Member States after Lisbon has already started.[152] Even if the EU will not exercise its new competence in this field immediately (by negotiating and concluding new international investment treaties), it still appears questionable that existing BITs with non-EU countries can remain in force.[153] As shown above, it is the Member States' obligation to amend or even terminate agreements that are incompatible with the Treaty, even though such agreements are recognized as fully valid from an international as well as European law perspective.[154] The Member States would be obliged to adapt their BITs to EU law, due to Article 351 TFEU (the current Article 307 EC Treaty) applied analogically and Article 4(3) EU Treaty (Lisbon version).[155] This might lead to an obligation to terminate those existing BITs, as the ECJ has just pointed out in several infringement cases.[156] Even though a direct application of Article 351 TFEU would not be possible with regard to all BITs concluded by the original six EEC members, since all BITs by those States were concluded after the year 1958. Nevertheless, such obligations to terminate existing BITs can clearly be drawn from Article 4(3) EU Treaty as well. In this regard, the obligation under Article 351 TFEU is an expression of the duty of loyal

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[150]See the overview under http://www.worldbank.org/icsid.

[151]Ceyssens, Towards a Common Foreign Investment Policy? — Foreign Investment in the European Constitution, Legal Issues of Economic Integration (2005), p. 259 seq. at p. 287; Pitschas/Krenzler, Die Gemeinsame Handelspolitik im Verfassungsvertrag — ein Schritt in die richtige Richtung, in: Herrmann/Krenzler/Streinz (eds.), *Die Außenwirtschaftspolitik der Europäischen Union nach dem Verfassungsvertrag*, 2005, p. 11 et seq. (31).

[152]See on this Ceyssens, Towards a Common Foreign Investment Policy? — Foreign Investment in the European Constitution, Legal Issues of Economic Integration (2005), p. 259 seq.

[153]ILA, Committee on Foreign Investment, Conference Report 2008.

[154]Opinion of Advocate General Maduro delivered on 10 July 2008 in Case C-205/06 — *Commission vs Austria* and Case C-249/06 – *Commission vs Sweden*, point 33.

[155]On the application of Article 307 EC Treaty analogically to these constellations in general, see Terhechte, Art. 307, in: Schwarze (ed.), *EU-Kommentar*, 2008, pt. 15.

[156]ECJ, C-249/06, *Commission vs Sweden*, Dec. of 3 March 2009, C-205/06, *Commission vs Austria*, Dec. of 3 March 2009.

cooperation formulated in Article 4(3) EU Treaty.[157] It is that duty which explains why Member States are obliged to amend agreements that are incompatible with the Treaty.[158] The case law of the ECJ seeks to minimize as far as possible the breach to the integrity of the Community legal order caused by pre-existing international obligations. This might even lead to an obligation to terminate existing BITs.[159]

A different — legitimate and practicable — approach would be a permission by the EU[160] for the Member States to keep those Member States' BITs in force until the conclusion of specific EU international investment agreements, to avoid a situation of no treaty protection,[161] because a transition period is not provided for by the treaty, nor is there a provision recognizing the right of Member States to keep in place their existing agreements. In the long run, Member States' BITs will have to be replaced by new agreements concluded at the EU level, if the wording of Article 207 TFEU is taken seriously. Nevertheless, Member States may be allowed to continue to pursue their own investment insurance schemes and other financial support to foreign investments.[162]

Negotiation and Conclusion of New Agreements

Because of the transfer of competences to the EU level, it will not be the Member States any more that negotiate and conclude BITs, but the EU itself. The crucial question after the entry into force of the Lisbon Treaty, in addition to the extent of competences in the field of foreign direct investments, is the question of competences for portfolio investments. It might be necessary to include the regulation of portfolio investments in international investment agreement negotiations, but an external EU competence in this area can only result out of competences outside the CCP — such as the provisions of the free movement of capital[163] and the

[157]Cf. the Opinion of Advocate General Tizzano in Case C-216/01 – *Budvar,* (2003) ECR I, 3617, para. 150; Opinion of Advocate General Maduro in Case C-402/05 – *Kadi*, para. 32; Opinion of Advocate General Maduro in Case C-205/06, delivered on 10 July 2008, *Commission vs Austria* and Case C-249/06, *Commission vs Sweden*, para. 33.

[158]ECJ, C-249/06, *Commission vs Sweden*, Dec. of 3 March 2009, para. 33.

[159]Tietje, Die Außenwirtschaftsverfassung der EU nach dem Vertrag von Lissabon, Beiträge zum Transnationalen Wirtschaftsrecht 83 (2009), p. 17 http://www.wirtschaftsrecht.uni-halle.de/InstitutWirtschaftsrecht/html/publikationen.html.

[160]See on this for possibility ECJ, 41/76 — *Donckerwolcke*, (1976) ECR 1921, at p. 1937.

[161]See on this Tietje, Die Außenwirtschaftsverfassung der EU nach dem Vertrag von Lissabon, Beiträge zum Transnationalen Wirtschaftsrecht 83 (2009) http://www.wirtschaftsrecht.uni-halle.de/InstitutWirtschaftsrecht/html/publikationen.html, p. 17; see on this practice also Vedder/Lorenzmeier, Art. 133 EG, in: Grabitz/Hilf (eds.), *EG-/EU-Vertrag*, pt. 23.

[162]See on this Ceyssens, Towards a Common Foreign Investment Policy? — Foreign Investment in the European Constitution, Legal Issues of Economic Integration (2005), p. 259 seq.

[163]Article 63 TFEU.

competences for association agreements[164] and development[165] — and therefore only cover provisions of market access and "post establishment treatment" but generally not aspects of investment protection.[166] Article 63 TFEU (free movement of capital) cannot cover BITs on the investment protection/expropriation matter either. An external competence for dispute resolution out of the freedom of capital movements would also be questionable.[167] Concerning these points no secondary law has yet been adopted, and the ECJ clearly has pointed out in Opinion 2/00 that if in specific cases harmonization at the community level has only achieved a very small part of a policy, the EC and its Member States share the competence to conclude an international agreement.[168]

Therefore, even after the Lisbon Treaty enters into force, future agreements which cover all forms of investments and their protection, including a procedure on dispute resolution, would neither in their entirety fall under an exclusive EU competence,[169] nor would the CCP along with competences deriving from the freedom of capital movement and the application of the ERTA Doctrine[170] be a sufficient basis for an EU agreement. It thus depends on the definition of "foreign direct investments" and the EU intention, to what extent "portfolio investments" should be protected, whether international investment agreements will have to be concluded as mixed or as community agreements. The conclusion of "pure BITs" without the Member States being able to veto, on the other hand, would only be possible if these agreements solely cover pre- and post-establishment regulation but have no provisions on protection, dispute resolution and expropriation with regard to portfolio investments. Therefore, the demands of EU investors as well as those of its negotiating partners might not be met. EU BITs comparable to the US Model BIT covering portfolio and direct investment, pre- and post establishment rules, protection of investment in cases of expropriation and indirect expropriation, as well as investor–state arbitration rules, would need joint action of the EU and its Member States.

At this point, it has to be asked whether the protection of portfolio investments accompanied by a dispute resolution mechanism is a necessary tool in the competition of systems "game." It has to be remembered that portfolio investments remain protected under the rules of international customary law.[171] Additionally, domestic

[164]Article 217 TFEU.

[165]Article 211 TFEU.

[166]Karl, The Competence for Foreign Direct Investment — New Powers for the European Union? JWT&I 5(2006) 3, p. 413 et seq. (425).

[167]See on this Ceyssens, Towards a Common Foreign Investment Policy? — Foreign Investment in the European Constitution, Legal Issues of Economic Integration (2005), p. 259 et seq. (282).

[168]ECJ, Opinion 2/00 — *Cartagena Protocol*, at para. 43–47.

[169]Krajewski, External Trade Law and the Constitution Treaty: Towards a Federal and More Democratic Common Commercial Policy? CMLRev. (2005), p. 91 et seq. (112).

[170]ECJ, 22/70 – *ERTA (Commission vs Council)*, (1971) ECR, 263.

[171]See on this for example Comeaux/Kinsella, *Protecting Foreign Investment Under International Law*, 1997; Sornarajah, *The International Law of Foreign Investment*, 1994.

and international investment insurance schemes give guarantees for EU investors abroad.[172] Diplomatic protection of EU undertakings engaging in portfolio investments could be granted by the investor's home country or by the EU — depending on a case-by-case analysis. A binding link to the OECD codices on foreign investments[173] within the concluded BITs could give further guarantees to those investments as well. In cases where there is a sufficient link to trade, even the Trade Barrier Regulation (TBR)[174] could be applied, and investors might under certain circumstances be able to force the Commission to intervene on their behalf. Furthermore, the TBR — as secondary law — could be modified and extended in its scope of application, from trade barriers to questions related to foreign investments. But even with these second-best protection possibilities for portfolio investments, the protection standard of future EU BITs will remain reduced in comparison to the US Model; the structure of the agreement would already have to distinguish between foreign direct investments and portfolio investments.

In conclusion, future agreements on investments will even after Lisbon be troublesome to negotiate. But to be able to react to the needs of its external economic policy requirements, and to be able to compete for example with the US Investment Agreements, the EU needs to be able to conclude pure BITs just as it might have to incorporate investment chapters in broad PTAs. However, only in the latter case the above-discussed limited competence in investment is of no importance; due to the inclusion of other topics, which do not fall in the exclusive competence of the EU, the agreement would have to be a mixed agreement anyway.

EU Model Law on Investment

The EU plans to develop its own "EU Model Investment Protection Agreement" after Lisbon, which then is supposed to be the basis for future agreements to be concluded by the EU. The EU has obviously already started working on this; a first step was the adoption of the "EU Minimum Platform on Investment,"[175] further developments and discussions on this topic have not been made public up to now.

The new EU model agreement will face multiple challenges — dispute resolution, the most-favored-nation clause, the scope of investments included, taking into consideration the "investment and . . ." topics, etc. The high quality of such an "EU Model Investment Protection Agreement", and the conclusion of EU BITs

[172] Multilateral Investment Guarantee Agency, ILM 24 (1985), p. 1598; in Germany the Government appointed a consortium formed by PricewaterhouseCoopers Aktiengesellschaft Wirtschaftsprüfungsgesellschaft (PwC AG), as lead partner, and Euler Hermes Kreditversicherungs-AG (Euler Hermes) to manage the investment guarantee scheme, see http://www.agaportal.de/en/dia/index.html.

[173] OECD, Decision of the Council on National Treatment, http://www.oecd.org/dataoecd/32/21/1954854.pdf.

[174] Regulation (EC) 3286/94, O.J. 1994 L-349/71.

[175] Revised version of 6 March 2009, see above.

comparable to the standard reached today by for example German BITs, could prevent EU companies from engaging in treaty shopping[176] and establishing themselves outside the EU in order to secure a better procedural standing in investment disputes, and make them stay with their establishments within the EU.

The effectiveness of international investment protection depends on an accepted and effective forum for dispute resolution. The most popular forum in this regard is arbitration according to the rules of the ICSID Convention — but neither the EC nor the EU is a member of the ICSID Convention.[177] Unless the statute of the International Monetary Fund — which is also relevant for ICSID membership[178] (only states can be signatories of the IMF Statute[179]) is modified, ICSID dispute resolution will remain no option for an EU Model BIT. Thus, at present ICSID arbitration will be excluded from EU investment protection, for in the real competition of systems up to now one does not expect the United States to agree to the necessary modifications of international economic law, as experience in other International Organizations has shown.[180] This might change with the global financial crisis and the acceptance of the EU as a global player in financial matters, though. As an alternative, a new dispute settlement system could be set up. This could even give a chance for a modified investment dispute resolution system taking into consideration the deficiencies of the ICSID Convention. Such a new mechanism could, e.g., introduce, some sort of a standing appellate system to exclude diverging decisions between arbitration tribunals comparable to the WTO Dispute Settlement mechanism.

Furthermore, obligations on promoting social standards, sustainable development, human rights, good governance, etc. have to be included in such an "EU Model BIT" because of the binding link of the Common Commercial Policy to the general principles and objectives enumerated in Article 21 EU Treaty.[181]

Today's BITs concluded by the EU Member States contain most-favored-nation clauses. A future EU Model BIT will have to deal with the scope of application of those MFN clauses and make sure that more favorable clauses which are part of old Member States' BITs cannot be invoked against the EU. In addition, it is necessary

[176]On the extent of this, Burgstaller, Nationality of Corporate Investors and International Claims against the Investor's Own State, JWI&T 7 (2006), p. 857 et seq.; Krajewski/Ceyssens, Internationaler Investitionsschutz und innerstaatliche Regulierung, AVR 45 (2007) p. 180 et seq. (190).

[177]See Article 25 ICSID Convention.

[178]Article 67 ICSID Convention.

[179]Article II Worldbank Statute.

[180]On this, see Hoffmeister, Outsider or Frontrunner? Recent Developments under International and European Law on the Status of the European Union in International Organizations and Treaty Bodies, CMLRev. 44 (2007) p. 41 et seq.; Govaere/Capiau/Vermeersch, In-Between Seats: The Participation of the European Union in International Organizations, EFARev. 9 (2004) p. 155 et seq.

[181]See above.

to exclude those agreements that could lead to a later accession to the EU from the benefit of such a clause.[182]

Necessary Modifications of EU Primary Law "After Lisbon"

Even after the entry into force of the Lisbon Treaty, still no EU BIT can be concluded that will be comparable in its quality with today's EU Member States' BITs or the US Model BIT. It is obvious that certain modifications of the constitutional conditions for international investment agreements in a post-Lisbon phase offer the chance of formulating a more efficient EU Model BIT. If the EU wants to become a global player in investment politics, it will need the capacity to conclude international investment agreements of a high quality — not having to differentiate between foreign direct and portfolio investments, and in consequence also being able to conclude pure EU BITs without its Member States being able to veto, including efficient modes of dispute resolution as well as questions of expropriation.

The obligatory link to the general principles and objectives [Article 21 EU Treaty (Lisbon version)] is not to be forgotten. In negotiations of international investment agreements, it might not be wise to ask for more than a requirement to "take into account" those listed principles, otherwise the EU investment platform will lose attractiveness for potential contracting partners from emerging markets,[183] since investment protection for EU investors abroad is needed irrespective if these countries fulfill all "western standards."[184] Independently, EU investors can be bound to EU standards by secondary law even when engaging and establishing abroad. A binding link to the OECD Guidelines for Multinational Enterprises[185] as well as on the ideas of the Global Compact[186] might be an alternative to provisions on public goods being part of the agreement.

Furthermore, an institutionalized system of diplomatic protection needs to be set up, and rules on diplomatic protection by the EU itself should be laid down in EU primary law.[187] This system should be spelled out explicitly in the specific EU

[182]European Commission, Note of 30 May 2006 for the attention of the 133 Committee, p. 2.

[183]See for example Johnson, Rights obstacle to EU–India trade pact, Financial Times of 4 March 2007.

[184]Critical on these developments, also Tietje, Die Außenwirtschaftsverfassung der EU nach dem Vertrag von Lissabon, Beiträge zum Transnationalen Wirtschaftsrecht 83 (2009), p. 19, http://www.wirtschaftsrecht.uni-halle.de/InstitutWirtschaftsrecht/html/publikationen.html.

[185]OECD, Working Papers Vol. V: *The OECD Declaration and Decisions on International Investment and Multinational Enterprises Basic Texts*, 1997.

[186]http://www.unglobalcompact.org.

[187]See on "EU Diplomatic Protection" Bungenberg, Diplomatischer Schutz, in Heselhaus/Nowak (eds.), *Handbuch der Europäischen Grundrechte*, 2006, § 48, point 37–41.

provisions on diplomatic protection.[188] The scope of the TBR could easily be extended to matters of investment, then leading to a future "Regulation on Trade Barriers and Investment Protection". Proceedings could be launched by the Commission on behalf of EU investors, if investor—state arbitration on the basis of an EU international investment agreement for whatever reason is not feasible.

Conclusion

The Lisbon Treaty will extend the Union's external competences in the CCP to the entirety of trade in services, commercial aspects of intellectual property rights and foreign direct investment. This competence will be an exclusive EU competence. It will therefore exclude the possibility for EU Member States to conclude agreements in these fields. Member States will have to adapt their international treaties to EU law. Because of the shift of competences, those agreements might have to be terminated. National parliaments will no longer need to give their consent to pure international trade or foreign direct investment treaties, provided they do not entail other topics that lead to mixed agreements. On the other hand, the influence of the European Parliament is strengthened. The non-economic principles laid down in Article 21 EU Treaty (Lisbon version) have to be fully included in future agreements. In addition, the European Parliament gains the power to force Commission and Council to respect these environmental and human rights obligations in the area of the CCP. Thus, the Lisbon Treaty, at least in the area of the CCP, constitutes a benchmark and a shift of paradigms. Of all changes brought about by the Lisbon Treaty, the ones regarding the CCP seem to be the largest but still the least discussed ones.

[188]See Article 23 EU Treaty.

Services Trade Liberalisation and Regulation: New Developments and Old Problems

Markus Krajewski

Introduction

In his foreword to a recent publication on trade in services, the Director General of the World Trade Organisation (WTO), *Pascal Lamy*, claims: "Gone are the days when services used to be considered non-tradables".[1] Indeed, creating a consensus among trade policy officials, business leaders and academic commentators that services can be traded across borders was a major step for the development of the multilateral trading system. However, the ensuing problems that followed from this consensus are at least as challenging. Considering services as tradables gives rise to a number of fundamental questions about the proper framework and legal rules for the liberalisation and regulation of such trade. It is therefore not surprising that trade in services moved to the centre of attention of political and academic discourses about the international trading system in recent years. As a result of the increased interest in trade in services, the challenges and difficulties associated with this concept became apparent. While early assessments of the inclusion of services in the multilateral trading system were often shaped by generally optimistic assumptions about the over-all positive effects of services trade liberalisation on the one side and unsubstantiated claims that the GATS would force governments to privatisation and deregulation on the other side, the debate is more balanced now. Most commentators – political and academic ones alike – recognise the complexity of the issues involved. In fact: Gone are the days when the liberalisation of trade in services used to be subject to simplistic assumptions and claims.

The present contribution aims to address some of the challenges associated with the notion of trade in services against the background of an experience of roughly

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[1]Lamy, Foreword, in: Marchetti/Roy (eds.), *Opening Markets for Trade in Services – Countries and Sectors in Bilateral and WTO Negotiations*, 2009, p. xix.

C. Herrmann and J.P. Terhechte (eds.), *European Yearbook of International Economic Law 2010*, European Yearbook of International Economic Law,
DOI 10.1007/978-3-540-78883-6_7,

two decades of trade liberalisation in services at the international level. The contribution will focus predominantly on the WTO's General Agreement on Trade in Services (GATS), but also discuss aspects of services trade liberalisation in bilateral and regional trade agreements. I shall begin by sketching the two decades of experience with international trade liberalisation in services (Sect. II). This section contains a short overview of the various international agreements covering trade in services and discusses the proliferation of regional agreements in recent years. The following section concerns itself with the intellectual basis of considering services as tradables and of the liberalisation of such trade in transnational contexts (Sect. III). The section aims to reconstruct and critically assess the notions of services, trade in services, barriers to trade in services and liberalisation of trade in services touching upon conceptual questions such as the modal structure of services trade, the contentious case of public services, the relationship between domestic regulation and trade liberalisation as well as the negative-list and positive-list approaches towards trade liberalisation of services. Subsequently, I discuss the state of the current services negotiations in the context of the so-called Doha Development Agenda (DDA) and the "built-in" agenda of the GATS (Sect. IV). In this part, I try to offer some explanations regarding the stagnation of these negotiations apart from the general problems of the DDA. Even though the body of case law relating to the GATS has been rather small, a discussion of the developments in GATS dispute settlement is called for because the dispute settlement institutions of the WTO have already touched upon a number of central aspects of the GATS (Sect. V). Some rulings of the panels and the Appellate Body provided clarity vis-à-vis those aspects. Others have created legal uncertainty. It will hence be of great interest to see whether the future development of the case law can increase the level of understanding of the GATS. The final section of this contribution tries to bring the recent developments and the new and not-so-new problems together and ventures a look into the – possible – future (Sect. VI)

Two Decades of International Trade Liberalisation in Services

Conventional wisdom has it that the modern international trade regime began with the ill-fated attempts to establish the International Trade Organisation (ITO) in the mid-1940s and the entry into force of the General Agreement on Tariffs and Trade on 1 January 1948.[2] It seems therefore fair to speak about roughly sixty years of the international trade regime. The last twenty years of that period have seen the existence of rules on trade in services. During those two decades, trade in services "used to be an arcane issue, whose secrets were to be revealed only to a few initiates"[3] for quite some time. Only recently, in fact, since the late 1990s, trade

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[2]Lowenfeld, *International Economic Law*, (2nd ed.), 2008, p. 23 et seq.

[3]Marchetti/Roy, Summary and Overview, in: Marchetti/Roy (eds.), *Opening Markets for Trade in Services – Countries and Sectors in Bilateral and WTO Negotiations*, 2009, p. 1.

in services became a subject of interest to a broader range of stakeholders including business and trade negotiators, but also academics, national policy-makers and civil society.

It should be noted, of course, that the Treaty Establishing the European (Economic) Community of 1957 (EC Treaty) also contains rules on services. In particular, the freedom to provide and receive services is considered one of the basic freedoms constituting the European internal market and a "fundamental principle" of the EC Treaty.[4] Would it hence not be more suitable to speak about five decades of international services liberalisation, one might ask. There are good reasons why there is no need to change the historical framework chosen for this contribution. First, it should be recalled that the services chapter of the EC Treaty was a "sleeping beauty" for a considerable number of years.[5] It was only in the late 1980s and early 1990s that the Court of Justice and the Community legislator (Commission, Council and Parliament) began to use the provisions on the freedom to provide services more frequently. This may be due to the fact that services are construed as a residual freedom in the EC Treaty: The provisions only apply if the other freedoms relating to goods, workers, establishment and capital are not applicable.[6] Second, and more importantly, the provisions on services of the EC Treaty aim at the establishment of an internal market. It is argued that this goal of European integration differs from a conceptual perspective fundamentally from the aims of trade liberalisation pursued by bilateral, regional and multilateral trade agreements. An approach taking the EC Treaty also into account would hence affect the analytical clarity of the notion of trade in services in international contexts.[7]

Leaving the EC Treaty therefore aside, the first international agreement to encompass "trade in services" still in force is the Protocol on Trade in Services, which was added to the Australia New Zealand Closer Economic Relations Trade Agreement (ANZCERTA) of 1983, in 1988 and entered into force on 1 January 1989.[8] It was predated only by a 1985 United States–Israel Declaration on trade in services, which was however, not legally binding.[9] The Australia–New Zealand Protocol on Trade in Services aims to liberalise trade in services between the two

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[4]ECJ, Case C-348/96, *Calfa* [1997] ECR I-11, para. 16.

[5]Hatzopoulos, Recent Developments of the Case Law of the ECJ in the Field of Services, CMLRev 37 (2000) p. 43 (43).

[6]Eeckhout, Constitutional Concepts for Free Trade in Services, in: de Búrca/Scott (eds.), *The EU and the WTO,* 2001, p. 211 (212).

[7]In other contexts, comparisons between the international and the European regime reveal interesting results, for example the emergence of a common concept of "services" in WTO and EC law due to the combination of the EC rules on freedom to provide and receive services with the freedom of establishment of service providers, see Krajewski, Of modes and sectors – External relations, internal debates and the special case of (trade in) services, in: Cremona (ed.), *New Developments in EU External Relations Law,* 2008, p. 172 (pp. 187–188).

[8]Australia Treaty Series 1988, No. 20, available at http://www.dfat.gov.au/geo/new_zealand/anz_cer/215.pdf.

[9]Feketekuty, *International Trade in Services: An Overview and Blueprint for Negotiations*, 1988, p. 176.

parties, improve the efficiency and competitiveness of the service industries, expand trade in services and facilitate competition in trade in services. The definition of the scope of the agreement differs from later agreements on trade in services, but it already contains key obligations such as market access, national treatment, and most-favoured-nation treatment as well as provisions on transparency, monopolies and licensing. Another pioneer of services trade liberalisation was the Canadian–United States Free Trade Agreement (CUSFTA), which also came into force in 1989.[10] This agreement has been described as one of the precursors of current preferential trade agreements.[11] The services chapter of the agreement featured a general national treatment obligation, but notably, no most-favoured nation clause.[12] With the entry into force of the North American Free Trade Agreement (NAFTA) between Canada, the United States and Mexico in 1993, the CUSFTA rules on services were largely subsumed by the respective NAFTA rules.[13]

Until the mid 1990s, international trade in services was hence confined to two agreements, one bilateral and one trilateral agreement. This picture changed dramatically with the entry into force of the GATS in 1995, the only multilateral agreement covering trade in services. It is one of the agreements annexed to the Marrakech Agreement Establishing the WTO and hence it is binding on all 153 Members of that organisation.

Since the entry into force of the WTO agreement there has been a remarkable proliferation of bilateral and regional trade agreements.[14] While all of these agreements cover trade in goods, some of them also apply to services. As of February 2009 a total of 63 regional trade agreements covering trade in (goods and) services were concluded and notified to the WTO.[15] Fifty-two of these agreements were concluded after 1994. In some cases, the provisions on trade in services were part of the agreement since its entry into force such as in the case of the Dominican Republic–Central America Free Trade Agreement (CAFTA-DR) of 2004. In other cases, the rules on trade in services were only included into the framework of these agreements after the rules on trade in goods had already been in operation for some time, e.g. the Montevideo Protocol on Trade in Services of MERCOSUR

[10] Text available at http://www.worldtradelaw.net/nafta/CUSFTA.pdf.

[11] Roy/Marchetti/Lim, Services Liberalization in the New Generation of Preferential Trade Agreements (PTAs): How Much Further than the GATS? WTO Staff Working Paper ERSD-2006-07, 2006, p. 7, available at http://www.wto.org/english/res_e/reser_e/ersd200607_e.pdf.

[12] Trebilcock/Howse, *The Regulation of International Trade*, (3rd ed.), 2005, pp. 353–354.

[13] Trebilcock/Howse, *The Regulation of International Trade*, (3rd ed.), 2005, p. 39.

[14] For a comprehensive overview see Fiorentino/Verdeja/Toqueboeuf, The Changing Landscape of Regional Trade Agreements: 2006 update, WTO Discussion Paper No. 12 (Geneva: WTO, 2007), available at http://www.wto.org/english/res_e/reser_e/discussion_papers_e.htm (last visited 18 February 2009).

[15] The figure includes the EC enlargement agreements of 2004 and 2007 and the notifications of agreements predating the entry into force of the GATS. Data taken from the WTO's database available at http://rtais.wto.org/UI/PublicSearchByCrResult.aspx (last visited 18 February 2009).

of 1997 and the General Framework of Principles and Rules for Liberalizing Trade in Services in the Andean Community of 1998.

The great majority of recent trade agreements addressing services are bilateral agreements. Forty-one of the 63 notifications of regional trade agreements covering services submitted to the WTO until February 2009 concerned bilateral agreements.[16] A significant number of them is concluded between non-neighbouring countries. While some agreements have been concluded between two developed countries (e.g. United States–Australia Free Trade Agreement of 2004), in most cases the agreements involve either a developed and a developing country or two developing countries, often emerging markets such as Chile, China, India, Mexico, Korea or Singapore.

(Re-)Constructing Liberalisation of Trade in Services

As pointed out in the introduction, liberalising trade in services raises a number of conceptual problems. In general, these problems can be summarised with the following four fundamental questions every agreement on trade in services needs to address in some way: First, the notion of "services" needs to be defined, which is a difficult task already. Since the agreements in question do not cover services per se, but "trade in services", the second question concerns this concept. Even more to the point, the agreements are not about trade in services in general, but about liberalising trade in services. In order to understand what this means, it is necessary to ascertain what "barriers to trade in services" are and finally, what the removal of these barriers, i.e. the "liberalisation of trade in services", entails.

"I Know It When I See it": Services

A common starting point of many analyses of trade in services is the proverbial statement – often attributed to *The Economist*[17] – that a service is a product of economic activity "that you cannot drop on your foot".[18] This usually leads to nodding heads in the audience, but it creates a wrong impression. While it is true that services are generally intangible, there are many products of an economic activity that are neither services nor can they be dropped on your foot, such as intellectual property rights, securities or assets. These products may come along

[16]Bilateral agreements are understood as agreements between two single entities (states or separate customs territories), but not between one state and a regional integration organisation such as the EC or EFTA.

[17]The Economist, "Services", Economics A–Z, available at http://www.economist.com/research/economics/alphabetic.cfm?letter=S (19 February 2009).

[18]Lester/Mercurio, *World Trade Law, Texts, Materials and Commentary*, 2008, p. 598.

with services, but their economic value extends beyond the value of the service as such. If anything, the proverb should be formulated negatively: Everything you can drop on your foot is not a service. However, this is not the whole picture either, since the result of a service is often stored in a physical good, such as the design of an architect on paper or artistic performances on CDs or DVDs.[19] More complex approaches to the idea of services usually refer not only to the intangibility of services, but also to their non-storability, the simultaneity of production and consumption of a service, which often requires a relative proximity of the service supplier and the consumer, the fact that services are often tailored to the needs of the consumers and that consumers participate in the production process.[20] Yet, commentators on trade in services usually agree that there is no need to define services on an abstract level, because the liberalisation commitments in services are made on a sectoral basis anyway and hence, it seems sufficient to understand services by enumerating the different services sectors which are used in the context of trade agreements.[21] This pragmatic approach seems to coincide with the fact that most trade agreements to do not define services in an abstract manner. In fact, Art. I:3(b) GATS defines services as “any service in any sector”.

However, it is important to note that most trade agreements contain carve-outs for governmental activities from the definition of services. In particular, the GATS excludes “services supplied in the exercise of governmental authority” which are defined as services which are “supplied neither on a commercial basis, nor in competition with one or more service suppliers” (Art. I:3(c) GATS). In the early days of the GATS, trade officials suggested that this clause could exclude all public services from the scope of the agreement if these services were supplied by the government directly. This is unconvincing, let alone because the sectoral list of the GATS[22] includes most services which are traditionally considered public services such as postal and telecommunication services, transportation services, water supply, waste and wastewater management, education, health and social services. Not surprisingly, the view that Art. I:3(c) GATS excludes public services per se from the scope of the GATS, is no longer upheld. Commentators agree today that the clause must be interpreted with regards to the terms “commercial basis” and

[19]Copeland/Mattoo, The Basic Economics of Services Trade, in: Mattoo/Stern/Zanini (eds.), *A Handbook of International Trade in Services*, 2008, p. 84 (85).

[20]Hoekman/Mattoo, International trade: trade in services, in: Guzman/Sykes (eds.), *Research Handbook in International Economic Law*, 2007, p. 113 (115); Hoekman/Kostecki, *The Political Economy of the World Trading System*, (2nd ed.), 2001, p. 241.

[21]Copeland/Mattoo, The Basic Economics of Services Trade, in: Mattoo/Stern/Zanini (eds.), *A Handbook of International Trade in Services*, 2008, p. 84 (85).

[22]GATT, Services Sectoral Classification List, Note by the Secretariat, MTN.GNS/W/120, 10 July 1991. The list is reproduced in the 2001 Scheduling Guidelines as Attachment 8, see Council for Trade in Services, Guidelines for the Scheduling of Specific Commitments under the General Agreement on Trade in Services, S/L/92, 28 March 2001.

"competition".[23] Hence, only governmental activities which are truly supplied on a non-competitive and non-commercial basis are excluded from the scope of the agreement. The exception clause is therefore a narrow one.[24] Its sectoral scope depends on the domestic regulatory framework of the service in question. Introducing elements of profitability and competitiveness into sectors previously operated as public non-profit monopolies deprives these services of their status as governmental services according to the GATS. As *Werner Zdouc* rightly pointed out: "Deregulation and liberalization reduce the coverage of the GATS exemption with respect to governmental services".[25] These considerations also apply to exception clauses in other trade agreements which follow the model of Art. I:3(b) and (c) GATS such as Art. II:3(b) and (c) of the Montevideo Protocol on Trade in Services, Art. 11.1(6) CAFTA-DR, Art. 75(2)(b) and (c) of the EC-CARIFORUM Economic Partnership Agreement (EPA) of 2008 and a number of bilateral free trade agreements.

Information, People and Capital Crossing Borders: Trade in Services

Unlike their relative silence on the notion of "services" trade agreements usually contain a definition of "trade in services" based on different modes of supply. Following the typology of Article I:2 GATS, the modes include the supply of a service from the territory of one Member into the territory of any other Member ("cross-border supply", Mode 1), the supply of a service in the territory of one Member to the service consumer of another Member ("consumption abroad", Mode 2), the supply of a service by a service supplier of one Member through commercial presence in the territory of any other Member ("commercial presence", Mode 3) and the supply of a service by a service supplier of one Member through presence of natural persons of a Member in the territory of any other Member ("presence of natural persons", Mode 4). The modal approach to the notion of trade in services is also followed in bilateral and regional trade agreements which cover trade in services. For example, the General Framework of Principles and Rules and for Liberalizing the Trade in Services in the Andean Community, the Mercosur Protocol on services and the United States–Jordan Free Trade Agreement of 2000 use the same definition of trade in services as the GATS.

[23]Adlung, Public Services and the GATS, JIEL 9 (2006) 455 (462 et seq.); Leroux, What is a "Service Supplied in the Exercise of Governmental Authority" Under Article I:3(b) and (c) of the General Agreement on Trade in Services? JWT 40 (2006), p. 345 (348 et seq.).

[24]Krajewski, Protecting a Shared Value of the Union in a Globalized World: Services of General Economic Interest and External Trade, in: Van de Gronden (ed.), *The EU and WTO Law on Services*, 2009, p. 173 (202).

[25]Zdouc, WTO Dispute Settlement Practice in relation to GATS, JIEL 2 (1999), p. 295 (321, n. 85).

A different approach can be found in NAFTA: Art. 1213 NAFTA provides that the Chapter 12 on services only covers the provision of a service from the territory of a Party into the territory of another Party, in the territory of a Party by a person of that Party to a person of another Party, and by a national of a Party in the territory of another Party with the exception of the provision of a service in the territory of a Party by an investment in that territory, which is covered by Chapter 11 NAFTA on investments. In short, NAFTA covers modes 1, 2 and 4 in the services chapter and mode 3 in the investment chapter. The NAFTA approach is also followed by a number of regional and bilateral agreements such as CAFTA-DR or the United States–Singapore Free Trade Agreement of 2003.

A third, albeit smaller group of regional and bilateral agreements combines both approaches and covers investment in services both as commercial presence in the chapter on trade in services and as investment under the investment chapter.[26] An example would be the Japan–Singapore Economic Partnership Agreement of 2000. Yet, another approach is used by the EC-CARIFORUM EPA. It contains a chapter on "commercial presence" which covers investment in goods and services (Mode 3), a chapter on cross-border supply of services covering Modes 1 and 2 and a chapter on temporary presence of natural persons for business purposes.

Despite the variations in their scope, all agreements base their understanding of trade in services on the different modes of supply. *Andrew Lang* has hence rightly labelled the definition of trade in services based on the four modes of supply as "canonical".[27] Indeed, the use of this definition in trade policy-making and academic analysis is nowadays so widespread that it would seem almost "unnatural" to approach the idea of trade in services based on any other understanding. Yet, it has to be remembered that the notion of trade in services encompassing commercial presence (investment or establishment), presence of natural persons and consumption abroad had to be intellectually construed and actively lobbied for prior and during the negotiations on trade in services in the Uruguay Round. In their fascinating account of the intellectual history of these activities, *William Drake* and *Kalypso Nicolaïdis* demonstrate how a growing "epistemic community" of trade officials, business representatives, professionals, think tanks and individual academics developed, consolidated and finally implemented the idea that "trade in services" was to be understood as a new field of trade policy, thus defining and socially constructing "a new reality".[28] The epistemic community conceptualised the idea of trading services across borders either on the basis of the physical embodiments of services, i.e. people, goods, and capital[29] or on the movement of

[26]Matoo/Sauvé, Regionalism in Services Trade, in: Mattoo/Stern/Zanini (eds.), *A Handbook of International Trade in Services*, 2008, p. 221 (247 et seq.).

[27]Lang, GATS, in: Bethlehem et al. (eds.), *The Oxford Handbook on International Trade Law*, 2009 p. 157 (161).

[28]Drake/Nicolaidis, Ideas, interests, and institutionalization: "trade in services" and the Uruguay Round, International Organisation 46 (1992), p. 37 (45).

[29]Feketekuty, *International Trade in Services: An Overview and Blueprint for Negotiations*, 1988, p. 28 et seq.

services suppliers and consumers across borders. Conceptualising trade in services in this manner led directly to the construction of trade in services based on the four modes of supply.[30] These four modes of supply of trade in services are hence the result of a re-characterisation of certain economic activities as trade in services.[31]

Restricting Foreign Supply and Burdening Economic Activities: Barriers to Trade in Services

Early approaches to the concept of barriers to trade in services are narrative accounts of various types of measures which affect transnational activities involving the supply of a service.[32] In order to tackle such barriers in a trade agreement, they had to be categorised on a more abstract level. Yet, in light of the social and intellectual construction of the notion of trade in services, barriers to trade in services had to be construed as well. In other words, similar to the re-characterisation of certain economic activities as trade in services, certain types of governmental regulation had to be re-characterised as "barriers to trade in services" in order to address them in trade agreements.[33]

The experience with barriers to trade in goods was only partially helpful. In general, three types of barriers to trade in goods can be distinguished: The first and most obvious type of barriers to trade in goods concerns measures which directly restrict the quantity of foreign goods on a domestic market such as tariffs or quantitative restrictions (market access limitations). The second type relates to measures which openly discriminate between domestic and foreign products or between different foreign products (discriminatory measures). The trade-distorting effect of these measures is also apparent. A third group consists of non-discriminatory measures which have no direct effect on the quantities of a foreign product in the domestic market, but which place a regulatory burden on the economic actors. Examples are product standards and requirements such as safety regulations.

Turning to services, it is a truism that there are no tariffs levied on services. In general, border measures are difficult to apply to services. Only services supplied through modes 2 and 4 can be subject to border measures, because in these cases

[30]Drake/Nicolaidis, Ideas, interests, and institutionalization: "trade in services" and the Uruguay Round, International Organisation 46 (1992), p. 37 (71).

[31]Lang, GATS, in: Bethlehem et al. (eds.), *The Oxford Handbook on International Trade Law,* 2009 p. 157 (159).

[32]Feketekuty, *International Trade in Services: An Overview and Blueprint for Negotiations*, 1988, p. 131 et seq.

[33]Lang, GATS, in: Bethlehem et al. (eds.), *The Oxford Handbook on International Trade Law*, 2009, p. 157 (159).

natural persons cross the border. In most cases, however, measures affecting trade in services are measures which are applied "behind the border". As one of the fathers of the concept of trade in services *Geza Feketekuty*[34] put it: "Most barriers to trade in services are embedded in domestic regulations".[35] This indicates an inherent tension between trade liberalisation and domestic regulation of services.

A useful typology of barriers to trade in services has been developed by *Alan Deardorff* and *Robert Stern:* They have introduced a 2 × 2-matrix which combines the effects of the measure (discriminatory or non-discriminatory) with the point of application of the measure (entry/establishment or operation).[36] An example for a discriminatory restriction on the entry of a service supplier would be a restriction of the number of foreign banks that may be established. An example for a non-discriminatory restriction on the entry of a service supplier would be the same restriction of the number of banks that may be established, but it would apply to foreign and domestic banks alike. A regulation that requires a certain performance from all service suppliers would be an example for a non-discriminatory barrier on the operation of the service, while the same performance requirement only applied to foreign service suppliers would be a discriminatory barrier on the operation of the service.

This typology highlights two important and contentious aspects: First, every non-discriminatory regulation of the operation of a service including qualification requirements, technical standards and performance requirements – in short: any service regulation – can be construed as a barrier to trade in services. Second, measures restricting "market access" in services (i.e. measures restricting entry/establishment) such as monopolies, quotas or economic needs tests are not necessarily measures aimed at the international provision of a service. This distinguishes market access in the goods context from market access in services. Barriers to market access for goods are typically measures applied at the border (tariffs and quantitative restrictions). They are hence aimed at the regulation of international trade and only apply to foreign goods. Measures restricting market access in services are not primarily aimed at the domestic supply of the service. Yet, they are conceived as barriers to trade, because they also restrict the market access of foreign service suppliers.

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[34]For an account of the important role of Geza Feketekuty in creating the GATS see Drake/Nicolaidis, Ideas, interests, and institutionalization: "trade in services" and the Uruguay Round, International Organisation 46 (1992), p. 37 (50) with further references.

[35]Feketekuty, *International Trade in Services: An Overview and Blueprint for Negotiations*, 1988, p. 209.

[36]Deardorff/Stern, *Empirical Analysis of International Services Transactions and the Consequences of Liberalization*, p. 167 (178).

Following the GATT Model: Liberalisation of Trade in Services

In light of the novelty of the notion of trade in services and the lack of any significant previous experience with liberalising trade in services, negotiators in the Uruguay Round used the GATT principles as a starting point for the development of the core principles of an agreement of trade in services. This is noteworthy because other parts of international economic law are founded on a much longer tradition and experience: The origins of international rules on trade in goods can be traced back to the middle of the nineteenth century[37] while the foundations of investment protection are laid down in the friendship, commerce and navigation agreements of the late eighteenth and early nineteenth century.[38]

The shadow of the GATT is ubiquitous in the GATS and other agreements on trade in services. It is most visible in the non-discrimination provisions. Most-favoured-nation (MFN) treatment and national treatment are the corner-stones[39] of trade liberalisation and they can hence be found in virtually every agreement on trade in services. Yet, there is a significant deviation: While MFN and national treatment provisions in the goods context only apply to products (goods), services agreements do not restrict the application of MFN and national treatment to services. Some non-discrimination clauses, such as Art. II and XVII GATS and provisions of other agreements modelled on the basis of the GATS apply to services and service suppliers, encompassing hence products and producers. Other provisions such as Art. 1202 and 1203 NAFTA and comparable treaty obligations only apply to service suppliers. They are hence limited to the producers. As most services regulation apply at least indirectly also to the service supplier, the practical difference between the two types of non-discrimination clauses may be limited. However, it should be noted that the NAFTA-type provisions do not raise the difficult problem of the relationship between non-discrimination of services and of service suppliers which cause considerable problems in the GATS context.[40] Three different views of this relationship are offered in the literature: According to the first, a measure violates Art. XVII GATS[41] if it treats foreign services less favourable than like domestic services or if it treats foreign service suppliers less favourable than like domestic suppliers (alternative test). A second view holds that

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[37]Winham, The Evolution of the World Trading System, in: Mattoo/Stern/Zanini (eds.), *A Handbook of International Trade in Services*, 2008, p. 5 (10).

[38]Dolzer/Schreuer, *Principles of International Investment Law*, 2008, p. 17.

[39]Matoo, National Treatment in the GATS, Corner-Stone or Pandora's Box? JWT 31 (1997) 1, pp. 107–135.

[40]Cossy, Determining "Likeness" Under GATS: Squaring the Circle? WTO Staff Working Paper ERSD-2006-08, http://www.wto.org/english/res_e/reser_e/ersd200608_e.pdf, pp. 10–11; Nicolaïdis/Trachtman, From Policed Regulation to Managed Recognition in GATS, in: Sauvé/Stern (eds.), *GATS 2000, New Directions in Services Trade Liberalization*, 2000, p. 241 (253–254). See also Krajewski/Engelke, Art. XVII GATS, paras 35 et seq., in: Wolfrum/Stoll/Feinäugle (eds.), *WTO – Trade in Services*, 2008.

[41]The same views can be applied to Art. II GATS (MFN).

there is a violation of Art. XVII if the measure treats foreign services less favourable than domestic services and, in addition, foreign service suppliers less favourable than like domestic suppliers (cumulative test). A third view claims that depending on the application of the measure to either services or service suppliers it should be tested if the measure treats services or service suppliers less favourable (disjunctive test). Applying an alternative test might yield a greater liberalising effect, but could lead to unwanted results, because a measure, which differentiates between different types of service suppliers for valid regulatory reasons could be eradicated if it leads to a differentiation in the treatment of like services. For example, a regulation requiring a bank to maintain higher capital reserves than an insurance company before granting a loan treats the service suppliers (which can be seen as unlike) differently.[42] However, since the measure also affects the supply of the services (which can be seen as like), it could be argued that the measure discriminates between like services and therefore violates national treatment. In order to exclude such a possibility the cumulative or the disjunctive test should be used for the application of Art. XVII GATS and other provisions covering services and service suppliers.

In lieu of the reduction of tariffs, agreements on trade in services provide for the reduction or elimination of quantitative restrictions on the number of service suppliers or services output. Here again, GATS- and NAFTA-models differ: While NAFTA's obligation to reduce quantitative restrictions is limited to the number of service suppliers or of services operations (Art. 1207, 1213(2) NAFTA), the market access provision of Art. XVI:2 GATS applies to a wide range of quantitative and qualitative restrictions including limitations on the number of service suppliers, the total value of service transactions or assets, the total number of service operations and the total number of natural persons that may be employed in a particular service sector as well as measures which restrict or require specific types of legal entity or joint venture and limitations on the participation of foreign capital. Despite this difference, the key aspects of the two types of provisions are very similar. Both types of market access obligations aim at the reduction of general restrictions on economic activities. This becomes apparent if one considers the measures both GATS and NAFTA mention as examples for a restriction on trade in services: Quotas, monopolies and economic needs tests. These instruments – if applied on a non-discriminatory basis – are typically not instruments which are aimed at the regulation of international trade, but at the regulation of domestic economic activities. This distinguishes them from the traditional tariffs and quantitative restrictions under GATT which are specifically targeted at the regulation of international transactions.

On a general level, international trade agreements covering services can also be distinguished according to their approach towards the application of the core

[42]Example taken from Nicolaïdis/Trachtman, From Policed Regulation to Managed Recognition in GATS, in: Sauvé/Stern (eds.), GATS *2000, New Directions in Services Trade Liberalization*, 2000, p. 241 (253–254).

principles of trade liberalisation.[43] The liberalisation commitments of NAFTA and a number of regional agreements following the NAFTA model are built on a negative-list approach.[44] Pursuant to such an approach the core obligations of market access and national treatment apply generally, but the parties to the agreement may exempt certain sectors or measures from these obligations by including them on a "negative list". Unlike NAFTA, the GATS and some other regional agreements are usually described as following a positive-list approach. According to this model, market access and national treatment only apply to sectors, which are positively included in a list.

The distinction between positive and negative-list agreements is a relatively crude one. In fact, many agreements are better described as following hybrid approaches which include elements of positive and negative lists. For example, at least four layers of GATS obligations can be distinguished on the basis of the level of their flexibility: On the first layer, there are some general obligations which apply without any restriction such as Art. III:1 or VI:2 GATS. These provisions neither use a positive nor a negative list. On a second layer, Art. II GATS is subject to country-specific exemptions. It therefore follows a negative-list approach. Third, there are provisions which apply only to sectors with specific commitments such as Art. III:3, VI:1 or VI:3 GATS. These provisions follow a pure positive-list approach as Members submit specific sectors to the obligations of these provisions. Finally, there are the specific commitments according to Art. XVI, XVII and XVIII GATS. These provisions only apply to sectors with specific commitments (positive-list approach), but Members can schedule limitations and exemptions from these commitments. This possibility therefore contains an element of negative-listing.

Explaining an Apparent Paradox: The State of Services Negotiations in the WTO

When the WTO agreements entered into force, the GATS was celebrated as a major success and one of the great achievements of the Uruguay Round. It was praised for its flexibility which allowed WTO Members to schedule services commitments based on their national policy objectives. The fact that the overall level of commitments at the end of the Uruguay Round remained relatively low is often explained by pointing to the novelty and technical complexity of services trade liberalisation and the fact that the negotiators had to concentrate on creating the rules and the framework of the agreement. Against this background, one could have expected

[43] Roy/Marchetti/Lim, Services Liberalization in the New Generation of Preferential Trade Agreements (PTAs): How Much Further than the GATS? WTO Staff Working Paper ERSD-2006-07, 2006, p. 8, available at http://www.wto.org/english/res_e/reser_e/ersd200607_e.pdf (last visited 18 February 2009).

[44] Stephenson, Regional versus multilateral liberalisation of services, WTR 1 (2002), p. 187 (193–194).

that Members would embrace the structure and flexibility of the GATS in a new round of trade negotiations.[45] However, the overall level of offers of further liberalisation commitments is relatively low "foreshadowing no new liberalization" in services at the end of the current round.[46] Furthermore, negotiations on the issues of the built-in agenda on domestic regulation disciplines, subsidies, emergency safeguard measures and government procurement have not produced any results despite the fact that they have been ongoing since more than a decade.[47]

Negotiations on Specific Commitments

As stipulated in Art. XIX:1 GATS, WTO Members began negotiations on further liberalisation commitments in 2000.[48] These negotiations were integrated into the overall framework of the Doha Development Agenda (DDA). After agreeing on negotiating guidelines in 2001, a number of Members exchanged a first set of initial requests and offers in 2002 and 2003. Due to the failure of the Cancún Ministerial Conference in 2003 the negotiations did not progress for almost a year. Members undertook a fresh approach in July 2004 and engaged in another round of exchanging offers and requests. By December 2005, the total number of initial offers had reached 69 complemented by 30 revised offers. Based on the approach envisaged by Annex C of the Hong Kong Ministerial Declaration[49] Members also engaged in negotiations on a plurilateral basis, but this has not changed the numbers and the scope of the offers much.[50] As shown by a recent WTO Staff Working Paper the overall level of offers is relatively small.[51] In fact, WTO Members seem even unwilling to bind themselves in the WTO at the level of their autonomous liberalisation. Why is this the case?

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[45] Adlung/Roy, Turning Hills into Mountains? Current Commitments Under the General Agreement on Trade in Services and Prospects for Change, JWT 39 (2005) 6, p. 1161 (1187).

[46] Jara/Domínguez, Liberalization of Trade in Services and Trade Negotiations, JWT 40 (2006) 1, p. 113.

[47] Adlung, Negotiations on Safeguards and Subsidies in Services: A Never-Ending Story? JIEL 10 (2007), p. 235 (236).

[48] For an overview of these negotiations see Leal-Arcas, Services as Key for the Conclusion of the Doha Round, LIEI 35 (2008), p. 301 (305 et seq.).

[49] Sixth Ministerial Conference, Doha Work Programme, Ministerial Declaration Adopted on 18 December 2005, Annex C, WT/MIN(05)/DEC.

[50] The total number of initial offers is 71 and of revised offers is 31, see "State of the Play", available at http://www.wto.org/english/tratop_e/serv_e/state_of_play_e.htm (last visited 16 March 2009).

[51] Adlung, Services Liberalization from a WTO/GATS perspective: In Search of Volunteers, WTO Staff Working Paper ERSD-2009-05, 2009, pp. 11–13, available at http://www.wto.org/english/res_e/reser_e/ersd200905_e.pdf (last visited on 12 March 2009).

A number of reasons have been suggested: The first argument is the "hostage" argument. It claims that Members are holding back with further offers because the services negotiations are taken hostage of the stalemate of other negotiations in the DDA, in particular regarding agriculture and non-agricultural market access (NAMA).[52] A variation of that argument is that WTO Members are waiting for the final phase of the negotiations in which they will bring everything on the table. While these assumptions may explain why the negotiations have not moved forward, they do not necessarily explain why countries have not made more far-reaching offers as a starting point for negotiations.

Another reason which is sometimes given, is the lack of progress regarding a number of rule-making and technical issues. On a fundamental level, there is uncertainty regarding the exact scope and contours of central provisions of the GATS such as Art. II, XVI and XVII and their relationship with each other.[53] It certainly did not increase the negotiating eagerness of trade diplomats in Geneva when the Appellate Body took a strict interpretation of the GATS schedules in *US – Gambling and Betting* demonstrating to WTO Members that they may have to pay a price for careless commitments.[54] Furthermore, the outcome of the rule-making negotiations discussed below may have an impact on the commitments.[55] For example, countries may be reluctant to make more substantial offers as long as they do not know which rules (if any) will be agreed upon for emergency safeguard measures. Developing countries in particular have often argued in the current negotiations that making further commitments depends on the existence of emergency safeguard measures.[56] Similarly, it has been pointed out that the commercial value of future commitments may depend on the existence of disciplines on domestic regulation or subsidies. Technical questions may also be a stumbling stone: For example, a continuing subject of debate is the distinction between different modes. Unless there is agreement on the exact delineation of the different modes of supply, WTO Members may find it difficult to evaluate the scope of offers and requests. Another problematic area are classification questions. During the Uruguay Round, GATT Members negotiated their commitments using a sectoral classification developed by the GATT Secretariat on the basis of the 1991

[52] Mattoo, Services in a Development Round: Three Goals and Three Proposals, JWT 39 (2005) 6, p. 1223 (1223).

[53] Adlung, Services Negotiations in the Doha Round: Lost in Flexibility? JIEL 9 (2006), p. 865 (877 et seq.).

[54] *US – Measures Affecting the Cross-Border Supply of Gambling and Betting Services*, Report of the Appellate Body, WT/DS258/AB/R. For a discussion of the impact of this decision on the GATS negotiations see Krajewski, Playing by the Rules of the Game? – Specific Commitments after *US – Gambling and Betting* and the Current GATS Negotiations, Legal Issues of Economic Integration 32 (2005), p. 417 (437).

[55] Jara/Domínguez, Liberalization of Trade in Services and Trade Negotiations, JWT 40 (2006) 1, p. 113 (117).

[56] Adlung, Negotiations on Safeguards and Subsidies in Services: A Never-Ending Story? JIEL 10 (2007), p. 235 (236).

United Nations Central Product Classification (CPC).[57] This classification was developed for statistical purposes and did not reflect the economic reality in many instances. Furthermore, technological changes and other innovations have rendered parts of this list, in particular in telecommunications, financial and audio-visual services, outdated in the view of many WTO Members.[58] Hence, there have been calls for the reclassification of sectors at the beginning of the negotiations, but no agreement has been reached yet.[59]

A third argument would point to the impact of existing GATS commitments and offers in the current round to regional and bilateral negotiations. As mentioned above, WTO Members have concluded a number of regional integration agreements covering trade in services. Most – if not all of these agreements – contain commitments which go beyond the level of GATS commitments.[60] In fact, often they may have to go beyond this level in order to meet the requirements of Article V:1 lit. b) GATS which calls for the elimination of substantially all discrimination.[61] Moreover, the existing revised offers in the current GATS negotiations have often been used as a threshold for bilateral and regional negotiations. In fact, WTO Members will usually have to offer their partners in bilateral and regional agreements a higher level of commitments than the one they are prepared to make on an MFN basis to all WTO Members. In this context, multilateral offers may simply become too costly for WTO Members engaged in negotiating bilateral and regional agreements.

Fourthly, and probably most importantly from a practical perspective, it must be noted that the services markets in many countries of the world are already relatively open. This is partly due to the above-mentioned instances of liberalisation in bilateral and regional contexts. However, services liberalisation is also often a policy which countries pursue autonomously. While this would not explain why these Members are reluctant to offer their current level of openness as commitments

[57]GATT, Services Sectoral Classification List, Note by the Secretariat, MTN.GNS/W/120, 10 July 1991. The list is reproduced in the 2001 Scheduling Guidelines as Attachment 8, see Council for Trade in Services, Guidelines for the Scheduling of Specific Commitments under the General Agreement on Trade in Services, S/L/92, 28 March 2001.

[58]See, e.g. Peng, Trade in Telecommunications Services: Doha and Beyond, JWT 41 (2007) 2, p. 293 (297 et seq.), who points out that “value-added facsimile services” or “Telex and telegraph services” are not much used today anymore, whereas “mobile services” have been developed into a large array of different activities not foreseen in the early 1990s.

[59]On audiovisual services see Communication from the United States, Audiovisual and Related Services, S/CSS/W/21, 18 December 2000. On telecommunication classifications see Communication from the European Communities, Classification in the Telecom Sector under the WTO-GATS Framework, S/CSC/W/44, 10 February 2005 and Communication from the United States, Classification in the Telecommunications Sector under the WTO-GATS Framework, S/CSC/W/45, 22 February 2005.

[60]Hufbauer/Stephenson, Services Trade: Past liberalization and future challenges, JIEL 10 (2007), p. 605 (619).

[61]Cottier/Molinuevo, Art. V GATS, paras 23 et seq., in: Wolfrum/Stoll/Feinäugle (eds.), *WTO – Trade in Services*, 2008.

in the GATS negotiations,[62] it can explain why there is no real industry pressure and lobbying for future liberalisation commitments. In fact, while there is relatively little demand for liberalisation from industry, many governments are under domestic pressure from trade unions and non-governmental organisations not to make any further liberalisation commitments in sectors considered as public services such as health, education, social or water distribution.

Based on these considerations, it is very likely that – in case the Doha round will come to a successful conclusion – the overall level of services commitments may remain limited. In fact, in light of the current state of the overall Doha negotiations, WTO Members may be already content with the fact that there have been some additional commitments at all. Such an outcome may not be the worst scenario for the future of the GATS and the WTO. It is submitted that there are still a number of outstanding legal and technical problems of the GATS which need to be resolved. Furthermore, the fundamental balance between trade liberalisation and regulation is not achieved at the transnational level. In this respect, it may be wise to remain cautious regarding further commitments and return to the open issues of the GATS framework immediately after the conclusion of the current negotiations on further commitments.

Negotiations on Built-in Issues

The outcome of the second set of services negotiations in the WTO, the so-called built-in agenda has also been very moderate until today. The built-in agenda, otherwise referred to as the "unfinished business" of GATS,[63] consists of four separate negotiating contexts, each based on a mandate in the GATS itself: Art. VI:4 GATS on disciplines on domestic regulation, Art. X:1 GATS on emergency safeguard measures, Art. XIII:2 GATS on government procurement, and Art. XV:1 GATS on subsidies.

Art. VI:4 GATS entitles the Council for Trade in Services to establish – through subsidiary bodies – disciplines on domestic regulation.[64] From 1995 to 1998 the negotiations under Art. VI:4 GATS took place in the Working Party on Professional Services (WPPS), which drafted a set of such disciplines for the accountancy

[62] Adlung, Services Liberalization from a WTO/GATS perspective: In Search of Volunteers, WTO Staff Working Paper ERSD-2009-05, 2009, p. 4, available at http://www.wto.org/english/res_e/reser_e/ersd200905_e.pdf (last visited on 12 March 2009).

[63] Sauvé/Stern, New Directions in Services Trade Liberalisation: An Overview, in: Sauvé/Stern (eds.), *GATS 2000 – New directions in services trade liberalisation*, 2000, p. 9.

[64] For a comprehensive treatment of this mandate and the negotiations see Wouters/Coppens, GATS and Domestic Regulation: Balancing the Right to Regulate and Trade Liberalization, in: Alexander/Andenas (eds.), *The World Trade Organisation and Trade in Services*, 2008, p. 207 (216 et seq.).

sector.[65] In 1999, the WPPS was replaced with the Working Party on Domestic Regulation (WPDR), which received a broader mandate and aimed at disciplines for all sectors. In the first years of the existence of the WPDR, the negotiations remained relatively general and broad. Since 2004, there has been considerable momentum in the negotiations with an increased pace in 2007 and 2008. The current state of the negotiations is reflected in a Draft of the Chairman of the WPDR of January 2008.[66] Even though the contents of this draft do not represent a consensus of the WPDR, it is very likely that the final version will not deviate substantially from this version.[67] It therefore seems possible that the Members of the WPDR will produce an agreed text at the end of the services negotiations. However, it should be pointed out that reaching a common ground was only possible because some contentious issues such as a general necessity test for all measures of domestic regulation was dropped from the draft.

The other pending negotiations take place in the Working Group on GATS Rules (WPGR).[68]

Elements discussed in the negotiations on emergency safeguard measures include the justification of safeguards, applicable measures, duration, compensation and surveillance. Some Members also questioned the desirability and feasibility of rules on safeguards in the context of trade in services. Aspects of the negotiations on government procurement in the WPGR concern the application of the most-favoured-nation principle, the relationship of rules under Article XIII GATS to the plurilateral Agreement on Government Procurement (GPA), and the possibility of distinguishing between procurement of goods and services. Regarding subsidies Members of the WPGR have mostly been exchanging information on subsidies and discussing a working definition of subsidies. In all three areas, the negotiations have not produced any substantive outcome and are still at a preliminary stage despite many years of negotiations.[69] WTO Members differ substantially on a number of

[65]Council for Trade in Services, Disciplines on Domestic Regulation in the Accountancy Sector, S/L/64, 14 December 1998.

[66]Working Party on Domestic Regulation, Revised Draft Disciplines on Domestic Regulation Pursuant to GATS Article VI:4, Informal Note by the Chairman, 23 January 2008. The draft is not publicly available from the WTO, because it is a Room Document. However, the text can be obtained from other sources, e.g. the website of the Permanent Mission of Pakistan to the WTO at http://www.wto-pakistan.org/documents/services/chair_jan_2008.doc (last visited on 16 March 2009).

[67]For an analysis of the key aspects of an earlier – very similar version – of the draft see Krajewski, Art. VI GATS, paras 42 et seq., in: Wolfrum/Stoll/Feinäugle (eds.), *WTO – Trade in Services*, 2008.

[68]For an earlier account of these negotiations see Sauvé, Completing the GATS Framework: Addressing Uruguay Round Leftovers, Aussenwirtschaft (Swiss Review of International Economic Relations) 57 (2002), pp. 301–341 and more recently Adlung, Negotiations on Safeguards and Subsidies in Services: A Never-Ending Story? JIEL 10 (2007), p. 235 (238 et seq.).

[69]For the most recent summary of the negotiations see Working Party on GATS Rules, Annual Report of the Working Party on GATS Rules to the Council for Trade in Service (2008), S/WPGR/18, 5 December 2008.

fundamental issues concerning these negotiations, which is why there has been so little progress.

What Have We (Not Yet) Learned?[70] The Case Law on Trade in Services

In an analysis of the achievements of the GATS *Gary Hufbauer* and *Sherry Stephenson* acknowledge the limited impact of the GATS in actually opening markets, but argue that one of the achievements of the GATS is its contribution to the successful resolution of trade disputes over services.[71] However, it should be noted that services disputes have been very rare at the WTO so far. In fact, of the 116 panel and Appellate Body reports adopted between 1995 and 2008 only five concerned GATS claims and only two were "GATS-only" cases.[72] Cases involving services are also not very frequent with regards to other international agreements on services. For example, in NAFTA the *Trucking services* case[73] was the only case concerning services.

Despite the limited number of cases, the GATS case law addressed a number of key issues such as scope of the agreement, scheduling of specific commitments, market access, likeness under national treatment and most favoured nation treatment, and general exceptions. There is no need to repeat the details here. However, it is worth stressing that the lessons learned from this case law are ambivalent: Some elements of the panel and Appellate Body reports provide useful guidance regarding key elements of the GATS though not all clarifications were welcomed by everyone. Other elements of the case law created confusion and have not added to legal clarity. The overall contribution of the reports to legal certainty and clarity of the GATS is therefore mixed. In this respect, there are some lessons which we have not learned yet.

[70] Leroux, Eleven years of GATS case law: What have we learned? JIEL 10 (2007), pp. 749–793.

[71] Hufbauer/Stephenson, Services Trade: Past liberalization and future challenges, JIEL 10 (2007), p. 605 (614 et seq.)

[72] The following cases contained GATS issues: *Canada – Certain Measures Concerning Periodicals (Canada – Periodicals)*, WT/DS31/AB/R, Report of the Appellate Body adopted on 30 July 1997; *European Communities – Regime of the Importation, Sale and Distribution of Bananas (EC – Bananas),* WT/DS27/AB/R, Report of the Appellate Body adopted on 25 September 1997; *Canada – Certain Measures Affecting the Automotive Industry (Canada – Automotive Industry),* WT/DS139 and WT/DS142, Report by the Appellate Body adopted on 19 June 2000; *Mexico – Measures Affecting Telecommunications Services (Mexico – Telecommunications [Telmex]),* WT/DS204/R, Report of the Panel adopted on 1 June 2004; and *United States – Measures Affecting the Cross-Border Supply of Gambling and Betting Services (US – Gambling and Betting)*, WT/DS258/AB/R, Report of the Appellate Body adopted on 20 April 2005.

[73] *In the Matter of Cross-Border Trucking Services (Mexico v. United States)*, USA-MEX-98-2008-01, Final Report of the Panel, 6 February 2001.

Generating Legal Clarity

Among the elements where the case law has added legal clarity are the scope of the GATS, the interpretation of the schedules and the general exceptions. With regard to the scope of the GATS, the Appellate Body held in *EC – Bananas* that the use of the term "affecting" in Art. I:1 GATS "reflects the intent of the drafters to give a broad reach to the GATS".[74] Because of its broad scope, the GATS can overlap with the GATT. In *EC – Bananas* and in *Canada – Periodicals* the Appellate Body ruled that a government measure can be subject to GATS and GATT disciplines, if the measure affects trade in services and trade in goods.[75]

Specific commitments of the WTO Members are considered integral parts of the GATS and will therefore be interpreted on the basis of the 1969 Vienna Convention on the Law of Treaties (VCLT). In particular, the Appellate Body recalled in *US – Gambling and Betting* that schedules represent a "common agreement among *all* Members".[76] This is not unproblematic, because it does not reflect the factual drafting of the schedules which are typically written unilaterally with language that may be derived from one particular national legal background. In *US – Gambling and Betting*, the Appellate Body also held that the interpretation of the schedules has to take the Scheduling Guidelines of 1993 and in particular the services sectoral classification list (W/120 list) into account and treat them as additional means of treaty interpretation on the basis of Art. 32 VCLT.[77] Consequently, WTO Members wishing to deviate from the W/120 list and the underlying CPC classifications must make this explicit. Otherwise, there is a general presumption that the structure and language of a schedule follows the W/120 and CPC nomenclature. Regarding possible limitations of market access commitments, the *Telmex* panel held that Members can only schedule measures explicitly mentioned in Art. XVI:2 GATS or limitations and conditions specified in Art. XX:1(d) and (e) GATS.[78] Hence, a WTO Member cannot restrict its commitments "until the corresponding regulations are issued"[79] without any indication of the anticipated time-frame.

Art. XIV GATS, the provision on general exceptions, was applied in *US – Gambling and Betting*. Both the panel and the Appellate Body interpreted this provision in a similar way as Art. XX GATT applying a "two-tier approach" to Art. XIV GATS.[80] First, the measures have to be tested against the requirements of one

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[74] *EC – Bananas,* Report of the Appellate Body, para. 220.

[75] *Canada – Periodicals*, Report of the Appellate Body, Section IV and *EC – Bananas,* Report of the Appellate Body, paras 220–222.

[76] *US – Gambling and Betting*, Report of the Appellate Body, para. 159.

[77] *US – Gambling and Betting*, Report of the Appellate Body, para. 196.

[78] *Mexico – Telecommunications (Telmex),* Report of the Panel, paras 7.354 et seq.

[79] This was one of the limitations in Mexico's scheduling regarding market access, see *Mexico – Telecommunications (Telmex),* Report of the Panel, paras 7.353.

[80] *US – Gambling and Betting*, Panel Report, paras 6.448 et seq.

of the subparagraphs of Art. XIV GATS. Second, the application of these measures needs to fulfil the conditions of the introductory clause ("chapeau"). The Appellate Body also interpreted the term "necessary" in Art. XIV(a) GATS in line with its case law under Art. XX GATT. It can therefore be concluded that the other parts of Art. XIV GATS will be interpreted in the same way as the corresponding parts of Art. XX GATT.

Creating Confusion and Insecurity

The GATS case law has been less clear and created confusion regarding key terms of the provisions on market access, national treatment and most favoured nation treatment. A first problematique concerns the meaning of various words and phrases in Art. XVI:2 GATS. In *US – Gambling and Betting* the panel was of the opinion that the list of measures mentioned in Art. XVI:2 GATS is exhaustive.[81] This finding was not appealed and the Appellate Body indicated that it would share this view.[82] Regarding the wording of Art. XVI:2(a) GATS the Appellate Body held that the words "in the form of" in Article XVI:2(a) should not be replaced by the words "that have the effect of".[83] However, panel and Appellate Body also stated that a "measure that is not expressed in the form of a numerical quota or economic needs test may still fall within the scope of Article XVI:2(a)".[84] This concerned in particular so-called "zero quotas", which the Appellate Body determined to be "numerical in nature" and which covered the total ban of an activity.[85] This reasoning is particularly confusing and has raised a lot of criticism in the literature as it impedes on national regulatory autonomy.[86] Commentators have argued that the Appellate Body was mistaken by construing a measure of qualitative regulation as a quantitative limitation and that the interpretation did not take the context and object and purpose of Art. XVI into account. Others have, however, defended the approach taken by the Appellate Body.[87]

[81] *US – Gambling and Betting,* Panel Report, para. 6.318.

[82] *US – Gambling and Betting*, Report of the Appellate Body, para. 215.

[83] *US – Gambling and Betting*, Report of the Appellate Body, para. 232.

[84] *US – Gambling and Betting*, Panel Report, para. 6.332.

[85] *US – Gambling and Betting*, Report of the Appellate Body, paras 239 and 252.

[86] Pauwelyn, Rien ne Va Plus? Distinguishing Domestic Regulation from Market Access in GATT and GATS, WTRev 4 (2005), p. 131 (161 et seq.); Krajewski, Playing by the Rules of the Game? – Specific Commitments after *US – Gambling and Betting* and the Current GATS Negotiations, Legal Issues of Economic Integration 32 (2005), p. 417 (437); Ortino, Treaty Interpretation and the WTO Appellate Body Report in US – Gambling: A Critique, JIEL 9 (2006), p. 117 (132 et seq.).

[87] Delimatsis, Don't Gamble with GATS – The Interaction between Articles VI, XVI, XVII and XVIII GATS in the Light of the *US – Gambling* Case, JWT 40 (2006) 6, p. 1059 (1069 et seq.).

The contentious issue of likeness in Art. II GATS (Most favoured nation treatment) and Art. XVII (national treatment) GATS has also concerned the WTO dispute settlement system. While there is general agreement that both provisions aim at maintaining the competitive relationship and that likeness must be interpreted in this light, some statements in the reports of the *Bananas* and *Automotive Industry* panels are less clear. For example, the *EC – Bananas* panel held: "[I]n our view, to the extent that entities provide like services, they are like service suppliers".[88] This broad statement has been criticised in the literature. *Werner Zdouc* pointed out that one effect of the Panel's finding would be that any natural or legal person who actually or potentially engages in supplying like services may claim the benefits of non-discrimination.[89] Another potentially broad statement was made by the panel in *Canada – Automotive Industry* claiming that "Services supplied through mode 3 and 4 and services supplied through mode 1 and 2 are like".[90] However, there is usually no full competitive relationship between services supplied through different modes of supply, because services supplied through different modes of supply may have different end-users.[91]

As the panel in *US – Gambling and Betting* decided to apply judicial economy and did not assess the Art. XVII claims of Antigua, the Appellate Body had no opportunity to interpret this provision. A number of key elements of the non-discrimination clauses of the GATS remain therefore unclear.

What Lessons Can We Expect in the Near Future?

The preceding analysis shows that there are still a number of GATS issues unresolved by the WTO dispute settlement system. In addition to these, another problem became apparent in the context of the implementation of the *Gambling* report. Since the United States did not comply with the report, Antigua requested and was granted authorization to suspend the application of concessions to the USA under Art. 22:6 DSU. The Arbitrator determined that the annual level of nullification or impairments of benefits accruing to Antigua amounts to US$ 21 million. In light of the specific trade pattern in services, the Arbitrator granted Antigua the right to suspend obligations under the TRIPS Agreement as a form of cross-retaliation.[92] However, in May 2007, the USA initiated proceedings to modify its schedule of

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[88] *EC – Bananas*, Report of the Panel, para. 7.322.

[89] Zdouc, WTO Dispute Settlement Practice Relation to the GATS, JIEL 2 (1999), p. 332.

[90] *Canada – Automotive Industry*, Panel report, para. 10.307. For a support of this argument see Matoo, National Treatment in the GATS, Corner-Stone or Pandora's Box? JWT 31 (1997) 1, p. 107 (121).

[91] Krajewski, *National regulation and trade liberalization in services*, 2003, pp. 102–103.

[92] *US – Gambling and Betting Services*, Recourse to Arbitration by the United States under Article 22.6 of the DSU, Decision by the Arbitrator, WT/DS285/ARB.

specific commitments pursuant to the rules laid down in Art. XXI GATS.[93] As stipulated in this provision and the procedural rules on the modification of commitments, the USA negotiated and concluded compensatory agreements with the EC, Canada, India, Japan, and other interested WTO Members.[94] Not surprisingly, the USA and Antigua could not agree on such an agreement. The matter was therefore submitted to an arbitrator under Art. XXI:3 GATS, which has to determine the level and scope of compensatory adjustments. This unprecedented parallel application of suspending concessions under Art. 22:6 DSU to trigger compliance with the DSB recommendations and of the procedures to modify the schedule of specific commitments under Art. XXI GATS which would withdraw the very basis of the DSB recommendations raises technical and fundamental questions. For example, is the arbitrator under Art. XXI:3 GATS bound by the findings of the arbitrator under Art. 22:6 DSU regarding the value of the proposed modification of the schedule? Furthermore, since there is no possibility for compensatory adjustments in another agreement but the GATS under Art. XXI:3 GATS, this proceeding may render the right of Antigua to cross-retaliate useless.[95] The parallel application of proceedings pursuant to Art. 22:6 DSU and Art. XXI GATS reveals a serious lack of coherence in the WTO legal order, which can only be rectified through an amendment of either the GATS or the DSU.

In the pending case *China – Trading Rights and Distribution Services,* the USA and the EC claim that certain measures of China restrict market access for, or discriminate against, foreign suppliers of distribution services for publications and foreign suppliers of audiovisual services (including distribution services) for audiovisual home entertainment products.[96] According to the claimants these measures appear to be inconsistent with China's obligations under Art. XVI and XVII GATS. The Panel report is scheduled to be issued in May 2009.[97] It is hoped that this report adds to the body of case law which contributes to legal clarity and not to the opposite.

Another case which also involves GATS claims against China has been settled by the parties. The EC, the USA and Canada claimed that a number of Chinese measures adversely affected financial information services and foreign financial

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[93] Council for Trade in Services, Notification from the United States Pursuant to Article XXI of the General Agreement on Trade in Services (GATS) – Addendum, S/SECRET/10/Add.1, 21 December 2007.

[94] Grosse Ruse-Khan, A Pirate of the Caribbean? The Attractions of Suspending TRIPS Obligations, JIEL 11 (2008), p. 313 (320).

[95] Grosse Ruse-Khan, A Pirate of the Caribbean? The Attractions of Suspending TRIPS Obligations, JIEL 11 (2008), p. 313 (323).

[96] *China – Measures Affecting Trading Rights and Distribution Services for Certain Publications and Audiovisual Entertainment Products (China – Trading Rights and Distribution Services),* Request for Consultations by the United States, WT/DS363/1.

[97] *China – Trading Rights and Distribution Services*, Communication from the Chairman of the Panel, WT/DS363/8.

services suppliers in China.[98] In particular, the claimants criticised the practice of "Xinhua News Agency", the State news agency in China, as the regulatory authority for foreign news agencies and for foreign financial information providers. Foreign suppliers could only operate in China through an agent designated by Xinhu and Xinhua News Agency only designated one of its branches as an agent. The claimants considered this – *inter alia* – to be a violation of China's GATS obligations. In December 2008, the parties reached a solution of the dispute which involved reassurances of China to guarantee that a new regulating authority would be independent of a financial information service supplier and that foreign service suppliers would be allowed to offer their services without requiring the involvement of any agent or intermediary.[99]

In light of the fact that many recently acceded WTO Members made substantial commitments in trade in services,[100] it is not surprising that two recent GATS cases originated from the schedules of a newly acceded WTO Member. It can be assumed that the two cases mentioned will not be the only ones. How many of those will see the light of a panel proceeding and how many will be settled on mutually agreed terms remains to be seen. If the cases reach the panel stage it is hoped that the panel and Appellate Body report will lead to coherent interpretations of the law which can be accepted by the WTO membership at large.

Conclusion and Outlook

The preceding analysis aimed to demonstrate that it is not sufficient to construe services as "tradables" and apply more or less the same framework to services as to goods. Instead, the manner in which the idea of trading services has evolved in trade agreements over the last two decades raises a large range of structural as well as technical problems. Some of these problems can be resolved through prudent and balanced dispute settlement. However, there have been instances where the panels and the Appellate Body have been struggling with the framework of the GATS and have not always come up with the most convincing answers. Partly, the ambiguity of the dispute settlement practice is a result of the ambiguity of the agreement itself, which again is a result of the novelty of the issues and concepts at the time the GATS was negotiated. Even though the number of dispute settlement cases involving the GATS may grow in the coming years, it would be a mistake to assume that many, let alone all problems discussed above will be resolved through dispute

[98]*China – Measures Affecting Financial Information Services and Foreign Financial Information Suppliers, (China – Financial Information Services),* Request for Consultations, WT/DS372/1, WT/DS373/1 and WT/DS378/1.

[99]See, e.g. *China – Financial Information Services*, Joint Communication from China and the European Communities, WT/DS372/4.

[100]Adlung, Services Liberalization from a WTO/GATS perspective: In Search of Volunteers, WTO Staff Working Paper ERSD-2009-05, 2009, pp. 6–7, available at http://www.wto.org/english/res_e/reser_e/ersd200905_e.pdf (last visited on 12 March 2009).

settlement. As indicated in this contribution, there are a number of issues which need a clarification by the Members themselves.

However, hoping that the Members will find quick answers would be naïve. The services negotiations in the WTO have shown that creating consensus among Members on services issues is very difficult. As suggested above there are a number of reasons why the GATS negotiations are not moving forward. The complexity of the issues is certainly one, but not the only reason for this. Interestingly, many WTO Members succeeded in negotiating and concluding bilateral and regional trade agreements which cover trade in services. Hence, most Members seem to share the view that the liberalisation of trade in services can be usefully achieved through or supported by international trade agreements if they are concluded on a regional and bilateral level. On a more fundamental level, one could even ask whether Members are of the view that a multilateral framework for trade in services is no longer needed or at least that the GATS is already outdated. Observing the slow movement in Geneva this thesis seems to have some merits. However, it should also be pointed out that many regional agreements covering services are based on the model of the GATS. Often, they even copy the framework of the GATS more or less. This shows the continuing dominance of the model of the GATS for the time being.

How to move forward? Apart from the proliferation of regional and bilateral agreements another trend of the regulation of trade in services is the increased use of sectoral approaches. Many trade agreements contain special regimes for telecommunications and financial services, because of the special regulatory requirements of these sectors. It would be worth exploring further possibilities for sector specific approaches. In this regard, the EC-CARIFORM EPA could be an interesting model to study, because it contains regulatory provisions for computer services, courier services, and tourism in addition to telecommunications and financial services. The relevant chapters of the agreement contain for example a basic rule on prohibiting anti-competitive behaviour by dominant enterprises in the tourism sector and a recognition of the possibility to impose universal service obligation in courier services.[101] Following the sectoral route it may also be an option to explore further inter-institutional links between the WTO and the international organisations and institutions with special expertise in specific sectors, such as the International Telecommunication Union (ITU), the Basel Committee on Banking Supervision[102] or – in tourism – the "other" WTO, the World Tourism Organisation

[101]On these provisions see Schloemann/Pitschas, Cutting the Regulatory Edge? Services Regulation Disciplines in the Cariforum EPA, Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ) GmbH, 2008, available at http://www.gtz.de/de/dokumente/en-epa-cutting-the-regulatory-edge-2008.pdf (18 March 2009).

[102]For the use of international standards set by the ITU and the Basle Committee into WTO dispute settlement see Howse, "Importing" Regulatory Standards And Principles Into WTO Dispute Settlement: The Challenge of Interpreting GATS Arrangements On Financial Services and Telecommunications, Paper presented at the International Conference on "Services Liberalisation in the EU and the WTO", Vienna, 5 and 6 March 2009.

(UNWTO). It is likely that many of the conceptual problems discussed in this contribution stem from the attempt to create uniform rules and principles for a large number of diverse and distinct economic activities which may, after all, have less in common than the architects of the GATS and other agreements on trade in services assumed.

Applying European Competition Law to International Organizations: The Case of OPEC

Jörg Philipp Terhechte*

Introduction

Fragmentation of International Economic Law and State Cartels

International economic law seeks to provide rules for international business activities. Nowadays, these activities have to be seen in the light of globalization and the emerging integration of product and service markets all around the world. Questions concerning International economic law are often delicate to handle, given the multiplicity of domestic and international rules that are potentially applicable to concrete cases. The difficulty of identifying appropriate rules and the relation of different legal regimes is, of course, a result of globalization. Complex cases often involve rules of International law (e.g. WTO provisions), rules of regional integration agreements such as NAFTA or MERCOSUR and domestic legislation. These different legal regimes can potentially collide because a guiding meta system is lacking at the moment. Is for example the supranational European competition law applicable to international organizations which might embody a cartel (e.g. to the

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Organization of Petroleum Exporting Countries – OPEC)? Just this question demonstrates the problems one could have if different legal regimes collided.

This problem can be characterized by the term "fragmentation," which means that there is an unconnected coexistence of legislative frameworks with regard to international business activities without creating an overall picture or a standard valuation. Thus, the popular "fragmentation debate"[1] is not only important for the level of International law in general, but for the special field of International economic law as well as the case of OPEC will show.

"Business activities" are usually defined as the commercial conduct of private parties such as corporations or private persons. From a general point of view multinational corporations are the key players of the game called globalization. But which role do the states play in this "game"? Are they just responsible for setting the framework – the "rules of the game" –, or are they engaged in all stages of international economic transactions? It is no secret that the latter is increasingly often the case. For example, states are involved in international economic activities as suppliers and sellers of goods and commodities. Because of this, it is always difficult to distinguish between economic conduct of states (so-called *acta iure gestionis*) and the exercise of sovereign power of states (so-called *acta iure imperii*). Only if states act *iure gestionis* can all rules of economic law be applied in a regular way.[2] If on the other hand states act *iure imperii* numerous special privileges have to be taken into account. Is this the case with OPEC, too?

It is important to mention that International law does not provide clear rules for business activities conducted by states. In this field a multitude of political considerations play a significant and highly complex role. As a result, most activities carried out by states are not subject to International economic law. Even in the case of restrictions of competition caused by states there are no coherent rules.

The Role of European Competition Law

An analysis of European law reveals a totally different and inverse situation: European Competition Law (Article 81 ECT) periodically makes the headlines and occasionally leads to transatlantic discussions between the EU and the United States with regard to record-breaking million-dollar fines which are now regularly imposed on multinational corporations[3] for collusive practices, and to the prohibition of

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[1]See, for example, Report of the Study Group of the International Law Commission of April 13, 2006 "Fragmentation of International Law: Difficulties Arising From the Diversification and Expansion of International Law," A/CN.4/L.682; Koskenniemi/Leino, Fragmentation of International Law? Post-Modern Anxieties, LJIL 15 (2002), p. 553.

[2]Fox, *The Law of State Immunity*, 2004, pp. 272 et seq.

[3]Imagine the € 855.23 Mio. fine, imposed by the Commission against the so-called Vitamin Cartel in 2001, Case COMP/37.512, OJ 2003, L 6/1, or the € 313.69 Mio. fine imposed on ten companies for a carbonless paper cartel, Case COMP/36.212, OJ 2004, L 115/1.

so-called mega-mergers such as the one between General Electric and Honeywell.[4] In particular, the GE/Honeywell case ignited heated debates as the EU Commission blocked the merger of the US companies, even though the U. S. Department of Justice had already approved the merger.[5] In spite of several disagreements European competition law has proven useful, especially in controlling private undertakings and combinations of undertakings.

The situation stands in fundamental contrast to the control of governmental or state conduct. In applying European competition law to the conduct of the EU member states, two important issues have to be taken into consideration: the sovereign jurisdiction of the member states – as the basic distribution of competencies between the EU and its member states – and the duty of the EU to protect a fair and undistorted competition in the common market (see Article 3 lit. g ECT). To assess whether European competition law is applicable to governmental conduct, the European Court of Justice (ECJ) has developed rather complex criteria. The crucial issue here is to be seen in the distinction between commercial conduct of the states on one hand and sovereign acts of states on the other. Thus, the situation under EU law is no different from the situation under International law at a first blush.

An even higher level of complexity has to be envisaged concerning the application of European competition law to countries that are not members of the European Union, or international organizations founded by such states; among these cases is the potential application of Article 81 ECT to OPEC.

This raises an interesting issue: why shouldn't it be possible to subject OPEC, which effectively operates as a cartel, to EU competition law? If European competition law may be used to combat multinational cartels and mergers, it might also be applied to the activities of international inter-governmental cartels. In other words: can international governmental cartels be controlled and sanctioned by supranational law?

These questions lead to several fundamental issues in the fields of International law, European law and national economic law that have yet to be resolved.[6]

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[4]Commission Decision Case COMP IV – M 2220, OJ 2004, L 48/1.

[5]For further details see Dabbah, *The Internationalisation of Antitrust Policy*, 2003, pp. 115 and 179 et seq.

[6]Up to now, the European Commission has not published a statement in terms of the relationship between European Competition Law and OPEC. M. Monti, former European Commissioner for Competition, explained once in a newspaper interview, that EU Law was — in his opinion — not applicable to OPEC because OPEC consisted of governments, not of undertakings and it was not possible for governments to act as a cartel. See http://www.netzeitung.de/wirtschaft/wirtschafspolitik/308286.html. In the court rulings of the ECJ, the application of European Competition Law to OPEC was once taken into consideration, yet played only a minor role in the aforesaid case. In its findings in the *Montecatini* case, the ECJ pointed out that the existence of distortion of competition on the polypropylene market, which was inter alia a consequence of high oil prices, which in turn are caused by OPEC, do not enable polypropylene-producing undertakings to participate in an agreement restricting competition. However, the ruling leaves unanswered whether or not a restriction of competition is caused by OPEC: "Thirdly, in as much as Monti's criticism is intended to show that, as a result of circumstances beyond the control of the undertakings involved, the agreements and concerted practices which presented the subject of the Polypropylene Decision could not have had an anti-competitive object, it must be pointed out that, even if well-founded, Monti's claims are

Is European competition law applicable to OPEC, its member states or their state-owned enterprises? Can OPEC or its member states avail themselves of established doctrines of international law such as the doctrine of state immunity or the comity doctrine, and thereby avoid an application of EU competition law? Assuming OPEC can be brought under EC law, which authorities should be responsible for enforcement – the EC Commission or the competition authorities of its member states? Additionally, can a private action be brought in order to recover damages? The following remarks suggest some first answers to these questions.

OPEC as an International Organization

General Remarks

OPEC is an international organization which acts as a representative body of several oil-exporting countries, with the primary purpose of coordinating oil production among its members.[7] It was established by Iran, Iraq, Kuwait, Saudi Arabia and Venezuela at a conference in Baghdad on September 14, 1960. Today it has 11 members.[8] All members of OPEC share an important characteristic: oil export is a dominant factor of their foreign trade balance (e.g., Saudi Arabia, approximately 87%; Libya, approximately 90%; Nigeria, approximately 94%). The founding statute of OPEC (the "OPEC Statute") shapes the legal framework for the coordination of national oil policies. The original text of the statute was accepted by OPEC members at the Caracas conference in January 1961.[9]

OPEC claims a special status in the context of International law. First, the volitional exclusiveness must be emphasized. According to Article 7 B. of the OPEC Statute, full members are the founding members, as well as those countries whose application for membership has been accepted since OPEC's founding. Only countries that have a substantial net export of crude oil are entitled to full membership (Article 7 C. OPEC Statute), with the result that memberships of western or

not likely to prove that the economic context excluded any possibility of effective competition," see Court of Justice Case C-235/92 P. *Montecatini SpA,* [1999], para. 127.

[7]Cp. for example Seymor, *OPEC: Instrument of Change*, 1981; Doran, *Myth, Oil, and Politics — Introduction to the Political Economy of Petroleum*, 1977; Fraser, *Political Economic Cartels — An Alternative Approach to the World Oil Market*, 1978; Ajomo, An Appraisal of the Organization of the Petroleum Exporting Countries (OPEC), 13 Tex. International L. J. (1977), pp. 11 et seq.; Skeet, *OPEC: Twenty-five years of prices and politics*, 1991.

[8]Cp. Art. 1 OPEC Statute. Current member states are: Algeria, Angola (since 2007) Indonesia, Iran, Iraq, Kuwait, Libya, Nigeria, Qatar, Saudi Arabia, Venezuela, and the United Arab Emirates. Ecuador was a member from 1973 to 1992, and Gabon participated in OPEC from 1975 to 1994. Both of them quit for different reasons. On the history of OPEC see Schiavone*, International Organizations*, pp. 244 et seq.

[9]Resolution of Conference of Caracas II. 6. The Statute is dated 2006 and available at OPEC's homepage at http://www.opec.org; see also United Nations Treaty Series 443, p. 248.

more highly developed nations is virtually impossible (with the exception of Norway). In addition to full membership, the status of an associate member can be achieved (Article 7 D. OPEC Statute), which grants the right to participate in the organization but not the right to vote (Article 7 E. OPEC Statute).

Aims and Organization

According to Article 2 A. of the OPEC Statute, the aim of the organization is to coordinate and to harmonize the oil policy of its member states. OPEC seeks to ensure the stability of global oil prices (Article 2 B. OPEC Statute). In 2000, OPEC introduced the so-called "price-band mechanism" to achieve this stability.[10] The goal was to maintain the oil price permanently at a range of US $22–28 per barrel. If the crude oil price happened to fall outside that range for more than 20 successive trading days, OPEC members were to reduce or increase (as necessary) oil production automatically. This mechanism – that can also be examined under the aspect of security of supply – was dropped by OPEC in January 2005. Since then, the member states have agreed on output quotas only.

Institutionally, OPEC is made up of three different organs: the Conference, the Board of Governors, and the Secretariat.[11] The highest body is the Conference,[12] which consists of delegations from each of the member states, and requires the presence of at least three-quarters of the member states to constitute a quorum.[13] The Conference convenes at least twice a year,[14] and it normally meets at OPEC's headquarters in Vienna. The Conference's functions include, for example, formulating the general policy of the organization and determining the appropriate ways and means of its implementation,[15] deciding on any application for membership in the organization,[16] confirming the appointment of members of the board of governors,[17] approving any amendments to the OPEC statute,[18] and appointing the secretary general as well as OPEC's auditor.[19]

[10] See Kohl, The Perfect Storm — OPEC and the World Oil Market, 26 Harvard International Review (2005), p. 72.

[11] Cp. Art. 9 OPEC Statute.

[12] Art. 10 OPEC Statute.

[13] Art. 11 B. OPEC Statute.

[14] Art. 12 OPEC Statute.

[15] Art. 15 No 1 OPEC Statute.

[16] Art. 15 No 2 OPEC Statute.

[17] Art. 15 No 3 OPEC Statute.

[18] Art. 15 No 9 OPEC Statute.

[19] Art. 15 No 11 and No 12 OPEC Statute.

Decision-Making and Dispute Settlement

Each OPEC member state has one vote, and all decisions other than those on procedural matters require unanimous agreement. In case a member state is absent, that member state may protest against a resolution of the Conference up to 10 days before the date fixed for publication of the resolution (Article 11 C. III. OPEC Statute). In principle, resolutions become effective 30 days after conclusion of the meeting.

The OPEC Statute contains no rules concerning the settlement of disputes, except for a decision by the Board of Governors that the continued membership of any governor is detrimental to the interests of the organization. Consequently, consultations among the members are the only means of settling disputes.

Perspectives

OPEC's future importance depends in particular on ensuring discipline among its members and on the whole situation in the world oil market. Only if all member states adhere to the agreed quotas can OPEC achieve its primary aim: coordinating oil prices. Because of the Iraq crisis and some members' tendency not to comply with the quotas, this aim can sometimes be hard to achieve.[20] Additionally, the heterogeneity of OPEC countries must be taken into account – uniting very affluent economies such as the United Arab Emirates (per capita GNP 2001, US $9,206) and developing countries such as Nigeria (per capita GNP 2001, US $290) – all of which naturally have very different interests.[21] OPEC is well aware of this problem, and tries to prevent deviations through long-term objectives.[22] A further aspect to look at in the future is the question how non-member states will react to a foreseeable dominance by OPEC.

The Economic Importance of OPEC for the European Union

The member states of the European Union are net importers of oil. A look at the available (estimated) sources of oil in the EU member states shows that there is no chance – neither short-term nor long-term – of achieving self-sufficiency. In fact,

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[20]See Ghalib, OPEC versus Non-OPEC, 30 The Journal of Energy and Development (2004), p. 81 (84). Saudi Arabia in particular tended to act on its own in the past, which can be ascribed to its very exposed position within OPEC.

[21]Blaydes, Rewarding Impatience: A Bargaining and Enforcement Model of OPEC, 58 International Organization (2004), p. 213 (220).

[22]Cp. OPEC's Long-Term Strategy from 2005 in detail, available at http://www.opec.org/library/Special%20Publications/pdf/OPECLTS.pdf.

over time the EU is likely to become increasingly dependent on imported oil.[23] Moreover, according to the present stage of technical progress (solar technology, wind, water and atomic energy on the one hand as well as economized technologies like hybrid vehicles on the other hand) it cannot reasonably be expected that without oil imports the European Union will be capable of surviving economically over the long term.[24]

The Importance of OPEC in the World Oil Market

OPEC's market share of the world oil market amounts to about 40% at present. At first glance, this market share does not appear sufficient to establish a strong influence on the oil prices. However, one should be aware of the fact that all other oil-producing countries take into account the economic strategy of OPEC, so that its actual influence is quite strong. The United States consumes about 24% of the total annual world oil output; Europe consumes 19%; and Japan 7%. Together the OECD countries consume approximately 60% of the annual world output of crude oil, but produce only about 26%.

The picture is even more disproportionate when looking at available crude oil reserves, which makes it clear that OPEC states hold 75–80% of the worldwide oil reserves (in particular Saudi Arabia with approximately 35,423 million tons, Iran with approximately 17,199 million tons, and Iraq with approximately 15,430 million tons).[25] Of the ten countries with the biggest oil reserves only Canada and Russia are not members of the OPEC. Additionally, all of the countries that are not members of OPEC have met or even passed their individual oil production peaks – only OPEC states remain capable of expanding their output.[26]

[23]Cp. Commission Green Paper "A European Strategy for Sustainable, Competitive and Secure Energy," COM (2006) 105 final, p. 3; Commission Green Paper "Towards a European Strategy for the Security of Energy Supply," COM (2000) 769 final, p. 3.

[24]Cp. Commission Green Paper "A European Strategy for Sustainable, Competitive and Secure Energy," COM (2006) 105 final, p. 3; Commission Green Paper "Towards a European Strategy for the Security of Energy Supply," COM (2000) 769 final, p. 3; Institute for International Relations, Clingendael, *Study on Energy Supply Security and Geopolitics*, pp. 267 et seq., available at http://www.clingendael.nl/ciep/events/20040130/CIEP_Final_Report_Complete_Version_2004.pdf.

[25]Cp. Energy Information Administration (ed.), Country Analysis Briefs: OPEC; available at http://www.eia.doe.gov/cabs/opec.html.

[26]See (German) Federal Institute for Geosciences and Natural Resources, Reserves, Resources and Availability of Energy Resources 2005, available at http://www.bgr.bund.de/cln_011/nn_335074/EN/Themen/Energie/Produkte/annual_report_2005,templateId=raw,property=publicationFile.pdf/annual_report_2005.pdf.

The Importance of OPEC in the European Market

The current imports from OPEC members are of huge importance to the entire European Union: about 70% of the demand for crude oil in 2000 had to be satisfied by imports. Slightly more than half of it is supplied by OPEC. This share will inevitably increase. The European Commission predicts that the EU will need to cover about 90% of its demand for crude oil through imports by 2030.[27]

The Importance of OPEC for National Markets: Germany as an Example

Germany imports 97% of its oil needs but receives only about 20% of its oil imports from OPEC Countries.[28] This rather low share is attributed to a change in Germany's supply structure as a result of the oil crisis in the 1970s. Germany was looking for alternative supplies after OPEC countries had "lopped off the lines" and has succeeded. Nevertheless, OPEC's significance for Germany will increase over the long term.

The Present Situation in the Oil Market

The topic "oil" is of huge interest for many other reasons. Steadily increasing oil prices have led to heated debates in many countries over recent years, particularly

[27] Cp. Commission memo — DG Transport and Energy "Green Paper — Towards a European strategy for the security of energy supply." According to that memo an additional 21% of the entire crude oil imports relate to Norway, 18% relate to Russia and CIS, 2% relate to Mexico, and a further 8% relate to other states. Within OPEC, Saudi Arabia covers 13%, Libya covers 10% and Iran covers 9%. All other OPEC Member States range from 7% (Iraq) to 2% (Venezuela); the memo is available at http://www.eur-lex.eu (Celex-No. 52000DC0769). Furthermore, the memo points out that a consistent approach in case of "cutting the lines" is still missing. Indeed, Member States are bound to maintain their stocks of petroleum products to at least 65 days' average daily internal consumption [Art. 1 Par. 1 of Council Directive of 20 December 1968 imposing an obligation on Member States of the EEC to maintain minimum stocks of crude oil and/or petroleum products (68/414/EEC), English special edition: Series I Chapter 1968(II), p. 586]. But there are very different kinds of regulations in Member States in respect of administration of resources. This fact, among other things, can cause a distortion of competition. Finally, the Commission does not dispose of any "emergency competences," or other instruments to guarantee a coordinated and fair disposal of provisions. Whether common principles of EU law, e.g., the principle of loyalty, may help in this situation or not must be doubted in the light of the enormous economic and political significance of oil resources and their possible disposal.

[28] In 2004 Germany imported altogether 110m barrels of crude oil. The main supplier was Russia and CIS with 37.1m barrel followed by the UK and Norway. In fourth place is Libya which is an OPEC Member State. Compare http://www.stern.de/wirtschaft/unternehmen/maerkte/:Ölimporte-Deutschland/554681.html.

in the United States, where prices for fossil fuels have traditionally been low, but where rapid price increases ("pain at the pump") as a result of the war in Iraq and hurricane "Katrina" paved the way for a political battle royal. Indeed, price increases have been dramatic in the last few years: the price per barrel (approximately 159 liters) was approximately US $65 on the world market in May 2006. The highest price in history so far reached US $140 in the summer of 2008. The price decreased due to the global economic crises over recent months, but a high oil price is expected for the near future.

To face these tendencies and to upgrade the security of supply, different approaches are being discussed in the United States. The most important approach is the so-called "NOPEC" bill.[29] This bill is intended to modify fundamental rules of US antitrust law and makes it much easier for US competition authorities to take action against OPEC. Additionally, some civil actions were launched against OPEC in the USA,[30] in the end without success due to technical questions and concerns in relation to International law.[31]

OPEC and Cartel Theory

The Concept of Cartels in General

OPEC is often referred to as a "cartel." But before thinking about applying EU competition law to OPEC, one should first clarify the definition of the term "cartel", and then ask whether or not OPEC is a cartel as that term is generally understood.

Economic theory identifies a number of elements of a cartel:

- *Agreement:* parties involved in a cartel must agree on the nature of co-operation and the objectives that can be achieved.
- *Achievement:* parties involved must agree on the course of action which is to guarantee the medium- and long-term understanding within the cartel (mechanism or process to achieve agreement).
- *Maintenance:* there must be a threat for every party willing to step out of line which outweighs a possible advantage gained by cheating. A balance is to be

[29]In detail see p. 198 et seq. below.

[30]See *International Ass'n of Machinists & Aerospace Workers (IAM) v. Organization of Petroleum Exporting Countries (OPEC)*, 477 F. Supp. 553 (C. D. 1979); *International Ass'n of Machinists & Aerospace Workers (IAM) v. Organization of Petroleum Exporting Countries (OPEC)*, 649 F. 2d 1354 (9th Cir. 1981); *Prewitt Enterprises, Inc. v. OPEC* 2001 U.S. Dist. Lexis 414 (N. D. Ala. 2001), 2001-1 Trade Cas. (CCH) ¶ 73, 246 (N. D. Ala. 2001); also see below p. 196 et seq.

[31]See Udin, Slaying Goliath: The Extraterritorial Application of U.S. Antitrust Law to OPEC, 50 American Univ. L. Rev. (2001), pp. 1321 et seq.; Griffin, Special International Antitrust Doctrines and Defenses, 60 Antitrust J. (1991), p. 543 (548); Waller, Suing OPEC, 64 Univ. Pitts. L. Rev. (2002), pp. 105 et seq.

established between the profits realized single-handedly, the possibility of being detected at the first attempt, and a punishment by the other parties involved.[32]

Following a shorter definition a cartel is characterized "as a coordination of the economic behavior of independent partners, based on their consent, which results in regulation of a particular market."[33]

Does OPEC fulfill these criteria? The prior determination of quotas is an agreement in the sense of cartel theory, because the amount of production is not a question of demand in the market but of quotas. Thus, the principle of supply and demand is annulled, and competition is distorted. Furthermore, there are possibilities of imposing sanctions within OPEC, e.g., higher capacities in case a member state diverges from agreed quotas. Thus, OPEC can be considered a cartel in the sense of general cartel theory.[34]

Application to OPEC or Its Members?

The last important question is: against whom exactly might EU competition law be applied? Possibilities include: (1) OPEC as an international organization, (2) OPEC's member states, or (3) national oil companies within OPEC, which implement OPEC's resolutions via governmental directives. In the end, it is likely the European Commission would address OPEC (as an association of undertakings), the member states (as undertakings) as well as national oil companies (as undertakings) in a decision based on Article 7 Reg. 1/2003. The ECJ has not disapproved of this practice so far.

Application of European Competition Law to OPEC

The Ban on Cartels in Article 81 ECT

Article 81 ECT prohibits all agreements between undertakings, decisions by associations of undertakings, and concerted practices that may affect trade between

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[32]Elliot/Nitze, in: Terhechte (ed.), *Internationales Kartell- und Fusionskontrollverfahrensrecht*, § 10 para 13.

[33]Kronstein, *The Law of International Cartels*, 1973, p. 41.

[34]See also Parker, Solutions to Competitive Problems in the Oil Industry, available at http://www.ftc.gov/os/2000/03/opectestimony.htm; *CFB — Netherlands Bureau for Economic Policy Analysis*, FAQs about oil and the world economy, p. 13, available at http://www.cpb.nl/eng/pub/cpbreeksen/memorandum/104/; Waller, Suing OPEC, 64 Univ. Pitts. L. Rev. (2002), pp. 105 et seq.; Udin, Slaying Goliath: The Extraterritorial Application of U.S. Antitrust Law to OPEC, 50 American Univ. L. Rev. (2001), pp. 1321 et seq.; Griffin, Special International Antitrust Doctrines and Defenses, 60 Antitrust J. (1991), p. 543; Fraser, Political Economic Cartels — An Alternative Approach to the World Oil Market, 1978.

member states and which have as their object or effect the prevention, restriction, or distortion of competition within the common market. This raises several questions: 1. Can OPEC member states be classified as undertakings? 2. Is OPEC itself an association of undertakings as defined in Article 81 Par. 1 ECT? 3. Is EU competition law also applicable to conduct which occurs outside the common market?

Personal Scope

The personal scope of application of the ban on cartels is limited to “undertakings” and “associations of undertakings.” As mentioned before, the ECJ applies a very wide, functional understanding of the term “undertaking.”[35] The decisive factor is whether the entity is engaged in economic activity, regardless of its legal form, object, or means of financing.[36] Consequently, there are no reasons to doubt the application of these rules to states, as long as they are engaged in economic activity as set forth in court decisions.[37] This applies not only in relation to EU competition law and EU member states but also to third countries.[38]

Up to this point it seems possible to see OPEC member states as undertakings within the meaning of Article 81 ECT. But an application of European competition law could still fail because of the fact that OPEC member states and OPEC itself are not primarily engaged in economic activities but, arguably, original sovereign conduct. Exploitation of resources and subsequent marketing seems to be a sovereign act at first glance. In particular, the dependence of the OPEC states’ national

[35]Court of Justice Case C-41/90, *Höfner and Elser,* [1991] ECR I-1979.

[36]Court of Justice Case C-41/90, *Höfner and Elser,* [1991] ECR I-1979 para. 21; Court of Justice Case 209-218/78, *van Landewyck,* [1980] ECR 3125 para. 88.

[37]Court of Justice Case C-342/95, *Diego Cali & Figli,* [1997] ECR I-1549 (1587) para 16. As far as European Competition Law is directly applicable to Member States, there is a consequent problem in the application of penalty mechanisms in Regulation 1/2003. According to the European Commission, an application of Article 81 Par. 1 ECT is out of the question because these cases are concerned with states. Judgments of the ECJ do not correspond to this opinion.

[38]This can be seen, for example, in the decision of the Commission about restrictive agreements between undertakings which are based in the EC, and national export organizations of former socialist countries. Here the Commission explains: “The foreign trade organizations (. . .) are also undertakings for the purposes of Article 85. The function of each of the organizations was to engage in the import and export in a range of goods. (. . .) Entities which engage in the activity of trade are to be regarded as undertakings for the purposes of Article 85, whatever their precise status may be under the domestic law of their country of origin, and even where they are given no separate status from the state. It follows that the applicability of Article 85, since it relates to trading activities, is not defeated by claims of sovereign immunity. Such claims are properly confined to acts which are those of government and not of trade. Even if the foreign trade organizations are indistinguishable under Socialist law from the State, no sovereign immunity would attach to their participation in the Brandeis agreements since this was an exclusively commercial activity. Furthermore the domestic law of Member States does not accord sovereign immunity to foreign trade organizations of the type concerned by these proceedings.” Commission Decision, COMP IV/26.870 — Aluminium imports from Eastern Europe, OJ 1985, L 92/1 (at 37).

economies on oil resources may raise doubts about regarding the activities as purely economic ones. On the other hand, it cannot be denied that this duty could be fulfilled just as well by private undertakings.[39]

It follows that the definition of the term "economic activity" is of central importance, as well as the market where it takes place. According to the ECJ, a strong indicator of economic activity is that it takes place in a competition-driven market. The ECJ defines economic activities as every kind of activity that deals with offering goods or services in a market.[40] On the one hand EU member states and private companies procure oil by way of private contracts of sale; on the other hand the activities of OPEC could be defined as the "national administration of resources," which is possibly not an economic activity. As long as OPEC member states decide by sovereign acts on the amounts of national oil produced, it is justified to speak of measures of an administrative character. But if these multilateral quotas have economic aims (like stability of prices and especially profits) the classification as administrative measures is not convincing. The OPEC member states would then have renounced sovereignty over their national oil resources in favor of economic aims.[41]

A number of arguments can be found to suggest that OPEC member states compete in a market with other private companies. In its *BP Amoco/Acro* decision,[42] for example, the European Commission had to deal with a merger of companies participating in all stages of the "oil business." The Commission assumed the oil market to be a competition-driven market that is characterized by competition between private oil companies and OPEC states.

Moreover, general reluctance to apply EU competition law to state conduct cannot apply in relation to third countries. Between the EU and OPEC duties of good faith as provided in Article 10 ECT do not exist; also special treaty provisions such as Article 86 ECT are not applicable because they relate to undertakings of member states and not to those of third countries.

Associations of undertakings fall within the personal scope of application of Article 81 Par. 1 ECT as well. According to the ECJ, associations of undertakings are all organizations that are able to effect the market behavior of their members

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[39]When looking more closely it can be found that duties usually related to sovereign state duties can also be enforced by private persons. This is explicitly mentioned by Advocate General Maduro in the FENIN case. According to him, it is unimaginable to abrogate state defense to private subjects. History shows examples for this. The limit is reached when an obligation is assumed which is not cost-covering.

[40]Court of Justice Case 118/85, *Commission/Italy,* [1987] ECR 2599 para. 7; Case C-35/96, *Commission/Italy,* [1998] ECR I-3851 para. 36; Case C-309/99, *Wouters,* [2002] ECR I-1577, para. 47.

[41]See also Udin, Slaying Goliath: The Extraterritorial Application of U.S. Antitrust Law to OPEC, 50 American Univ. L. Rev. (2001), p. 1321 et seq.; Griffin, Special International Antitrust Doctrines and Defenses, 60 Antitrust J. (1991), p. 543; Waller, Suing OPEC, 64 Univ. Pitts. L. Rev. (2002), pp. 105 et seq.

[42]Commission Decision, Case IV/M.1532 – BP Amoco/Acro, OJ 2001, L 18/1.

regardless of their legal form.[43] Inasmuch as OPEC's member states can be seen as undertakings in the sense of Article 81 ECT, the question arises whether OPEC as an international organization is an association of undertakings in the sense of this rule.

OPEC provides the framework in which their members can coordinate their national oil policies (see Article 2 OPEC Statute). OPEC also represents the interests of the member states. Therefore all criteria of an association of undertakings in terms of Article 81 ECT are present. The fact that OPEC is an international organization does not change this conclusion for the level of competition law.

Material Scope

Furthermore, it has to be clarified whether the activities of OPEC fall within the material scope of EU competition law. If OPEC's member states can be qualified as undertakings in the sense of Article 81 ECT and OPEC itself is an association of undertakings in this sense, it would be legally admissible to say that there are agreements between undertakings as well as decisions by associations of undertakings.

According to the judgments of the ECJ there is an agreement if the undertakings concerned have the common will to coordinate their market behavior.[44] In addition to an agreement a decision between associations of undertakings is mentioned in Article 81 ECT. A decision under Article 81 ECT is any act that constitutes the will of an association of undertakings.[45]

OPEC member states arrange quotas (and potentially prices) for their oil production to which they are bound. Those quotas can be subsumed under the term "agreement" in Article 81 Par. 1 ECT as well as under the term "decision." It does not matter whether these quotas are international treaties as OPEC member states act according to the quotas and therefore have the will to coordinate their behavior on the worldwide oil market.

All conduct covered by Article 81 Par. 1 ECT must be capable of restricting competition. Elements of this rule mention three different effects of the respective conduct: prevention, restriction, and distortion of competition within the common market. Conduct offending the ban on cartels includes, among other things:

- Direct or indirect fixing of purchase or selling prices or any other trading conditions (Article 81 Par. 1 lit. a ECT)
- Limitation or control of production, markets, technical developments or investment (Article 81 Par. 1 lit. b ECT)

[43]Court of Justice Cases C-180-184/90, *Pavlov,* [2000] ECR I-6451 paras. 78 et seq.

[44]Court of Justice Case 41/69, *ACF Chemiefarma/Commission,* [1970] ECR 661 para. 110.

[45]Mestmäcker/Schweitzer, *Europäisches Wettbewerbsrecht*, 2004, § 9 para. 10.

OPEC's aim is to coordinate the oil production of its member states. This contains a restriction on the production as well as the sale of a market commodity. Because of the mechanism of supply and demand, these "output restrictions" also have a direct effect on the price, even though OPEC denies any influence on prices.[46] Nevertheless, the object of the agreements (on the quotas) is to control production and prices of oil on the worldwide and European market.

Affect Trade between Member States

EU competition law is applicable to restrictions on competition and trade between the EU member states only. This clause has the aim of distinguishing between the application of European and national competition law. The ECJ held that "in order that an agreement between undertakings may affect trade between member states it must be possible to foresee with a sufficient degree of probability on the basis of a set of objective factors of law or fact that it may have an influence, direct or indirect, actual or potential, on the patterns of trade between member states, such as might prejudice the realization of the aim of a single market in all the member states."[47] First, this criterion decides on who would be responsible for an application of competition rules on OPEC and its members. Inasmuch as agreements concerning price and quotas would affect only one member state, this would be within the scope of application of national competition law (e.g., § 1 of the German Act Against Restraints of Competition – ARC). If more than one member state were affected, the European Commission would be responsible for an application of Article 81 Par. 1 ECT.[48]

As all EU member states import oil from OPEC, all of them are affected by the quotas. Consequently these quotas fall within the scope of EU competition law. The quota-induced oil prices have an effect on the prices on the common market and thus OPEC has an effect on the trade between the EU member states.[49]

The Extraterritorial Reach of EU Competition Rules

EU competition law applies to the common domestic markets, i.e., its main purpose is to protect the common market from any restrictions of competition. However, restrictions of competition are not exclusively carried out by EU member

[46]See statement of Secretary General Daukoru: "Wir haben keine Kontrolle," available at http://www.manager-magazin.de/unternehmen/artikel/0,2828,398129,00.html.

[47]Court of Justice Case 56/65, *Maschinenbau Ulm,* [1966] ECR 282 (303); Case 42/84, *REMIA,* [1985] ECR 2545, para. 22.

[48]Cp. Commission Notice — Guidelines on the effect on trade concept contained in Articles 81 and 82 of the Treaty, OJ 2004, C 101/81.

[49]Cp. Commission Notice — Guidelines on the effect on trade concept contained in Articles 81 and 82 of the Treaty, OJ 2004, C 101/81, especially paras. 100 et seq.

states or by undertakings domiciled in EU member states. Restrictions of competition can also emanate from undertakings domiciled outside the EU or even from states outside the EU. This leads to the issue: is EU competition law (especially Article 81 ECT) applicable to these sorts of restrictions? More specifically, is a mere effect of restrictions on competition in the common market sufficient to enable the application of EU competition law (the so-called "effects doctrine"[50])? The ECJ has considered the effects doctrine in its rulings, but has not unequivocally determined its application. According to the ECJ, the effect of restrictions on competition in the common market is only one requirement among others. In addition, the corresponding conduct (agreement, concerted practice etc.) has to be implemented in the common market (the so-called "qualified effects doctrine" or "implementation doctrine").

Meanwhile, the Qualified Effects Doctrine is susceptible to interpretation. For instance, in the case *Ahlström Osakeyhtiö vs. EU Commission*[51] the ECJ regarded supplies into the common market as sufficient in order to affirm application of EU competition law. An organized business activity carried out by establishments or subsidiaries is not necessary. In the last few years the EU Commission has also focused on the effect as the crucial factor.

Having this approach in mind, Article 81 ECT can be applied to OPEC, its member states and their state-owned enterprises. The international organization OPEC resides in Vienna, Austria – i.e., within the territorial scope of EU competition law (Article 299 ECT).[52] The state-owned oil enterprises of OPEC member states supply their oil to the EU common market, thus EU cartel law is applicable. As the member states own some of the oil companies and are therefore the initiators of oil supplies to the common market, EU competition law applies to them as well. Hence, from the perspective of European law a differentiation between state-owned enterprises and member states is not necessary. The consequence is that even though OPEC member states are third party states and the state-owned companies are not resident in the EU, they fall into the territorial scope of Article 81 ECT.

Exemption Under Article 81 Par. 3 ECT?

Of course, assuming OPEC is subject to EU competition law, it is also entitled to avail itself of the exemptions from the application of Article 81 Par. 1 ECT as set forth in Article 81 Par. 3 ECT, to the extent that they apply. The key issue regarding individual exemptions is that the corresponding agreement, concerted practice, etc., contributes to the improvement of production or distribution of goods or to the

[50]For further details see Neale/Stephens, *International Business and National Jurisdiction*, 1988, pp. 163 et seq.; Dabbah, *The Internationalisation of Antitrust Policy*, 2003, pp. 162 et seq.

[51]Court of Justice Cases 89, 104, 114, 116, 117 and 125 till 129/85, [1988] ECR 5193, para. 12.

[52]This is of particular importance for the serving of a judgment or a decision of the Commission, because they should simply be served in Vienna. Whatever OPEC does with it after it has been served is an internal affair.

promotion of technical or economic progress, while allowing consumers a fair share of the resulting benefit. Even if these criteria are met, an exemption will only be granted if the agreement does not impose on the undertakings concerned restrictions which are not indispensable to the attainment of these objectives (Article 81 par. 3 lit. a ECT) or afford such undertakings the possibility of eliminating competition in respect of a substantial part of the products in question (Article 81 par. 3 lit. b ECT).

The security of supplies was put forward by OPEC as the main purpose of its restrictions on competition. This seems to be connected with the improvement of the distribution of goods within the meaning of Article 81 par. 3 lit. a ECT. However, the resulting benefit of their goal to "ensure the security of supplies" is not actually shared with the consumers, because its main effect is an increase in prices of oil and gas. Furthermore, there is no need to ensure the security of supplies by means of cartels rather than by the basic principle of supply and demand. Private oil companies and states such as Norway and Russia take OPEC's policy as a guideline for their own production and price policy. Thus, OPEC has an effect on the production and price policy not only of its members but of the whole market.

Conclusions

Therefore, EU competition law can be applied to OPEC as an international organization and to its member states because their conduct infringes EU law. Agreements violating Article 81 par. 1 ECT are null and void (see Article 81 par. 2 ECT). However, this legal consequence is more or less irrelevant within the context of OPEC. Reg. 1/2003 is significantly more important as it offers the possibility of imposing and enforcing sanctions such as fines.

Abuse of a Dominant Position (Article 82 ECT)

The EU Commission's assessment of the long-term development in the world and in the common oil markets leads to the question whether Article 82 ECT is applicable to OPEC. Nowadays, OPEC holds neither a dominant position in the world market (40%) nor in the common market (51%). However, due to its strong position with regard to the assessed worldwide oil reserves (app. 75%), it is possible that OPEC might be in such a position in the future.

Obstacles and Immunities Under International Law

The extraterritorial application of supranational law interferes enormously with the sovereignty of the state to which the national law shall be extended. In general, there are no provisions offered by International law in order for those interventions to be tolerated. To minimize the foreseeable conflict between extraterritorial application on the one hand and sovereignty on the other hand International law has developed certain principles to prevent restrictions on sovereignty, like, for example, the state immunity doctrine. These principles share a common basis, namely the principle of non-interference and the idea of equality of states. The principle of non-interference represents the general term specified by further doctrines of International law such as the principle of comity.

State Immunity

The Law of State Immunity is in motion at present: after a preparation period of nearly 20 years the UN member states agreed upon a convention in 2005 ("United Nations Convention on Jurisdictional Immunities of States and Their Property") which provides a detailed regulation of the Law of State Immunity.[53] Article 5 of the Convention lays down the basic principle of state immunity. States in the sense of the Convention comprise the states and their organs of government as well as the constituent units of a federal state or political subdivisions of the state which are entitled to perform acts in the exercise of sovereign authority and are acting in that capacity (Article 2 Par. 1). Hereby it is evident that the Convention neither applies to state-owned enterprises as long as they do not exercise sovereign powers derived from the state, nor to international organizations.

According to Article 10 Par. 1 of the Convention, a state which engages in a commercial transaction with a foreign natural or judicial person may not rely on the Principle of State Immunity in the sense of Article 5 of the Convention. In order to determine the criteria for such a commercial transaction, Article 2 Par. 2 primarily refers to the nature of the transaction but does not interfere with the parties' right to agree on the objective of the transaction as being the decisive factor.

Consequently, the question whether OPEC's activities, those of its member states and those of the state-owned enterprises are protected by the principle of State Immunity is to be answered in accordance with the preconditions set by the UN Convention as an expression of common principles of International law. However, further conditions have to be met, given that the EU (or its member states) has to ratify the Convention and the particular OPEC states have to submit to the Convention as well. The crucial question occurring once again in terms of International law is: "Is OPEC engaged in commercial activities or not?" This paper assumes that the activities are commercial by their very nature.

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[53]The Convention is available at http://untreaty.un.org/English/notpubl/English_3_13.pdf; see also Gardiner, UN Convention on State Immunity: Form and Function, 55 International and Comparative Law Quarterly (2006), p. 407; Foakes/Wilmhurst, State Immunity: The United Nations Convention and its effect, Chatham House International Law Programme, May 2005 (ILP BP 05/01), available at http://www.chatham house.uk.org.

Comity

The Comity Principle, as another potential obstacle on the level of International law, can be interpreted as a "duty to show consideration." The central idea of the Comity Principle is to limit a jurisdiction through different instruments such as proportionality. According to the Comity Principle, EU competition law is inter alia applicable if there is a corresponding connecting factor for the application, or the application is not considered an abuse. However, these criteria focus primarily on the application of cartel provisions to undertakings located in third states and not to third states themselves.

When judging whether or not the Comity Doctrine can be regarded as an expression of the prohibition of interference in internal affairs of the state, it obviously depends on the point of view taken. As long as the general principles of public International law do not apply, there is prima facie no need to fall back on the very indefinite Comity Doctrine.

Recent Developments in US Antitrust Laws

Unlike in Europe, there is a broad public discussion and academic debate in the United States concerning the application of US antitrust law to OPEC. This discussion may be looked at as a model, in particular as US antitrust law exerts a great influence on EU competition law and both regulatory frameworks are comparable. However, the fact that in the case of USA only one state is dealing with OPEC facilitates the resolution of many questions.

It is important to mention that applying antitrust rules to OPEC is not merely an interesting academic debate in the United States at the moment, but has become a question of practical relevance. In addition to certain trials in recent years, in June 2007 Congress passed a new NOPEC legislation, which potentially enables the US attorney general to bring an action against OPEC in any federal district court.

Previous Cases

Civil proceedings against OPEC have been launched in the US three times to date. It is remarkable that all proceedings were initiated by private parties and up to now no official has ever tried to seek a judgment approving the application of US antitrust law to OPEC.[54] All three cases displayed an interesting tendency: during the first two claims the discussion focused on privileges OPEC might probably enjoy, whereas the last case in 2003 concentrated in detail on the US code of civil

[54]Parker, Solutions to Competitive Problems in the Oil Industry, available at http://www.ftc.gov/os/2000/03/opectestimony.htm, p. 5.

procedure. If it did not regard OPEC as the proper defendant to the claim and the conduct as liable for a trial in the court of justice within the meaning of US law respectively, there was no need for the court to consider all questions concerned with the civil procedure code.[55]

The International Association of Machinists (IAM) initiated the first trial in the District Court of California.[56] The IAM charged OPEC with violation of the cartel provision of Section 1 of the Sherman Act by means of price fixing.[57] The district court ruled that the Foreign Sovereign Immunity Doctrine applied to OPEC, which meant that OPEC enjoyed immunity. The court dismissed the objection that OPEC's conduct was deemed to be economic and therefore exempted from the application of the Foreign Sovereign Immunity Doctrine. It considered the conduct as an act of state ("terms and conditions for the removal of a prime natural resource").[58]

The IAM appealed this judgment.[59] Although the court of appeals approved the district court's judgment, the reasons stated differed from the district court's. By denying the application of the Foreign Sovereign Doctrine and applying the Act of State Doctrine, the Court of Appeals gave the case a new twist. While the Sovereign Immunity Doctrine pays attention to the fact that foreign states may not be the proper defendant to a claim in a US court, the Act of State Doctrine — in the US context — deals in particular with the issues of separation of powers and delimitation of competences. US courts do not regard themselves to have the authority to review the legality of sovereign acts by foreign states.[60]

The change of perspective made in this judgment reflects internal competence problems rather than solving the questions raised by this case. Finally, it is possible to infer from this judgment that one crucial issue of the claim is by whom the proceedings are initiated. This differentiation is of importance in the European context, keeping in mind that a similar case under European jurisdiction might depend on whether the proceedings are initiated by a private person or by a decision of the EU Commission.

The third case was the Prewitt case of 2003.[61] The facts of this case are similar to the IAM case. Remarkably, the 11th Circuit Court of Appeals did not deem it

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[55] See below p. 198.

[56] *International Ass'n of Machinists & Aerospace Workers (IAM) v. Organization of Petroleum Exporting Countries (OPEC)*, 477 F. Supp. 553 (C. D. Cal. 1979); see regarding this Hilton, Note, IAM v. OPEC: The Demise of the Restrictive Theory of Sovereign Immunity and of the Extraterritorial Effect of the Sherman Act Against Foreign Sovereigns, 41 Univ. Pitts. L. R. (1980), pp. 841 et seq.; Neale/Stephens, *International Business and National Jurisdiction*, 1988, p. 83.

[57] 15 U. S. C. § 1.

[58] 477 F. Supp. 567.

[59] *International Ass'n of Machinists & Aerospace Workers (IAM) v. Organization of Petroleum Exporting Countries (OPEC)*, 649 F. 2d 1354 (9th Cir. 1981), *cert. denied*, 454 U.S. 1163 (1982).

[60] 649 F.2d 1358.

[61] *Prewitt Enterprises, Inc. v. OPEC* 2001 U. S. Dist. Lexis 414 (N. D. Ala. 2001), 2001-1 Trade Cas. (CCH) 73, 246 (N. D. Ala. 2001).

necessary to concern itself with the immunity of OPEC or with the Act of State Doctrine but dealt with the service-in-process maxim of the US Federal Code of Civil Procedure. This may be described as a tactic to avoid a decision as well as a denial of the previous court rulings, as they were not even taken into consideration.

The US court rulings cannot be regarded as consistent and unequivocal. The Supreme Court has yet to deliver a judgment in these matters.[62] However, the change in the court rulings from immunity to civil procedure obstacles is remarkable and displays the immense changes from 1979 to 2003. Up to now, it has been fairly accepted that state conduct can be carried out by acts of state or on a private enterprise basis. This shift should improve the chance of a successful claim against OPEC in the future.

The NOPEC Legislation of 2007

Nevertheless, any claim still has to overcome the previously mentioned obstacles. The most prominent solution to tackle these obstacles is the NOPEC bill, which has been tentatively discussed over recent years.[63] The bill was approved by the US House of Representatives on May 22, 2007 and passed the Senate on June 21, 2007 as part of the Renewable Fuels, Consumer Protection, and Energy Efficiency Act 2007.[64] This package of statutes consists mainly of provisions that should be

[62]Cp. Parker, Solutions to Competitive Problems in the Oil Industry, available at http://www.ftc.gov/os/2000/03/opectestimony.htm, p. 5.

[63]For further details about the previous history, see Reinker, NOPEC: The No Oil Producing and Exporting Cartels Act of 2004, 42 Harvard Journal on Legislation (2005), pp. 285 et seq. with further references.

[64]Renewable Fuels, Consumer Protection, and Energy Efficiency Act of 2007 (excerpts):

Sec. 710. No Oil Producing and Exporting Cartels Act of 2007.

(a) Short Title—This section may be cited as the "No Oil Producing and Exporting Cartels Act of 2007" or "NOPEC."

(b) Sherman Act — The Sherman Act (15 U.S.C. pp. 1 et seq.) is amended by adding after section 7 the following:

Sec. 7A Oil Producing Cartels

(a) In General — It shall be illegal and a violation of this Act for any foreign state, or any instrumentality or agent of any foreign state, to act collectively or in combination with any other foreign state, any instrumentality or agent of any other foreign state, or any other person, whether by cartel or any other association or form of cooperation or joint action:

(1) to limit the production or distribution of oil, natural gas, or any other petroleum product;

(2) to set or maintain the price of oil, natural gas, or any petroleum product; or

(3) to otherwise take any action in restraint of trade for oil, natural gas, or any petroleum product; when such action, combination, or collective action has a direct, substantial, and reasonably foreseeable effect on the market, supply, price, or distribution of oil, natural gas, or other petroleum product in the United States.

(b) Sovereign Immunity — A foreign state engaged in conduct in violation of subsection (a) shall not be immune under the doctrine of sovereign immunity from the jurisdiction or judgments of the courts of the United States in any action brought to enforce this section.

inserted in the Sherman Act,[65] partly changing the Sovereign Immunity Doctrine as well as the Act of State Doctrine under US law.[66] Due to the explicit inclusion of states in the scope of application of the Sherman Act and the prohibition of oil cartels, US antitrust law can be more easily applied to OPEC. Another feature to note: the privilege of enforcing the new provisions is exclusively reserved to the Attorney General, private parties being denied this authorization. Subsequently, it remains a question of politics whether the NOPEC legislation will ever be applied to OPEC. Under the new Obama administration it remains unclear whether this legislation will come into force.

Conclusions

Due to significantly increasing oil prices the further development in US law has to be observed closely. Where the discussion may head can be inferred from a statement of the FTC given in 2000,[67] which noticed that, although the application of US antitrust law was problematic, the main issues were not located in the field of antitrust law itself: a certain conduct might be within the law, but this does not necessarily mean it is politically appropriate. This inspires the following assumption: OPEC is not excluded from the scope of application of the Sherman Act. With regard to developments in recent years, a case could be successful.[68] If the new legislation would come into force, the Attorney General of the United States is entitled to bring an action in any district court of the United States.

Obstacles to the Application of Article 81 ECT

In fact, there are no legal obstacles to be found in the material scope of Article 81 ECT which might rule out its application to OPEC. However, the question whether

(c) Inapplicability of Act of State Doctrine — No court of the United States shall decline, based on the act of state doctrine, to make a determination on the merits in an action brought under this section.
(d) Enforcement — The Attorney General of the United States may bring an action to enforce this section in any district court of the United States as provided under the antitrust laws.
(e) Sovereign Immunity — Section 1605(a) of title 28, United States Code, is amended:
(1) in paragraph (6), by striking “or” after the semicolon;
(2) in paragraph (7), by striking the period and inserting; “or”; and
(3) by adding at the end the following: “(8) in which the action is brought under section 7A of the Sherman Act.”

[65] 15 U.S.C.A. §§ 1–7.

[66] In particular it is an amendment of 28 U.S.C.Sec. 1605(a), in which a new § 8 would be inserted: “(8) in which the action is brought under section 7A of the Sherman Act.”

[67] Parker, Solutions to Competitive Problems in the Oil Industry, available at http://www.ftc.gov/os/2000/03/opectestimony.htm, pp. 5 et seq.

[68] See Waller, Suing OPEC, 64 Univ. Pitts. L. Rev. (2002), pp. 105 et seq.

procedural rules may provide any obstacle has remained unanswered so far. In trying to answer this question two situations need to be distinguished: the enforcement by the EU Commission according to Reg. 1/2003, and private action to cease and desist or to recover damages according to § 33 of the German ARC or any other applicable provision of national law in the EU in relation to Article 81 ECT.

Application by the European Commission

The EU Commission may first consider a decision in accordance with Article 7 par. 1 Reg. 1/2003. Based on this provision, the EU Commission can require the parties of an agreement to quit their infringement. In ordering termination of an infringement the EU Commission is empowered to impose behavioral and structural remedies. However, structural remedies are limited to cases where there is no equally effective behavioral remedy or where a structural remedy would be more burdensome. A behavioral remedy could be an injunction of output coordination. A rather unrealistic structural remedy could be the divestiture of OPEC.

In theory the EU Commission may impose a fine according to Article 23 par. 2 Reg. 1/2003. Indeed, this fine could be very large, as the economic misallocation caused by OPEC is immense. Nonetheless, due to significant problems in enforcement, fines may not be the appropriate remedy. From the viewpoint of order policy, stopping the output limitation would already be an immense achievement.

Another crucial issue is the enforcement of the EU Commission's decisions. According to Article 256 ECT, decisions of the Commission are not enforced by the EU itself but by its member states.[69] If OPEC and its members do not respect a decision within the meaning of Article 7 Reg. 1/2003, the only remaining possibility would be the imposition of a fine. Such a decision would not be enforceable in practice. The enforcement depends, due to the agreement on the domicile of OPEC with Austria (see Article 5 par. 2 of the agreement),[70] on the approval of OPEC which is unlikely to be given. This agreement could thus undermine the effective application of EU competition rules. In addition to this, OPEC does not dispose of the financial resources to cover large fines.[71] This raises the question of whether the fine can be collected directly from the member states who participated in the infringement. In practice the member states are likely to refuse to pay the fines. Still, the previously mentioned issue has to be taken into consideration to figure out

[69]For further details, see Terhechte, Die Vollstreckung von EG-Bußgeldbescheiden in den Mitgliedstaaten der Europäischen Gemeinschaft — Rechtliche Grundlagen, Umsetzungspraxis und Rechtsmittel am Beispiel der Bundesrepublik Deutschland, EuZW 2004, pp. 235 et seq.

[70]See Art. 5 Par. 2: "Judicial acts of enforcement within the official residence, including the seizure of private property, require the explicit approval of the Secretary-General and shall only be carried out under the conditions set by him," Austrian Federal Law Gazette (1974), p. 382.

[71]OPEC's budget was € 19.8m in 2005.

if it is possible to enforce a decision of the EU Commission against OPEC in general. One obstacle lies in the valid serving of the decision on OPEC member states (e.g., to their embassy or diplomatic representation), which is to a certain extent contrary to International law.[72] So, how is this Gordian knot to be cut?

A good starting point might be to address the EU Commission's decision — corresponding to the Commission's practice — to OPEC as an international organization, the member states and if necessary to the state-owned enterprises. The decision would only be served on OPEC in Vienna (the serving of a decision does not fall explicitly under the agreement on the domicile of OPEC with Austria[73]). Then OPEC would be obliged to forward the decision. Fines might also be executed against assets of state-owned enterprises located within the territorial scope of application of the ECT. This approach would circumvent the restrictions of international law and immunity. Furthermore, it would match the regular practice of the Commission which has not been criticized by the ECJ so far.

Concerns similar to those brought up in the American cases about the application of antitrust law to OPEC exist in Europe as well. For a number of reasons any action against OPEC is dangerous for the EU, in particular regarding the fact that the EU is short of oil. What would happen if OPEC were to shut down the supply of oil again? At the present time, speaking from an economic perspective, the EU depends on OPEC, even though there are approaches such as the "mix of energy sources" to limit this dependency. On the contrary, OPEC depends on large markets such as the European Market, which is the second largest in the world. Hence, there would be a significant counterweight to a one-sided oil shortage. Furthermore, it is undeniable that the necessary competences for taking such actions on the "energy" sector have been conferred on the European Union. The key issues are the measures proposed in the Green Book "An Effective Strategy for an Efficient, Competitive and Secure Energy."[74] These measures include inter alia the accomplishment of a domestic market, an enhanced coordination regarding the security of supplies, the promotion of innovation regarding energy-technology and a coherent foreign energy policy.[75] Within the limits of the transatlantic partnership combined actions of the competition authorities are also possible.

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[72]See Rehbinder, in: Immenga/Mestmäcker (ed.), *EG-Wettbewerbsrecht*, 4th ed. 2007, I. chapter, para. 77.

[73]In addition, Austria is obliged under EU law to avoid conflicts between international treaties and EU law, see Art. 307 ECT. As a last resort, it has the duty to cancel the agreement with OPEC.

[74]Commission Green Paper "A European Strategy for Sustainable, Competitive and Secure Energy," COM (2006) 105 final.

[75]See Moore, The Natural Law Basis of Legal Obligation: International Antitrust and OPEC in Context, 36 Vanderbilt J. Transnational L. (2003), pp. 243 et seq.

Private Enforcement

The previously mentioned difficult considerations do not apply to the same extent to a civil claim against OPEC. One difficulty and certainly an enormous economic challenge – arising inter alia under German law – is to specify the amount of the damage. But in a civil claim under German law this question could be left unanswered. Under German law there exists under special provision the possibility that the court be given the task of defining the damage (§ 287 Par. 1 German Civil Procedure Act).

Due to the 7th amendment of the German law of damages regarding cartel cases a new provision (§ 33 ARC) was enacted which provides a civil claim for damages in case of an infringement of Article 81 ECT.[76] Thus, a private plaintiff has to initiate proceedings in the civil courts where, according to § 88 ARC, the District Courts have exclusive jurisdiction.

Alternative Approaches

In addition to the application of cartel law, further approaches have to be taken into consideration. For instance, actions could be taken within the confines of the World Trade Organization (as almost all member states of OPEC are members of the WTO). However, GATT provides exemptions for the exploitation of natural resources, which lead to the same difficulties as found in the cartel approach (see Article XX [g] GATT). But the main problem is that energy is not on WTO's agenda. For many years a gentlemen's agreement has existed that excludes energy issues from the WTO system.[77] Apart from these approaches proceedings in the International Court of Justice (ICJ) in The Hague and one-sided measures such as embargoes are being discussed.[78] However, whether or not the cartel approach is going to prevail is a political decision.

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[76] See Schmidt, Wirtschaftsrecht: Nagelprobe des Zivilrechts — Das Kartellrecht als Beispiel, AcP 206 (2006), pp. 167 et seq.; Schneider, in: Terhechte (ed.), *Internationales Kartell- und Fusionskontrollverfahrensrecht*, § 12 paras. 238 et seq.

[77] See Schorkopf, "Energie" als Thema des Welthandelsrechts, in: Leible/Walter/Lippert (eds.), *Die Sicherung der Energieversorgung auf globalisierten Märkten*, pp. 99 (102 et seq.).

[78] See fn. 75.

Conclusions

OPEC and European Competition Law

The intention of this paper was to point out the problems that may arise when applying supranational law to "state cartels." EU competition law refers to the EU domestic market. That does not imply, however, that the law is only applicable to restrictions on competition caused by conduct within the market; it is also applicable to restrictions on competition referring to conduct outside the market, as long as the criterion of "implementation" provides a connecting factor. In this case there is no need to rely on comity principles to restrict the scope of application, this restriction being implied in the criterion of "implementation" itself.

The application of competition rules to third states or international organizations reflects a change in the understanding of state behavior — third states participating in economic exchange through economic and competitive conduct cannot claim the protection of long-established doctrines of International law. This conclusion may not be beyond any doubt and may be subject to controversial discussions; absolute certainty in this respect can be attained by an ECJ ruling only. The ECJ has already started to smooth the path, leaving open the question of whether anybody will ever walk on it. Sure enough this approach still includes risks: extraterritorial application of competition law has already caused the complete opposite of harmonization in the past, when several states enacted so-called blocking statutes declaring foreign law inapplicable. Nowadays, however, daily practice proves that actions against foreign states — in particular in connection with economic activities — are no longer anything special.

Alternatives

The discussion can be shifted to another level by asking if competition law really is the right answer to restrictions on competition caused by conduct of states, or whether this issue should rather be solved by International law, e.g., within the framework of the WTO. But International law provides no powerful way of opposing OPEC, proving that "state cartels" are not generally disapproved of by International law. Obviously there is a lack of understanding between the levels of International law, European law, and domestic law. Coherence is possible in two ways: either limits are set up for the application of national and supranational law, so that the outcome is identical on all levels, or alternatively the attempt might be made to ban state cartels on the level of International law. In this context, a strengthening of WTO law represents an alternative worth keeping in mind.

Fragmentation of International Economic Law and Private Enforcement

It turns out that EU competition law is applicable to OPEC, even though its application might not be considered for political reasons. However, with private enforcement political aspects become irrelevant. In so far as individuals are entitled to certain rights, it is assumed that they will try to enforce these rights in court, on their own or with the help of public authorities. The application of the European competition rules could furthermore help progress be made on solving the problem of fragmentation of International economic law. Its application could lead to a convergence of the different systems of laws and regimes, as states are forced to agree on solutions or on a meta-system in case they want to avoid such outcomes.

Mitigating Climate Change Through Price Instruments: An Overview of the Legal Issues in a World of Unequal Carbon Prices

Roland Ismer

Introduction

Politicians all over the world have recognised[1] that anthropogenic climate change, despite the vociferous protests by a few climate sceptics, can now be taken for granted.[2] Mere adaptation to climate change most likely will not be sufficient: in particular, there is a risk that feedback loops lead to accelerated and unforeseeable changes. Moreover, the poorest regions and within them the most deprived people probably will be disproportionately affected. All this arguably means that mitigation of climate change will be the greatest challenge for the next decades.

Economists teach us that putting a price on greenhouse gas and in particular carbon dioxide emissions – all of which, for ease of exposition, are in the following simply referred to as Carbon Emissions – should play a major part in the mitigation

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*The author thanks *Karsten Neuhoff* and the participants in the Climate Strategies project "Tackling leakage in a world of unequal carbon prices" and *Gudrun Oram*. The usual caveat applies.

[1]See, e.g. the G8 summary statement, Joint declaration by the G8-Presidency and Brazil, China, India, Mexico and South Africa, 2008, downloadable under http://www.bmu.de/files/pdfs/allgemein/application/pdf/g8_toyako_declaration_energy_security_climate_change.pdf.

[2]For recent summaries of the state of research cf. the 4th Assessment Report (4AR) by the three working groups of the Intergovernmental Panel on Climate Change, Climate Change, 2006 and 2007 as well as the *Synthesis Report*, 2007; Stern, *Economics of Climate Change*, 2006.

C. Herrmann and J.P. Terhechte (eds.), *European Yearbook of International Economic Law 2010*, European Yearbook of International Economic Law,
DOI 10.1007/978-3-540-78883-6_9, © Springer-Verlag Berlin Heidelberg 2010

efforts.[3] Although recent events on financial markets may have shattered public confidence in market rationality, they should not mislead us into doubting the power of monetary incentives. On the contrary, the most straight-forward lesson from these events seems to be the awareness of the overwhelming power of such incentives. Therefore, pricing instruments – i.e. government instruments that rely on price signals to influence indirectly behaviour by economic agents – are rightly seen as a highly effective tool by much of the economics literature.

Thus, around the world, carbon pricing systems have spruced up. In 2003, the European Union has adopted an emissions trading system for Carbon Emissions. Some regions in the USA have already followed suit. The Obama administration apparently pursues plans for a nation-wide emissions trading system. Similar systems are either implemented or under consideration in Canada, South Africa, Australia, New Zealand, South Korea and Japan.[4] Moreover, taxes related to the carbon content are levied in most countries. Yet countries still vary both in the degree of importance they attach to the mitigation of climate change and in their ability to pursue that goal. Moreover, countries with a similar level of ambition may differ in the choice of instruments. An agreement on a carbon price that is both significant and uniform worldwide therefore seems unlikely. Given its adverse distributional impacts, such an agreement even appears undesirable. Much to the chagrin of some economists, for the foreseeable future, this will imply a world of unequal carbon prices and a "parallel evolution" of mitigation regimes.

Yet the legal challenges created by such a "parallel evolution" remain uncharted territory. The inscription "hic sunt leones" (here are lions), used in ancient Roman maps to describe hitherto unexplored territories, has to be evoked all too often. The present article seeks to give an overview of these legal issues. The following analysis comes in two parts: Part B first explains the rationale for using carbon pricing instruments and gives an overview of the measures employed for the electricity sector in Germany as both illustrative and representative examples. The discussion then moves on to the competitiveness and leakage issues caused by carbon price differentials as well as potential remedies to address these concerns, with preference given to border adjustments. Part C explores the details of implementing border adjustments. It shows that multilateral coordination seems warranted. Part D concludes the analysis.

[3]For a starting point see, e.g. Neuhoff, Tackling Carbon. How to Price Carbon for Climate Policy, 2008, downloadable under http://www.electricitypolicy.org.uk/TSEC/2/neuhoff230508.pdf.

[4]Tuerk et al., Linking of emissions trading schemes – Synthesis report – draft, Climate Strategies, Draft February 2009, downloadable under http://www.climatestrategies.org/our-research/category/33/126.html.

Pricing Instruments with Unequal Carbon Prices Create Competitiveness and Leakage Concerns

Pricing Instruments in a Domestic Setting

Why Use Carbon Pricing Instruments?

In a purely domestic setting, pricing instruments often are advocated on the basis of rectifying a market failure[5] through internalisation of externalities.[6] Carbon emissions cause damage to others which the emitter does not take into account when determining the quantity of her emissions. Therefore, so the argument first proposed by the British economist *Pigou*[7] goes, the polluter should pay an amount per ton of emissions that fully compensates the damage done to others. Then the externality is removed and the decision of how much to emit is no longer distorted, but brought to the socially optimal level. At first glance, such reasoning may appear appealing. Yet it can hardly withstand closer scrutiny. An analysis of the contributions in the economics literature seeking to quantify marginal damage from greenhouse gas emission reveals a very wide range of values.[8] Some contributions calculate that the marginal damage of 1 ton of CO_2 emissions exceeds US $300. Others arrive at far lower values of close to US $0. Some authors even propose slightly negative values. In other words, this latter, albeit small, group hold the view that the overall effect of greenhouse emissions is beneficial. Moreover, some fundamental questions – such as the weight attached to the welfare of future generations when making decisions today[9] and the question whether classical welfare economics as a strand of utilitarianism can provide meaningful insights into intergenerational justice issues at all[10] – are not yet satisfactorily resolved. All this means that governments do not dispose

[5]Generally on these cf. e.g. Barr, *The Economics of the Welfare State*, (4th ed.) 2004, pp. 74 ff. For the case of Carbon Emissions, the large number of emitters and the wide range of emitting activities imply that the transaction costs are too high for the market to implement a solution on its own, as proposed by Coase, The Problem of Social Cost, Journal of Law and Economics 3 (1960), p. 1 ff.

[6]For a more rigorous analytical discussion of the concept of externalities cf. e.g. Cowell, *Microeconomics*, 2006, pp. 441 ff.

[7]Pigou, *The Economics of Welfare*, (4th ed.) 1932.

[8]See, e.g. Hope/Newbery, Calculating the Social Cost of Carbon, in: Grubb/Jamasb/Pollitt (eds.), *Delivering a Low-Carbon Electricity System*, 2008, pp. 31 ff.; *Stern Review*, 2007, p. 323; Tol, The Marginal Damage Costs of Carbon Dioxide Emissions. An Assessment of the Uncertainties, Energy Policy 33 (2005), 2064.

[9]This debate was reraised by the Stern Review. For an overview cf. Hepburn, Valuing the far-off future, in: Atkinson/Dietz/Neumayer (eds.), *Handbook of Sustainable Development*, 2007, p. 109 (112).

[10]For corresponding doubts see Sen, Approaches to the choice of discount rate for social benefit–cost analysis, in: Lind (ed.), *Discounting for Time and Risk in Energy Policy*, 1982, p. 325.

of the information necessary for setting pricing instruments with a sufficient degree of precision at a level that allows internalising externalities.

Nevertheless, pricing instruments can still be used as a means of achieving a given mitigation target. Then the level of the target is not derived endogenously from internalisation of externalities. Rather, stabilisation target has to come from non-economic considerations.[11] It must be the outcome of the political process, which should be informed by scientific knowledge and ethical considerations. It has to reflect value judgments and compromises necessary to ensure its passage through the pertinent decision-making processes.

Employing pricing instruments has the advantage of creating incentives to reduce Carbon Emissions, whilst at the same time granting the choice to bear the financial burden from the pricing instrument instead. This feature proves particularly beneficial for Carbon Emissions[12] where there are a large number of emitters, where the government disposes of limited information on their respective mitigation potentials,[13] and where the emissions nevertheless can be sufficiently verified.[14]

More precisely, pricing instruments can work through two distinct channels:[15] they create incentives for efficient production and they change relative prices further down the value chain so that lower carbon products become relatively cheaper. The more obvious first channel works through establishing *incentives for more efficient production*, i.e. producing a given output with a lower level of Carbon Emissions. In this respect, the incentives are effective both in the short and in the long term. In the short term, pricing instruments make lower carbon technologies relatively cheaper. Thus, they shift the balance among existing technologies towards less carbon-intensive technologies. In the long run, incentives are created to develop new low-carbon technologies.

Second, pricing instruments *change relative prices further down the value chain*. Customers have to pay more for carbon-intensive products. Thus, they can reduce their cost by using inputs with lower carbon content. It is precisely this second channel that marks the biggest advantage of pricing instruments vis-à-vis regulatory instruments, which can only achieve production efficiency but are less effective in communicating the information down the value chain.[16]

[11] Baumol/Oates, The Use of Standards and Prices for Protection of the Environment, Swedish Journal of Economics 73 (1971) 1, p. 42.

[12] Lübbe-Wolff, Instrumente des Umweltrechts. Leistungsfähigkeit und Leistungsgrenzen, Neue Zeitschrift für Verwaltungsrecht 2001, p. 481 (487).

[13] Hepburn, Regulation by Prices, Quantities, or Both. A Review of instrument Choice, Oxford Review of Economic Policy 22 (2006) 2, p. 226 (228 f.).

[14] Weitzman, Prices vs. Quantities, Review of Economic Studies, 41 (1974) 4, p. 477.

[15] Neuhoff, Tackling Carbon, 2008, pp. 8 ff.

[16] Neuhoff, Tackling Carbon, 2008, p. 10

Overview of Pricing Instruments: The Example of the German Electricity Sector

Given the plenitude of human activities entailing Carbon Emissions, it seems warranted to move from the rather abstract and general to a more concrete example. The electricity sector lends itself particularly well to that task for two reasons. First, the sector will have to occupy centre stage in mitigation efforts. The share of primary energy consumed in the generation of electricity amounts to 40%; conversely, two thirds of world electricity is produced from fossil fuels.[17] At the same time, the sector promises significant mitigation potential.[18] Second, this sector is particularly interesting from a legal perspective, since – at least in Germany – it is covered by three main pricing instruments that seek to reduce its long-term carbon intensity: first, the European emissions trading system for greenhouse gases (EU ETS); second, an electricity tax; and finally third, feed-in tariffs for electricity from renewable sources and from combined heat and power plants that are financed through a levy on electricity consumption:

- The *EU ETS* currently is the global frontrunner for a carbon cap and trade mechanism. The mechanism, which was introduced through directive 2003/87/EC,[19] prescribes an overall cap on certain greenhouse gas emissions from large installations. For that purpose, a fixed number of allowances corresponding to 1 ton of carbon dioxide each are issued. Operators of certain installations must surrender a number of allowances equal to their emissions. The allowances are transferable and can thus be traded. A cap and trade mechanism such as this can, as shown before, achieve its aim of reducing emissions through two channels: first, those operators who can do so at the lowest cost will reduce their carbon emissions. Second, companies and consumers further down the value chain can reflect in their decisions any Carbon Emissions from the production of the goods and services further upstream. It can be shown that those two channels can only be fully achieved through full auctioning of allowances. Therefore, the European Commission was to be commended for its proposal to amend the emissions trading directive, which it presented in January 2008. The proposal sought to

[17]IPCC, 4AR WG III, p. 260. In Germany, 37% of carbon emissions can be attributed to electricity generation (excluding combined heat and power plants), BMU, *Revidierter Nationaler Allokationsplan 2008–2012*, 2007, p. 19; the corresponding figure for the USA is 40%, see Choi, Global Climate Change and the Use of Economic Approaches. The Ideal Design of Domestic Greenhouse Gas Emissions Trading with an Analysis of the European Union's CO_2 Emissions Trading Directive and the Climate Stewardship Act, Natural Resources Journal 45 (2005), p. 865 (866).

[18]IPCC, 4AR WG III, pp. 254 f.

[19]DIRECTIVE 2003/87/EC OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 13 October 2003 establishing a scheme for greenhouse gas emission allowance trading within the Community and amending Council Directive 96/61/EC, Official Journal, L 275/32.

introduce full auctioning of allowances in the medium term. Such approach seems preferable to the watered-down compromise reached in December 2008.

- In addition, an *electricity tax* is levied on electricity consumption.[20] In the EU, such taxes are (only) partially harmonised.[21] The electricity tax does not differentiate according to what emissions result from the generation. Hence, it does not seek to reduce carbon intensity. Moreover, the EU ETS foresees an overall cap on emissions by large installations, so that the electricity tax has no significant direct effect on emissions. However, the coexistence of such taxes with the EU ETS can be justified through the extra pressure they create for the reduction of electricity consumption and the ensuing incentives for innovation.
- Thirdly, a *feed-in tariff*[22] promotes electricity from renewable energy sources[23] and from combined heat and power plants.[24] For any KWh of electricity from these sources fed into the grid, the generator receives a fixed remuneration or a fixed bonus. The payments are not made by the government, but by the grid operator. The amount varies for different generation technologies. For example, electricity from photovoltaic energy receives far higher payments than electricity from wind. The law prescribes that the payments be passed on to and

[20]German Electricity Tax Act (Stromsteuergesetz) as of 24.3.1999, Bundesgesetzblatt 1999 I, p. 378, last amended by Article 2 of the law of 18 December 2006, Bundesgesetzblatt 2006 I, p. 3180.

[21]COUNCIL DIRECTIVE 2003/96/EC of 27 October 2003 restructuring the Community framework for the taxation of energy products and electricity, Official Journal, L 283/51. On the directive, see Bongartz/Schröer-Schallenberg, Ein systematischer Überblick über die beabsichtigten Änderungen auf dem Gebiet des Energiesteuerrechts, Zeitschrift für Zollrecht 2006, p. 82; Jatzke, Neue gemeinschaftsrechtliche Rahmenbedingungen für die Energiebesteuerung, Betriebsberater 2004, p. 21; Leitgeb/Pilz, Energiebesteuerung – nationale und gemeinschaftsrechtliche Umsetzung, Österreichische Steuerzeitung 2004, p. 322.

[22]Such feed-in tariffs are the most widespread in Europe for the promotion of renewables, see COM (2005) 627 final, pp. 4 f. On the different instruments for the promotion of renewables, see Coenraads/Voogt, Promotion of Renewable Electricity in the European Union, Energy & Environment 17 (2006) 6, p. 835 (839); Held/Haas/Ragwitz, On the Success of Policy Strategies for the Promotion of Electricity from Renewable Energy Sources in the EU, Energy & Environment 17 (2006) 6, p. 849. The promotion of electricity from renewables and from combined heat and power plants is, again only partially harmonised in the EU, see DIRECTIVE 2001/77/EC OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 27 September 2001 on the promotion of electricity from renewable energy sources in the internal electricity market, Official Journal L 283/33; DIRECTIVE 2004/8/EC OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 11 February 2004 on the promotion of cogeneration based on a useful heat demand in the internal energy market and amending Directive 92/42/EEC, Official Journal L 52/50.

[23]Gesetz zur Neuregelung des Rechts der Erneuerbaren Energien im Strombereich und zur Änderung damit zusammenhängender Vorschriften (Erneuerbare-Energien-Gesetz, EEG 2009), Bundesgesetzblatt 2008 I, p. 2074.

[24]Gesetz für die Erhaltung, die Modernisierung und den Ausbau der Kraft-Wärme-Kopplung, Bundesgesetzblatt 2002 I, p. 1092, last amended by Article 1 of the law of 25 Oktober 2008, Bundesgesetzblatt 2008 I, p. 2101.

ultimately borne[25] by consumers according to their electricity consumption. Except for government consumption of electricity, at no stage in the process is the public purse touched by the scheme.

Competitiveness and Leakage Concerns

The above analysis changes, however, when an international dimension is taken into consideration: Producers abroad, who are not exposed to a carbon pricing signal, can undercut domestic producers and gain market share. As a consequence, domestic producers reduce their production or relocate their plants. Domestic industry therefore will call for counter-measures. Indeed, most states grant some sort of preferential treatment to industries exposed to international competition.

From an environmental perspective, such preferential treatment threatens to undermine the environmental effectiveness of the pricing instruments. Due to the global nature of climate change, nothing is gained when emissions are shifted from one place to another. It therefore appears warranted to differentiate between two different concerns: competitiveness and leakage. The former designates the ability of domestic industry to compete on a level playing-field with producers from abroad. The latter describes the undesired impact of a mitigation policy in one country that leads to higher emissions in other countries. Technically, leakage can be defined as a ratio of the increase in emissions in other countries attributable to a mitigation policy in one country divided by the emissions reduction in the country pursuing the mitigation policy.[26] The two concerns are not identical: a policy may increase the cost of domestic production and thus reduce domestic competitiveness. If as a consequence less of the product is consumed or if more is produced abroad with a cleaner technology – say aluminium with hydro power – leakage will not be a concern.

Leakage can occur through two channels: international trade in energy goods and shift in production. First, when one country takes measures to reduce consumption of carbon intensive goods the world price of these goods will fall. At this lower price, demand in other countries will rise so that the reduction in the first country is

[25]However, there is a lively debate with respect to the incidence of the scheme, see Ragwitz/Sensfuß/Genoese, The Merit-order Effect: A Detailed Analysis of the Price Effect of Renewable Electricity Generation on Spot Market Prices in Germany, Energy Policy 2008, p. 3086; Wissen/Nicolosi, Ist der Merit-Order-Effekt der erneuerbaren Energien richtig bewertet? Energiewirtschaftliche Tagesfragen 2008/1/2, p. 110.

[26]IPCC, *Climate Change 2001 – Working Group III: Mitigation*, 2001, p. 11, fn. 22: Leakage is "the increase in non-Annex [I] emissions divided by the reduction in Annex [I] emissions". For a similar definition specifically in the context of environmental taxes see Barker et al., Carbon leakage from unilateral environmental tax reforms in Europe, 1995–2005, Energy Policy 35 (2007) 12, p. 6281. A different understanding is proposed by Peters/Hertwich, CO_2 embodied in international trade with implications for global climate policy, Environmental Science and Technology 42 (2008) 5, p. 1401 (1402 f.).

partially offset. This channel – the importance of which depends on the elasticities of supply and demand for energy intensive goods[27] – appears undesirable, but inevitable. Second, as carbon prices rise in only one country, production is shifted to other locations either through decreases and increases in the production of existing plants or through permanent closure and relocation of plants. This channel is the cause of most concern in the political debate.[28] Finally, leakage is reduced through a third channel, namely technology diffusion. When pricing instruments induce the development of new technologies, these technologies can be applied in other countries as well and thus reduce emissions even more.[29] Evidence from economic research conducted with respect to the so-called pollution haven hypothesis nevertheless suggests that the leakage problem can be real.[30]

However, recent economic research has shown that only a few sectors face a significant risk of leakage.[31] In their seminal paper, *Hourcade*, *Demailly*, *Neuhoff* and *Sato* examine 159 industry sectors for the United Kingdom. They initially look at the ratio of additional cost from EU emissions trading at an allowance price of 20 € per ton of CO_2 to value added. From that ratio, they identify the sectors with a significant ratio. Those sectors represent only 1.1% of gross domestic product and 0.5% of employment. The steel and the cement sectors are particularly exposed. For Germany, similar figures are obtained by *Graichen et al*.[32] And even for those sectors, the figures cannot necessarily be interpreted as evidence of leakage. For

[27]Gerlagh/Kuik, Carbon Leakage with International Technology Spillovers, 2007, downloadable under http://www.feem.it/NR/rdonlyres/DA90131F-7766-4698-9934-7FFE44FA8239/2298/3307.pdf, p. 7 with further references.

[28]The importance of this effect again depends on the degree to which consumers consider foreign and domestic products as substitutes. A measure for this is the so-called Armington elasticity, proposed by *Armington*, A Theory of Demand for Products Distinguished by Place of Production, International Monetary Fund Staff Papers, XVI (1969), p. 159.

[29]Di Maria/van der Werf, Carbon Leakage Revisited: Unilateral Climate Policy with Directed Technical Change, Environmental and Resource Economics 39 (2008) 2, p. 55; Gerlagh/Kuik, Carbon Leakage with International Technology Spillovers, 2007; Grubb et al., The Economics of Changing Course – Implications of Adaptability and Inertia for Optimal Climate Policy, Energy Policy 23 (1995) 4/5, p. 417; *Grubb*, Journal of Economic Studies 27 (2000) 1/2, p. 111; Grubb et al., Climate Implications of the Kyoto Protocol: the Contribution of International Spillover, Climatic Change 54 (2002), 11.

[30]This research builds on previous, more general work undertaken with respect to so-called pollution havens, see, e.g. Brunnermeier/Levinson, Examining the Evidence on Environmental Regulations and Industry Location, The Journal of Environment Development 13 (2004) 1, 6; Copeland/Taylor, Trade, Growth, and the Environment, Journal of Economic Literature, 42 (2004) 1, 7; Levinson/Taylor, Unmasking the Pollution Haven Effect, International Economic Review 49 (2008) 1, 223; Porter/van der Linden, Toward a New Conception of the Environment Competitiveness Relationship, Journal of Economic Perspectives 9 (1995) 4, 97.

[31]Hourcade et al., Differentiation and dynamics of EU ETS industrial competitiveness impacts, 2008, downloadable under www.climatestrategies.org/our-research/category/17/37.html; Graichen et al., Impacts of the EU Emissions Trading Scheme on the industrial competitiveness in Germany, 2008, downloadable under http://www.umweltdaten.de/publikationen/fpdf-l/3625.pdf.

[32]Graichen et al., Impacts of the EU Emissions Trading Scheme on the industrial competitiveness in Germany, 2008, pp. 8 ff., in particular p. 12.

transportation costs – which can be particularly high in the case of the cement sector – need to be taken into account.[33] All this implies that a targeted approach seems warranted to address competitiveness and leakage concerns.

Instruments Addressing Competitiveness and Leakage Concerns

What instruments are available to address competitiveness and leakage concerns? In practice, three instruments have received most attention: exemptions, e.g. in the form of free allocation of allowances under an emissions trading scheme; sectoral approaches and finally border adjustment schemes. In the following, these instruments and the main concerns with respect to these instruments will be introduced. It will be argued that border adjustments appear as the most appropriate instrument.

Unilateral Exemptions: Compromised Integrity and Questionable WTO Compatibility

(a) Currently, in Germany and apparently in most other countries, all pricing instruments seek to protect the competitiveness of domestic industry by granting large emitters/users privileges that go beyond the interim period required for the protection of legitimate expectations. Under the EU ETS, emitters still receive the lion's share of allowances at no cost. Although from 2013 onwards free allocation is to be scaled down, companies exposed to international competition will still receive most allowances for free. Similarly, for the electricity tax and for the charges from feed-in tariffs, reduced rates apply for large users.

Such rules appear questionable: their practical application gives rise to a significant number of legal disputes. Further, and more importantly, they achieve their aim of protecting domestic producers only by compromising the environmental integrity.[34] They eliminate the demand channel, i.e. they fail to use the full set of incentives to lower Carbon Emissions.

(b) In addition to compromising the environmental integrity, these instruments are questionable from a world trade law perspective. Although there is no directly pertinent case law, a violation of the obligations under the Subsidies and Countervailing Measures (SCM) Agreement seems conceivable:[35]

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[33]Hourcade et al., Differentiation and dynamics of EU ETS industrial competitiveness impacts, 2008, pp. 61 f. who also discuss further factors explaining the observed heterogeneity in cement prices around the world.

[34]Grubb/Neuhoff, Allocation and Competitiveness in the EU Emissions Trading Scheme: Policy Overview, Climate Policy 6 (2006) 1, p. 7 for the distortions from free allocation of allowances.

[35]The author wishes to thank *Sadeq Bigdeli* who initially drew the author's attention to the problem. On a related point see Bigdeli, Will the "Friends of Climate" Emerge in the WTO? The Prospects of Applying the "Fisheries Subsidies" Model to Energy Subsidies, Carbon and Climate Law Review 2 (2008) 1, p. 78.

(aa) The exemptions can be considered as subsidies in the sense of Article 1 of the SCM Agreement. Under Article 1.1 of that Agreement, a subsidy requires a *financial contribution* by a government. Such financial contribution can also lie in the fact that government revenue that is otherwise due is foregone or not collected. Fiscal incentives such as tax credits explicitly are given as examples. Similar to the case law by the European Court of Justice in the field of direct taxation,[36] the WTO dispute settlement bodies habitually emphasise the sovereignty of Members with respect to taxation but stress that such sovereignty must be exercised in accordance with the requirements imposed by the SCM Agreement.[37] Therefore, a careful analysis of the tax system is necessary to determine whether the revenue would be "otherwise due". The requirement can be understood as demanding a minimum of coherence[38] which has to be defined relative to a normative benchmark.[39] The Appellate Body put it as follows: "panels must obviously ensure that they identify and examine fiscal situations which it is *legitimate to compare*. In other words, there must be a rational basis for comparing the fiscal treatment of the income subject to the contested measure and the fiscal treatment of certain other income".[40] This requires a comprehensive analysis of the pertinent tax legislation in force in the respective Member.[41]

For the exemptions from the electricity tax, such analysis reveals that two types can be distinguished: the first concerns the exemption for electricity used for chemical reductions. The electricity tax is designed to tax the use of electricity for heat and power purposes only. The exemption fits into a coherent design of the tax base as such and should thus be in conformity with WTO rules. In contrast, special rules reducing the tax rate for industry in general constitute a preferential treatment and thus a financial contribution by the government.

In a similar vein, free allocation of allowances under an emissions trading system can be a financial contribution by the government. Through free allocation, industry does not receive funds, goods or services. Thus, again, the normative benchmark becomes decisive. Then, the limitations to large emitters and to certain greenhouse gases cannot be seen as a financial contribution. The same would hold true if all allowances were distributed at no cost. In contrast, a free distribution of allowances merely to those installations that are subject to international

[36]On this see Cordewener, *Europäische Grundfreiheiten und nationales Steuerrecht*, 2002, in particular pp. 25 ff.

[37]Appellate Body, WT/DS108/AB/R – *United States – Tax Treatment for "Foreign Sales Corporations"*, paras. 90 and 98.

[38]Panel, WT/DS 108/RW – *United States – FSC (21.5)*, paras. 8.25–8.26; Appellate Body WT/DS 108/RW – *United States – FSC (21.5)*, paras. 98–106.

[39]Appellate Body, WT/DS108/AB/R – *United States – Tax Treatment for "Foreign Sales Corporations"*, para. 88; WTO Analytical Index, 2nd ed. 2007, Art. 1 SCMA para. 18.

[40]Appellate Body, WT/DS108/RW – *United States – FSC (21.5)*, para. 90. Italics added by the author.

[41]For a discussion of questions relating to Benchmarking cf. Wagner, *Direkte Steuern und Welthandelsrecht*, 2006, pp. 110 ff.

competition constitutes an exception to the general rule that allowances are distributed for a consideration. It therefore has to be qualified as foregoing revenue otherwise due and thus as a financial contribution.

In contrast, the reductions of equalisation payments from the feed-in tariffs are not to be measured against the yardstick of Article 1.1 (a) (1) (i)–(iii) SCM, but against the anti-circumvention provision of Article 1.1 (a) (1) (iv) SCM.[42] The government does not make payments to a funding mechanism.[43] Hence, the question becomes prevalent whether the government entrusts or directs a private body to carry out one or more of the type of functions illustrated in (i)–(iii) which would normally be vested in the government and whether the practice, in no real sense, differs from practices normally followed by governments. The connection to the government can easily be established through the explicit provision in the laws setting up the feed-in tariffs, allowing but a reduced passing on of charges to large electricity consumers. At first glance, it may appear daring to capture the reduction of payment obligations to third parties under Article 1.1 (a) (1) (iv) SCM ("to carry out . . . functions"). However, closer scrutiny reveals that the provision also refers to Article 1.1 (a) (1) (ii) SCM and thus to the foregoing of "government revenue that is otherwise due". Moreover, the function also would normally be vested in the government, since the promotion of electricity from renewable energy and from combined heat and power explicitly serves the public interest.[44] In contrast to what the European Court of Justice decided on the state aid provisions of the EC Treaty,[45] the reduction of payments under the feed-in tariffs can be qualified as financial contributions for purposes of the SCM Agreement.[46]

(bb) Through the financial contributions, a *benefit* is conferred upon the producers that directly enjoy the tax reductions, the free allocation and the reduced equalisation payments under the feed-in tariff schemes. In contrast, it would appear difficult to argue that a benefit were conferred to economic agents further down the value chain. Although in theory a financial contribution to producers further up the value chain might confer a benefit to agents down the value chain when the advantage is passed on from the former to the latter,[47] such proof would be hard to establish given that the financial contribution only seeks to level the playing field between domestic and foreign producers further up the value chain.

(cc) For most of the constellations discussed here, the applicability of the SCM Agreement arguably is not ruled out for lack of *specificity* as required by Article 1.2 of

[42]On this Adamantopoulos, in: Wolfrum/Stoll/Koebele (eds.), *WTO – Trade Remedies*, 2008, Art. 1 SCMA para. 63.

[43]Adamantopoulos, in: Wolfrum/Stoll/Koebele (eds.), WTO – *Trade Remedies*, 2008, Art. 1 SCMA para. 67, according to whom a mere omissal is not sufficient.

[44]Adamantopoulos, in: Wolfrum/Stoll/Koebele (eds.), *WTO – Trade Remedies*, 2008, Art. 1 SCMA para. 83.

[45]ECJ, C-379/98, *PreussenElektra*, [2001] ECR I, 2099, para. 54.

[46]Different view held by Oschmann, in Altrock/Oschmann/Theobald (eds.), *Erneuerbare Energien Gesetz –Kommentar*, (2nd ed.) 2008, Einleitung paras. 100 ff.

[47]Appellate Body, WT/DS257/AB/R, *United States – Softwood Lumber IV*, adopted on 17.2.2004.

that Agreement. The preferential treatment in question is not limited to certain enterprises located within a designated geographical region within the jurisdiction of the granting authority in the sense of Article 2.2 of the SCM Agreement. Neither does it constitute a prohibited subsidy falling under the provisions of Articles 2.3 and 3 of the SCM Agreement which would be deemed specific.[48] Therefore, specificity has to be assessed against the yardstick of Article 2.1 of the SCM Agreement.

Its chapeau requires that the subsidy be granted to certain enterprises, i.e. an enterprise or industry or group of enterprises or industries. Currently, it appears not entirely clear how large the set of enterprises can be so that it still constitutes an industry. Rather, the dispute settlement bodies have adopted a case-by-case approach.[49] The term industry is to be defined according to the manufactured product or products.[50] For these, a large number of specific end-products does not hinder the assumption of an industry,[51] as long as the products are sufficiently similar.[52]

Subsidies to these recipients are specific if they are either *de jure* specific under Article 2.1 (a) SCM, because access to such subsidies is explicitly limited to certain enterprises, or at least *de facto* specific under Article 2.1 (c) SCM, because there are reasons to believe that the subsidies may in fact be specific. In contrast, subsidies on the basis of the objective criteria laid out in Article 2.1 (b) SCM are not specific. The footnote to this Article is quite restrictive and demands that the subsidy not favour certain enterprises over others. Exemptions granted to all enterprises based on their electricity consumption would not be specific. In contrast, the proposed rules for free allocation contained in the abridged emissions trading directive[53] would be specific since only those enterprises benefit that are subject to international competition. Beyond that, it appears not entirely clear whether the exemptions from the electricity tax and from the charges under the renewables and CHP promotion schemes would be *de jure* specific: one could consider transferring the rather generous case law of the European Court of Justice. Such transfer would be supported by footnote 2 that purports to clarify Art. 2.1 (b) SCM. Then they would be *de jure* selective, since they are only granted to enterprises from the manufacturing sector, while service providers in particular are excluded. In the context of state aid provisions of the EC Treaty, the European Court of Justice has considered that to be sufficient for specificity.[54]

[48]Ohlhoff, Verbotene Beihilfen nach dem Subventionsabkommen der WTO im Lichte aktueller Rechtsprechung, EuZW 2000, p. 645 (648 ff.).

[49]Evtimov, in: Wolfrum/Stoll/Koebele (eds.), *WTO – Trade Remedies*, 2008, Art. 2 para. 14.

[50]WT/DS257/R, para. 7.120; WT/DS267/R, paras. 7.1140–1142- US – *Upland Cotton*.

[51]WT/DS257/R, para. 7.120; WT/DS267/R, paras. 7.1140–1142- US – *Upland Cotton*.

[52]WT/DS257/R, para. 7.120; WT/DS267/R, paras. 7.1140–1142- US – *Upland Cotton*.

[53]Evtimov, in: Wolfrum/Stoll/Koebele (eds.), *WTO – Trade Remedies*, 2008, Art. 2 para. 18.

[54]ECJ, C-143/99, *Adria-Wien Pipeline GmbH*, [2001] ECR I, 8384, para. 40. However, given that under the EU State aid rules, a justification is possible, while this arguably is not the case for the SCM, it cannot be excluded that the WTO dispute settlement body will construe the specificity criterion under the SCM more narrowly.

(dd) As a consequence, where the specific subsidies result in injury to its[55] domestic industry, nullification or impairment or serious prejudice, another WTO Member could take the multilateral approach and, after failed consultations, refer the matter to the dispute settlement bodies. Alternatively, it can impose countervailing duties unilaterally.[56]

Sectoral Approaches

Sectoral approaches[57] are often portrayed as a better remedy than unilateral exemptions. They aim at levelling the playing field for all producers in a particular sector by making them subject to the same rules. Therefore, they seek to create global rules. Two forms can be distinguished: Voluntary agreements bring together producers on a voluntary basis. Since governments are not involved in such agreements, they are non-binding and enforceable only in the court of public opinion. In contrast, government-led sectoral agreements are concluded with the participation of governments or international organisations, which enforce them in case of violation.

Voluntary approaches suffer from the fact that they are not incentive compatible: participation in those agreements is by definition voluntary. Individual firms, however, would be better off without such scheme. While in theory it would be feasible that such agreement provided for technology transfer and for some kind of privileges for industry located in developing countries, in practice this appears hardly likely. For this would imply that industry promoted competition from its direct competitors in developing countries.

In contrast, government-led sectoral agreements seem more promising. Participation by developing countries becomes more likely when revenue is raised

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[55]WT/DS54/R, WT/DS55/R, WT/DS59/R, WT/DS64/R, *Indonesia – Autos*, para.14.202.

[56]For more details see Durling, in: Wolfrum/Stoll/Koebele (eds.), *WTO – Trade Remedies*, 2008, Art. 5 SCMA para. 8.

[57]Baron, Sectoral Approaches to GHG Mitigation: Scenarios for Integration, OECD/IEA Information Paper, 2006, downloadable under http://www.iea.org/textbase/work/2006/cop12/ghg.pdf; Baron et al., Sectoral Approaches to Greenhouse Gas Mitigation – Exploring Issues for Heavy Industry, IEA Information Paper, 2007, downloadable under http://www.iea.org/textbase/papers/2007/Sectoral_Approach_Info_WEB.pdf; Bodansky, International Sectoral Agreements in a Post 2012-Climate Framework, PEW Working Paper, 2007, downloadable under http://www. pew-climate.org/docUploads/International%20Sectoral%20Aggreements%20in%20a%20Post-2012%20Climate%20Framework.pdf; Egenhofer/Fujiwara, *Global Sectoral Industry Approaches to Climate Change – The Way Forward*, 2008; Ellis/Baron, Sectoral Crediting Mechanisms: An Initial Assessment of Electricity and Aluminium, OECD/IEA Working Paper, 2005, downloadable under http://www.iea.org/textbase/papers/2005/rb_sectoral.pdf2005; Kulovesi/Keinänen, Long-term Climate Policy: International Legal Aspects of Sector-based Approaches, Climate Policy 6:3 (2006), 313; Philibert/Pershing, Considering the Options: Climate Targets for All Countries, Climate Policy 1 (2001), 211; Philibert/Reinaud, Emissions Trading: Taking Stock and Looking Forward, OECD/IEA Information Paper, 2004, downloadable under http://www.oecd.org/dataoecd/58/59/32140134.pdf, pp. 38 f.

that can be shared among them. To increase further the incentives for governments to participate, the agreements ought to be supplemented by mechanisms such as border adjustments, which will be discussed shortly, or CFC type legislation as is used in international tax law.[58] They appear particularly appealing for sectors such as the aluminium industry where relatively few players divide up the market among themselves. Moreover, they may be pursued where for legal or factual reasons a purely domestic regulation cannot be adopted. Arguably, a case in point would be shipping where the Kyoto Protocol provides for an international agreement under the auspices of the IMO; however, it remains to be seen whether the organisation will be able to deliver. If it did not come up with a satisfactory proposal, more consideration should be given to unilateral implementation as was done recently by the EU that chose to include the airline industry in the scope of the EU ETS.

Yet it should also be noted that such government agreements create the danger of a fragmented carbon market. By some yardstick or another, the reduction potentials of the respective sectors need to be evaluated. Each sector will have its own agreement with a corresponding reduction obligation and, where a pricing instrument is contained in such agreement, its own carbon price. Then the efficiency gains that result from an economy-wide carbon pricing scheme are lost.

Border Adjustments

Just as the exemptions discussed above, border adjustments can be applied unilaterally. In line with the classic 1970 report by the GATT Working Group on the matter, border tax adjustments can be defined "as any fiscal measures which put into effect, in whole or in part, the destination principle (i.e. which enable exported products to be relieved of some or all of the tax charged in the exporting country in respect of similar domestic products sold to consumers on the home market and which enable imported products sold to consumers to be charged with some or all of the tax charged in the importing country in respect of similar domestic products)".[59] The principle of border adjustment is that a charge is imposed on imported products into the country that is equal to the charges payable when producing in that country. In addition, exporters from that country may get a refund on the CO_2 charges they incurred during production in the country.

As an alternative to the money-based adjustment, it has been proposed for emissions trading to make the adjustment in the form of an obligation to surrender allowances.[60] The systems could also be combined so that the importer, say with

[58]Under the CFC legislation, income from corporate entities in low tax-legislations are directly attributed to the controlling shareholders. An actual distribution by the corporation is not necessary. For more details see, e.g. Lang et al. (eds.), *CFC Legislation – Domestic Provisions, Tax Treaties and EC Law*, 2004; Rust, *Die Hinzurechnungsbesteuerung,* 2007.

[59]Border Tax Adjustments, Report of the Working Party adopted on 2 December 1970, para. 4.

[60]Wiers, French Ideas on Climate and Trade Policies, Carbon and Climate Law Review 2 (2008) 1, p. 18 (30).

imports below some specified threshold, could be given the choice whether to surrender the allowances or to make the payment. Then the importers would be spared the expenses of setting up and operating a trading account for the allowances as well as of following the carbon market.

Border adjustments are subject to a rather controversial debate.[61] Generally, five different motivations are advanced in favour of border adjustments:[62]

1. Provide assurance to voters that measures are pursued to address competitiveness concerns during the implementation of carbon pricing
2. Avoid relocation of production of carbon intensive commodities to areas not covered by the domestic emissions trading and thus preserve environmental integrity
3. Facilitate a move from free allowance allocation to auctioning of allowances to ensure full carbon price signal also for production with leakage concerns
4. Provide incentives for other countries to pursue more ambitious climate policy or even join an international agreement on climate policy
5. Provide incentives for producers in countries not covered by carbon pricing to improve the efficiency of their production

[61]On this topic cf. e.g. Biermann/Brohm, Implementing the Kyoto Protocol without the United States: The Strategic Role of Energy Tax Adjustments at the Border, Climate Policy 4 (2005), p. 289; De Cendra, Can Emissions Trading Schemes Be Coupled with Border Tax Adjustments? An Analysis vis-à-vis WTO Law, Review of European Community and International Environmental Law 15 (2006) 2, p. 131; Genasci, Border Tax Adjustments and International Emissions Trading: The Implications of International Trade Law for Policy Design, Carbon and Climate Law Review 2 (2008) 1, p. 33; Goh, The World Trade Organization, Kyoto and Energy Tax Adjustments at the Border, Journal of World Trade 38 (2004) 3, p. 395; Ismer/Neuhoff, Border Tax Adjustment. A Feasible Way to Support Stringent Emission Trading, European Journal of Law and Economics 24 (2007), p. 137; Pauwelyn, US Federal Climate Policy and Competitiveness Concerns, 2007; Sindico, Climate Taxes and the WTO: Is the Multilateral Trade Regime a further Obstacle for Efficient Domestic Climate Policies? EcoLomic Policy and Law, 3 (2006) 8, p. 1; Syunkova, WTO – Compatibility of Four Categories of US Climate Change Policy, 2007, downloadable under http://www.nftc.org/default/trade/WTO/Climate%20Change%20Paper.pdf, pp. 22 ff.; Wiers, Carbon and Climate Law Review 2 (2008) 1, p. 18; Zhang, Greenhouse Gas Emissions Trading and the World Trading System, Journal of World Trade 32 (1998) 5, p. 219. On border adjustments for carbon taxes Demaret/Stewardson, Border Tax Adjustments under GATT and EC Law and General Implications for Environmental Taxes, Journal of World Trade 28 (1994) 4, p. 5; Düerkopf, Trade and Environment: International Trade Law Aspects of the Proposed EC Directive Introducing a Tax on Carbon Dioxide Emissions and Energy, GATT/WTO Rules for Border Tax Adjustment and the Proposed European Directive Introducing a Tax on Carbon Dioxide Emissions and Energy, Common Market Law Review (1994), p. 807; Petersmann, International Trade Law and International Environmental Law, in: Revesz/Sands/Stewart (eds.), *Environmental Law, the Economy and Sustainable Development*, 2000, p. 127; Pitschas, Georgia Journal of International and Comparative Law 24 (1994), p. 479. Generally on border tax adjustments Hufbauer, *Fundamental Tax Reform and Border Tax Adjustments*, 1996.

[62]Neuhoff/Ismer, International cooperation to limit the use of border adjustments, 2008, downloadable under http://www.econ.cam.ac.uk/eprg/TSEC/2/BA%20Workshop%20Report_Nov%206%202008.pdf, p. 3.

From a mitigation of climate change perspective, the second and the third point appear the most valid. Border adjustments avoid the drawback of reduced environmental integrity and of imperfect price signals motivated by leakage concerns. Or in other, quite optimistic words, "the discussion of border adjustment has moved away from the idea of a 'stick' to force other countries, towards a sector-specific policy instrument and now aims to create domestic incentives for low-carbon investment, production and consumption choices".[63] While economists are therefore quite favourably inclined towards border adjustments, the WTO compatibility of such measures is frequently called into question. The answer to those challenges cannot be given in the abstract, but requires an analysis of the precise options for implementation. We will take a closer look at this in the following part.

Implementing Border Adjustments

Unilateral Implementation Feasible

Despite the aforementioned doubts, in my view, a unilateral implementation of border adjustments can be in compliance with world trade law. This requires that such measures constitute neither illegal discriminations nor prohibited subsidies. For imports, both the national treatment under Article III GATT and the most favoured nation treatment under Article I GATT must be granted or an exception under Article XX GATT must apply. For exports, the requirements of the Agreement on Subsidies and Countervailing Measures (in the following referred to as SCM) have to be met. Since, legally, the criteria need not necessarily be the same, refunds for exports and taxes on imports will be analysed separately. Nevertheless, we will interpret to the extent possible the requirements for exports in line with the requirements for imports.

Imports

(a) *Article III:2 first sentence GATT* prescribes national treatment for like products. It stipulates that "products of the territory of any contracting party imported into the territory of any other contracting party shall not be subject, directly or indirectly, to internal taxes or other internal charges of any kind in excess of those applied, directly or indirectly, to like domestic products".

Hence, the first hurdle to be surmounted is that the pricing instruments and the corresponding obligations must constitute a *tax or similar internal charge*. While this is immediately obvious for the electricity tax, allowances under an emissions trading scheme only qualify insofar as they imply a payment to the state.[64] This is the case if and to the extent the allowances are auctioned or otherwise sold.

[63]Neuhoff/Ismer, International cooperation to limit the use of border adjustments, 2008, p. 5.
[64]Ismer/Neuhoff, European Journal of Law and Economics 24 (2007), p. 137.

Admittedly, one might doubt whether the obligation to surrender allowances really can be likened to an internal charge: allowances are tradable and the payment to the state to acquire them thus may have been made by an entity other than the one surrendering the allowances. However, there are other instances in which the qualification as a charge is not called into question by such tradability. For example, even though court fee stamps are tradable, court fees would still be seen as involving a payment to the state. In contrast, payments by electricity consumers under the schemes to promote renewable and combined heat and power plants do not qualify as taxes or similar internal charge. For under both schemes, the payments are not made to the government.

Second, the adjustment must not go beyond the level for *like domestic products*. Two options are available to set the level of adjustments: best available technology and average technology with possibility of refutation. When adjustments are made at the level of best available technology, the charges borne by any like domestic product will not be exceeded, irrespective of how likeness is defined. Such adjustment level would have the advantages of both demonstrating that the underlying aim was not protectionist and of avoiding extraterritorial verification constraints. If, in contrast, border adjustments are applied at a rate higher than the level of best available technology the question of how exactly like products are defined under WTO law becomes pertinent. This is so, even when the importer is given the right to demonstrate that actual emissions were lower, an approach based on the Superfund case.[65] Despite some dissent in the scholarly literature, WTO case law assesses likeness taking into account physical properties, the product's properties, nature and quality, its end-uses in a given market, consumers' tastes and habits, as well as the tariff classification of the product.[66] Production processes that do not change the physical properties, etc., of the product are considered to be irrelevant. The question whether Carbon Emissions resulting from such production can be taken into account is not yet fully resolved.

Where the adjustment is applied at the level of best available technology, the question arises whether adjustments may be made for electricity consumed in the course of production. For electricity can be generated from renewable sources. This leads to virtually zero Carbon Emissions. Thus, an adjustment at the level of best available technology would imply an adjustment of zero. In case an adjustment for emissions from electricity is desired, a combination of adjustments at the best available technology level in order to determine the quantity of electricity consumed would be adequate whereas the emissions per unit of electricity would have to be evaluated at some refutable average level.

[65] Panel, BISD 34S/136 – *United States – Taxes on Petroleum and Certain Imported Substances* ("Superfund"), adopted 17 June 1987.

[66] Appellate Body, WT/DS8/AB/R, WT/DS10/AB/R, WT/DS11/AB/R – *Japan – Taxes on Alcoholic Beverages*, adopted 1 Nov. 1996, p. 20.

(b) In contrast, there should be fewer problems with respect to *Article III:2, second sentence GATT*.[67] The provision extends the requirement of national treatment to directly competitive domestic products. In conjunction with Article III:1 GATT and the Note Ad Article III, it demands that imports not be taxed dissimilarly from directly competitive or substitutable domestic products in such a way as to protect domestic production. A violation of the provision would require that the border adjustments would be applied so as to afford protection which could be safely prevented through proper design of the measure.

(c) Under Article I:1 GATT, Members have to grant *most favoured nation treatment* to foreign products. They must accord any advantage granted to any product from 1717one Member with respect to customs duties and charges of any kind imposed on or in connection with importation or exportation to the like product originating in or destined for the territories of all other contracting parties. A general border adjustment applied to all imports would be in compliance with the clause. In contrast, there is a certain tension between the most favoured nation treatment and any differentiation according to the carbon policy pursued by the country where the product originates.[68] Such distinctions would constitute a breach of the most favoured nation clause, implying the need for the exemption of Article XX GATT to apply.

(d) In case of a breach of the national treatment clause or the most favoured nation treatment clause, the *exemptions* of Article XX GATT could be invoked. The body of case law on world trade construes a two-tier structure of justification under the article.[69] First, the requirements of any of the eight headings, of which Article XX (b) and (g) GATT appear pertinent, have to be fulfilled. Given the recent developments in WTO case law,[70] this can be achieved. Second, the chapeau basically demands that the measures must not be applied in a discriminatory manner and that it must be applied in a *bona fide* manner.[71]

It is sometimes proposed that in order to comply with that requirement, a distinction needs to be made with respect to countries that have undertaken mitigation obligations under an international agreement and those that have not, even where the former pursue their reduction aims through a regulatory approach. However, this does not appear entirely convincing since under a carbon pricing regime with allowance auctioning, additional costs are borne by producers compared to a purely regulatory approach. In any event, international coordination of

[67]Ismer/Neuhoff, European Journal of Law and Economics 24 (2007), p. 137.

[68]Wiers, Carbon and Climate Law Review 2 (2008) 1, p. 18 (21 ff.).

[69]Appellate Body, WT/DS2/AB/R – *United States – Standards for Reformulated and Conventional Gasoline*, adopted 20 May 1996, p. 21; Appellate Body, WT/DS58/AB/R – *United States – Import Prohibition of Certain Shrimp and Shrimp Products*, adopted 6 November 1998.

[70]Appellate Body, WT/DS332/AB/R – *Brazil – Retreaded Tyres*, adopted 17 December 2007, para. 159.

[71]Quick/Lau, Environmentally motivated tax distinctions and WTO law – The European commission's green paper on integrated product policy in light of "Like Product" and "PPM"-debates, Journal of International Economic Law 6 (2003) 2, p. 419 (440 ff.).

border adjustments seems warranted, not least with a view to increasing the likelihood of successfully invoking the exemptions. Moreover, such distinctions could only work were they applied identically by all countries that have undertaken the obligation. Otherwise, the products could be channelled through those countries with the least restrictive border adjustments.[72]

Exports

Any refund for exports must comply with the requirements imposed by GATT and the Agreement on Subsidies and Countervailing Measures. The latter extends the range of adjustable prior-stage cumulative taxes under GATT. Annex I to the agreement contains an illustrative list of prohibited export subsidies. Litera (h) allows a region to remit taxes in respect of prior stages of cumulative taxes on inputs that are consumed in the production of the exported product, making normal allowances for waste. Since the list is illustrative, it should extend to other similar duties such as auctioned carbon allowances. Carbon allowances can also be understood as creating a cumulative duty since there is no remit for prior-stage charges.[73] Moreover, Carbon Emissions are directly related to the emissions from the consumption of fuel inputs and are therefore captured by the provision. For footnote 61 to Annex II specifies inputs consumed not only as inputs physically incorporated, but also as energy, fuels and oils used in the production process and catalysts which are consumed in the course of their use to obtain the exported product.

Practicality requirements imply that the adjustment should be fixed at a level that is independent of actual emissions. To avoid over-compensation, again a best available technology approach would appear feasible. Finally, it should be noted that it appears hard to construe the possibility of an invocation of the exemption provision.

Multilateral Approach Preferable

However, even though a unilateral approach appears feasible, a multilateral approach appears preferable. International cooperation on border adjustment can and should seek to (1) limit their use to a narrowly defined set of products and protect developing countries from discriminating approaches, (2) create confidence that leakage concerns are addressed where countries want to move from free allowance allocation to full auctioning or carbon taxation to ensure effective carbon

[72]Ismer/Neuhoff, European Journal of Law and Economics 24 (2007), p. 137 (152).

[73]Ismer, Klimaschutz als Rechtsproblem, forthcoming. Doubts are expressed by Fauchald, *Environmental Taxes and Trade Discrimination*, 1998, pp. 188 ff.; Genasci, Carbon and Climate Law Review 2 (2008) 1, p. 33 (36).

pricing, and (3) ensure simple and harmonised approaches to avoid the creation of new no-tariff trade barriers.

In particular, international coordination could provide guidance, restrictions or requirements on the following topics: a sufficiently flexible international process might provide a list of commodities/products for which border adjustment is possible. If border adjustments are pursued at the level of best available technology, the international process and body of experts might provide guidance for this level for the relevant commodities. It could be discussed whether border adjustments are pursued for imports, for both imports and exports, and whether to account for both direct and indirect emissions. International coordination could harmonise the procedures of border adjustment applied by countries (similar to work undertaken by the OECD). A formal coordination could involve an international agreement, or could be pursued using a WTO or UNFCCC framework. In either case the coordination could involve an *ex-ante* approval process for countries that aim to pursue border adjustments, or provide an *ex-post* dispute settlement process to ensure the domestic implementation is in line with the objectives formulated in the international coordination. Informal coordination could possibly consist of guidelines agreed on in an informal international consultation process. In contrast, it might be preferable, and indeed necessary, to allow individual states to decide whether they want financial border adjustments or allowance-based adjustment.

The Way Forward

Both from an economic and from a legal perspective, border adjustments seem warranted to address leakage concerns in some specific sectors. Currently, the biggest drawback could be their potentially adverse impacts on international climate cooperation. Therefore, even though such adjustments can be made unilaterally, the article purported to show that a multilateral approach appears preferable. While the exact modalities still have to be sorted out, it seems clear that such coordination should serve the double purpose of both facilitating and limiting the use of border adjustments. Then leakage concerns can be addressed and more stringent pricing instruments can be applied while the gains from free trade are not overly threatened.

Part II
Regional Integration

Regional Trade Agreements in the World Trade Order

Richard Senti

A total of 178 Regional Trade Agreements (RTAs) is registered with the World Trade Organization (WTO)[1] at present. *Pascal Lamy*, Director-General of the WTO, expects this number to rise to 400 notified RTAs within the next two to three years.[2] Most actively pursued are regional integration initiatives in Europe, the Middle-East and Northern Africa (MENA), North and Central America, Southeast Asia, China, Japan and South Korea. Latin America, Central and Southern Africa and the former Soviet Union have signed only a very small number of RTAs.

The integration agreements have developed over time essentially within four phases. A first move towards integration occurred in Europe in the 1950s and 1960s, on the one hand to foster peace and political stability between the former wartime enemies, and on the other hand to overcome the economic problems of the post-war period. The European Economic Community (EEC) and the European Free Trade Association (EFTA) date back to these years, as does their expansion to other European and Mediterranean-bordering countries. A second wave of free trade agreements followed after the failure of the 1982 Ministerial Conference of the General Agreement on Tariffs and Trade (GATT) in Geneva. As a reaction to the refusal of the US proposal for a new trade round under the GATT, the United States turned purposefully towards regional trade agreements. The results of this realignment were the Caribbean Basin Initiative (1984), the USA–Israel Agreement (1985)

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[1] http://rtais.wto.org/UI/PublicMaintainRTAHome.aspx.

[2] Lamy, Regional Agreements, Lecture in Bangalore/India, 17 January 2007, WTO-Homepage (effective January 2007).

C. Herrmann and J.P. Terhechte (eds.), *European Yearbook of International Economic Law 2010*, European Yearbook of International Economic Law,
DOI 10.1007/978-3-540-78883-6_10,

and the USA–Canada Free Trade Agreement (1989).[3] A third phase of integration involved free-trade areas in Asia. As Chien-Huei Wu points out in his contribution about integration in Asia, there were three incidents which initiated the development in Asia: firstly the Asian financial crises in 1997/1998 and the assistance of the USA and the International Monetary Fund (IMF) which was felt to be insufficient at the time, secondly the progress of regional integration in Europe and North America at that time, and thirdly the unsuccessfulness of the WTO in the Doha Round.[4] In this environment, the Association of Southeast Asian Nations (ASEAN) determined an earlier than planned coming into effect of the ASEAN Free Trade Area (AFTA), as well as a close collaboration with China (2002), Japan (2003) and South Korea (2005). India, a country which used to limit itself to a small number of development agreements with Asian regions,[5] also changed its strategy and concluded several agreements with already established integration regions and with countries in South East Asia, Latin America and Europe.[6] The fourth development is becoming apparent today through so-called cross-regional trade agreements, i.e. agreements that exceed neighbouring countries. The agreements between Japan and Canada (2002), Japan and Chile (2005), Japan and Mexico (2007), South Korea and Canada (2005), South Korea and the EU (2006), South Korea and the USA (2007), Switzerland and the South African Union (2006), as well as Switzerland and Japan (2009), are examples of such cross-regional agreements.[7]

Part II of this yearbook provides a detailed survey of the coming into being, the functioning and the importance of RTAs in force today. The contributions are not — as is common in conventional academic literature — arranged according to the specific peculiarity of the agreements, but from a geopolitical viewpoint. This representation provides a deep insight into integration politics and their distinctiveness in the respective regions.

The present introductory contribution aims at depicting the specific attributes which are common to the different RTAs irrespective of their geographic affiliation. A first, but not most important, common feature is the conceptual classification. In the past few years, terms have emerged that are used similarly or even identically in politics, trade and academic writing. Further common characteristics are the historical backdrop of the agreements within the GATT and the WTO, and the principles and rules of the present world trade order, on which the integration agreements are

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[3]For the failed GATT Conference of Ministers 1982, cf. Baldwin, Changes in the global trading system: a response to shifts in national economic power, in: Salvatore (ed.), *Protectionism and world welfare*, 1993, p. 91.

[4]Cf. Wu, The ASEAN Economic Community under the ASEAN Charter, its External Economic Relations and Dispute Settlement Mechanisms, pp. 331 and 338 et seq. in this volume.

[5]E.g. South Asian Association Regional Cooperation Preferential Trade Agreement (SAPTA).

[6]Cf. Farasat, India's Quest for Regional Trade Agreements: Challenges Ahead, Journal of World Trade 42 (2008) 3, pp. 433–460.

[7]A first Cross RTA was the agreement between the USA and Israel from 1985.

based. Finally, the question about the effect connects the integration areas. How do the agreements affect trade, economy and politics in reality?

Conceptual Classification

The conceptual delineation of different trade agreements is challenging, because the departure point differs according to whether the point of view is an economic or legal one. Economists label the agreements as agreements on goods and services, customs agreements or Economic Partnership Agreements (EPAs), if they refer to cross-border trade of goods or services. Lawyers characterize the agreements, depending on the number of contracting parties, as bilateral, plurilateral or multilateral trade agreements. If the terms relate to the content of the contract, the kind of collaboration or the purpose, they are agricultural agreements, association agreements or preferential trade agreements.

The conceptual classification used in the following does not claim academic logic or general validity. Instead, it tries to demonstrate how the different terms are being used in a mutually comprehensible way.

Multilateral Trade Agreements

The word "multilateral" has different meanings within the law of nations. "Multilateral" as a reference to "many" or "all" WTO Members, "multilateral" in contrast to "plurilateral", and "multilateral" as a contractual fundamental consensus.

The notion "multilateral" with regard to the WTO Agreement evolved from the Uruguay Round (1986–1993), where Canada and the European Communities (EC) proposed to transform the GATT secretariat into a "Multilateral Trade Organization" (MTO), without touching upon the legal existence of the GATT, the General Agreement on Trade in Services (GATS) and the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS). However, the fear of a fragmentation of the entire agreement resulted, as *Wolfgang Benedek* puts it, "in a reconsideration of the great solution that resorts back to the International Trade Organization (ITO)".[8] Before the termination of the Uruguay Round, the USA agreed to the proposal, provided that the organization was renamed "World Trade Organization" (WTO). Agreements that are organizationally and institutionally centralized within the framework of the WTO are – despite the new naming – called "multilateral" contracts (both "multilateral" and "plurilateral"), in contrast to "regional" agreements outside the WTO.

Secondly, the WTO differentiates between "multilateral" and "plurilateral" agreements. The "Legal Texts" of the WTO specify as "Multilateral Agreements"

[8]Benedek, *Die Welthandelsorganisation (WTO)*, 1998, p. 4.

in Annex 1A, the GATT 1994 and the Agreements on Agriculture, on the Application of Sanitary and Phytosanitary Measures, etc. The GATS is not characterized as “multilateral” in Annex 1B, but as a “General” agreement. The TRIPS is also characterized neither as “multilateral” nor “general” in Annex 1C. However, Art. II:2 of the Agreement establishing the World Trade Organization explicitly defines “Multilateral Trade Agreements” as referring to the Agreements contained in Annexes 1, 2 and 3. Following that proviso, a country, upon accession to the WTO has to accept all three “Multilateral Trade Agreements”, unless it has declared not to apply one or more of them vis-à-vis a specific WTO Member according to Art. XIII WTO. As a complement to the “multilateral” agreements, Annex 4 of the WTO Agreement contains the “Plurilateral Trade Agreements” (cf. Art. II:3 WTO), of which only the Agreement on Trade in Civil Aircraft and the Agreement on Government Procurement are still in force. The “plurilateral” agreements are also part of the WTO agreements, but only binding on those WTO members that have accepted them voluntarily.

Thirdly, within the World Trade Organization, the term “multilateral” alludes to agreements sharing a common fundamental consensus. At the time of conclusion of the GATT, the Most-Favoured-Nation principle (MFN) and the National Treatment obligation constituted this fundamental consensus. Over the course of GATT history, it was recurrently necessary to defend the multilateral character of these contracts against development preferences, regional agreements and protectionist efforts (particularly in agriculture), and to extend them to new trade sectors such as the provision of services, and to the protection of intellectual property rights. From this perspective, those agreements are denoted as “multilateral” which reflect a concerted fundamental consensus and which are far-reaching, geographically as well with regard to the volume of trade affected. This includes the WTO agreements all together (i.e. the GATT, the GATS, the TRIPS and the supplementary agreements), as well as both plurilateral agreements on trade in civil aircraft and on government procurement.

In the contributions contained in this yearbook, “multilateral” refers to agreements which are binding on all WTO Members. RTAs, in contrast, are agreements in which only some WTO Members and/or non-WTO Members participate.

Regional Trade Agreements

RTAs involve two or more trading partners, who constitute a free-trade area, a customs union or a common market on a treaty basis. The term “Regional Trade Agreement”, also known as “Preferential Trade Agreement” (PTA), has in recent years more and more replaced the term “free-trade agreement” (FTA), in order to prevent the wrong association — that agreements were meant which effectively provide for “free” trade.[9]

[9] Cf. Bhagwati, The Unilateral Freeing of Trade versus Reciprocity, in: Bhagwati, (ed.), *Going Alone*, 2002, pp. 2 et seq.

In more recent academic literature, "Regional Trade Agreements" (RTAs) in terms of "Intra-regional relations" are distinguished from "Cross-Regional Trade Agreements" (CRTAs) or "Cross-regional relations". RTAs relate to agreements between neighbouring countries or regions, such as Northern American countries (USA, Canada and Mexico, NAFTA). In contrast, CRTAs establish integration areas beyond their neighbourhood across regions.[10] The distinction between "intra" and "cross" might be interesting for national–political and sociopolitical purposes, but from the perspective of international law or economics the distinction is barely relevant.

RTAs are often limited to WTO Members, which is partially due to the increasing growth of the WTO membership. Yet there are still RTAs, which are signed by non-WTO Members. Laos, for example, which is not a WTO Member, is a partner of the AFTA, and the non-WTO Members Lebanon, Libya, Iraq, Sudan and Syria participate in the Greater Arab Free Trade Area (GAFTA).[11]

Technically, RTAs can be subclassified into non-reciprocal and reciprocal agreements. Non-reciprocal agreements are known as "Preferences" or "Preferential Trade Agreements" (PTAs). However, in many instances, such preferences are not granted on a contractual basis but unilaterally by industrial countries in favour of developing countries under the WTO Enabling clause. PTAs are presently undergoing contradictory developments. On the one hand, they become less important because of generally decreasing level of tariffs on industrial goods; on the other hand, they gain importance due to the increasing industrialization of economically weaker countries.

If RTAs are solely limited to tariff concessions, they are Tariff agreements. If the reciprocally granted trade preferences go beyond tariff benefits, and also coincidentally pursue the communitarisation of economic–political and administrative goals, one can speak of "Economic Partnership Agreements" (EPAs).

As regards tariff agreements, it is important to distinguish between free-trade areas (FTAs) and customs unions (CUs). Members of FTAs continue to apply individual tariffs on imports from third countries. The liberalizing effect on trade between the members is limited to so-called products of origin, i.e. products which are manufactured entirely in one of the member countries, or sufficiently processed or handled therein. "Entire production" requires that neither raw material nor intermediate product inputs originate from another country. Whether the requirement "sufficiently processed or handled" is fulfilled depends on the applicable Rules of Origin (RoO). Often, a change in the tariff line as a result of the processing or handling will suffice to make a product "originating" from the country where this transformation has taken place. In other cases, a percentage of value-added or other criteria are being used. The RoO prevent the transhipment of products from non-parties to one which maintains higher tariffs. The most important example of a

[10]Cf. Katada/Solís, *Cross Regional Trade Agreements, Understanding Permeated Regionalism in East Asia*, 2008.

[11]Cf. Broude, Regional Economic Integration in the Middle East and North Africa: A Primer, in this volume, pp. 286 et seq.

Free-trade area is the NAFTA of 1994. Another example is the Trade Agreement between Australia and New Zealand.

In contrast to a free-trade area, a customs union has a uniform common external tariff. The intra-union trade is free, i.e. no duties are imposed. Rules of origin are unnecessary in such cases, since goods from third countries are imported on equal terms to all Union members and are subsequently "in free circulation". The most important instance of a customs union is the European Economic Community (EEC) founded in 1958 and renamed as the European Community (EC) in 1993.[12] Further examples are the Southern Common Market (MERCOSUR), the Andean Community (CAN) and the Central American Common Market (CACM).

Economic Partnership Agreements developed — in addition to the European integration activities — within the past decade in Asia. The EPAs' similarity is that — as previously mentioned — they go beyond trade in goods and tariff reduction, and also regulate questions of free movement of persons, payments and capital transactions, competition and investment protection, trade facilitation, etc. A typical EPA is the ASEAN free trade area (AFTA).[13] Recently, Western industrial countries have also started to apply the notion "EPAs". The EU, for example, announced in 2008 that the Cotonou Agreement with the ACP countries that expired by the end of 2007, was replaced on 1 January 2008 by "WTO-compliant Economic Partnership Agreements". In the negotiations between the EU and Mexico, Switzerland and Japan there is also talk of partnership agreements.[14]

Legal History Background

On the one hand, WTO law is based on the idea of non-discrimination; on the other hand, it explicitly permits the conclusion of trade agreements, whose benefits are not passed on to third parties. *John H. Jackson* pointed towards this discord already at the end of the 1960s by declaring the integration provisions of the GATT "the most troublesome provisions of the GATT".[15] How did the provisions within the frameworks of the GATT, the GATS and the Enabling clause come into existence?

[12]Since then, the EC has moved forward with integration and has established an International Partnership Agreement.

[13]Cf. Wu, The ASEAN Economic Community under the ASEAN Charter, its External Economic Relations and Dispute Settlement Mechanisms, in this volume, pp. 331 et seq.

[14]http://www.acp-eu-trade.org/epa/A11ACP.php (effective February 2008).

[15]Jackson, *World Trade and the Law of GATT*, 1969, p. 575.

The Provisions of the GATT

The integration provisions of the GATT arose from the immediate post-war era. In November 1945, the USA claimed in Sec. H, par. 2 of the "Proposals for Expansion of World Trade and Employment" that members of the designated International Trade Organization should still, subject to certain qualifications (which were unspecified), be entitled to establish a customs union.[16] The "Suggested Charter for an International Trade Organization of the United Nations", which was submitted a year later, adhered to this proposal in Sec. J, Art. 33, and stated more precisely that the establishment of a customs union must not burden third countries additionally, and would have to include almost the entire trade of the members. The proposed wording and the subsequent ITO negotiations in Havana 1947/1948 led to the assumption that what was envisaged was primarily an exemption clause for the continuation of the agreements between Great Britain and the Commonwealth countries, France and her Overseas territories, the Benelux and their colonies, the USA and the Philippines, as well as between Chile on the one hand, and Argentina, Bolivia and Peru on the other hand.[17]

There were two issues under consideration in the Havana negotiations: the establishment of integration areas between developing countries, and the supplementation of the customs union through the free-trade area. The representatives of third world countries argued that it was a mistake to leave the possibility of economic integration to the industrialized countries, so that they could use the poor countries as suppliers of raw material. Meanwhile, the economically weak partners would have to refrain from reciprocal agreements because of the MFN clause. The USA and Great Britain counter-argued that severe differences existed between the integration areas, which existed for years, and the newly demanded preferences. The traditional agreements, according to the USA and the UK, were a defining element of the prevailing world trading structure. To break up these customs territories immediately would cause economic shocks and would damage global economic growth. The abandonment of the previous settlements had to happen gradually. It was also said to be illogical to repeal the traditional free-trade areas in order to create new preferences.[18]

The preference debate came out in favour of the developing countries. Art. 15, which was attached to chapter III of the Havana Charter (Economic Development and Reconstruction), stipulated "that special circumstances, including the need for economic development or reconstruction, may justify new preferential agreements

[16]US Department of State, Proposals for Expansion of World Trade and Employment, Publ. 2411, November 1945.

[17]Cf. the List of customs unions and free-trade areas in Annex A–F of the GATT.

[18]A detailed presentation of the discussion at that time about the continuation or repeal of existing integration areas is to be found in: Brown, *The United States and the Restoration of World Trade*, 1950, pp. 72 et seq.; cf. also Senti, Reformbedarf der WTO im Bereich der Integrations- und Präferenzabkommen, Aussenwirtschaft 62 (2007) III, pp. 325 et seq.

between two or more countries [. . .]". The establishment of integration areas required the consent of the other ITO members, the limitation to neighbouring countries and a period of 10 years, with a one-time possibility of a 5-year extension. However, this provision in favour of developing countries was not incorporated in the GATT, thus did not enter the world trade order.

In Havana, not only the integration areas were at issue. The industrialized countries Denmark and Belgium demanded further options for preferential policies, in addition to the customs union exemption already discussed. After several months of inconclusive debate, the Lebanese delegation tabled the proposal to permit all ITO members under certain conditions to establish preferential trade areas in the form of "free-trade areas"[19]. Within FTAs, tariffs and other trade barriers can be dismantled reciprocally, without having to pass these advantages on to third countries. However, privileges must be restricted exclusively to products from member countries of the free-trade area. Non-originating products remain subject to tariffs. This construction permits the partners of the free-trade area — as opposed to the situation of a customs union — to preserve their sovereignty.[20] France, who favoured the project of a free-trade area in Europe, supported the Lebanese proposal. The USA did not defeat this proposal. It proceeded on the assumption that the administrative cooperation between FTA countries, and the wish for greater bargaining power could pave the way from a free-trade area to a customs union.[21]

On this note, Art. 44 of the Havana Charter, which till then only addressed customs unions, underwent an amplification with regard to the free-trade area. Through the inclusion of Art. 44 Havana Charter in Art. XXIV GATT (first GATT revision on 3/24/1948[22]), the free-trade area entered the GATT, which came provisionally into effect on 1 January 1948.[23]

In the 1980s, a group of experts chaired by *Fritz Leutwiler* criticized the inability of GATT Contracting Parties to define and enforce limits to a major exception to the MFN rule, the custom unions and the free-trade areas. "The exceptions and ambiguities which have thus been permitted have seriously weakened the trade rules [. . .]. We believe that the GATT rules on customs unions and free-trade areas should be examined, redefined so as to avoid ambiguity, and more strictly applied".[24]

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[19]Cf. Brown, *The United States and the Restoration of World Trade*, 1950, pp. 155 et seq.

[20]Referring to Art. 44.4(b) Havana Charter (US Department of State, Havana Charter for an International Trade Organization, Publ. 3206, March 1948); cf. Brown, *The United States and the Restoration of World Trade*, 1950, p. 156.

[21]Cf. Brown, *The United States and the Restoration of World Trade*, 1950, p. 156.

[22]Special Protocol Relating to Article XXIV of the GATT of 3/24/1948, came into effect on 6/7/1948.

[23]Experts on international law judge the revision of Art. XXIV GATT referring to the Havana Charter as a legal best performance. Paras. 1 and 2 of Art. XXIV GATT correspond with Art. 42 of the Havana Charter, para. 3 with Art. 43, paras. 4–10 with Art. 44, para. 11 with Art. 99.1(d) incl. appendix 11, and para. 12 with Art. 104.3; cf. GATT, Analytical Index, 1970, p. 133.

[24]GATT, Trade policies for a better future, Proposals for action, 1985, pp. 20 and 41.

The Uruguay Negotiations on Art. XXIV GATT resulted in the "Understanding on the Interpretation of Article XXIV of the GATT 1994". The barely four-page-long declaration limits itself almost exclusively to a reiteration of the principles which are already contained in Art. XXIV GATT, without showing a new direction for integration politics.[25]

The history of Art. XXIV GATT illustrates that the founders of the post-war world trade order wanted to prevent the establishment of development-oriented preference areas, and abolish in the long term the existing integration areas between industrialized countries. The delegates for negotiations of the GATT founding period seemed not to appreciate (or did not want to) that trade policy development would follow a different track than that foreseen. It went in a direction, in which — within a few decades — the greater part of world trade took place within and between RTAs, and the principle of non-discrimination became more and more an exception.[26]

The Provisions of the GATS

Integration areas for cross-border trade in services were neither provided for in the Havana Charter, nor in the GATT. Service trade was not as important 50 years ago as it is today.[27] And the registration of services at the border always caused great difficulties. However, trade in services — although or only because no appropriate regulation existed in the GATT provisions — was incorporated into the RTAs in Europe as well as in the USA. So the EEC Treaty from 1958 laid down in Art. 59 et seq. (today Art. 49 et seq.) that the service trade market — analogous to the trade of goods — has to be open for all member countries. Likewise the US integrated services in the Agreement from 1985 with Israel, the Agreement from 1989 with Canada (Art. 1401), as well as in NAFTA 1994 (Art. 1201).

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[25] A specification of Art. XXIV:5 GATT lies in the fact, that one has to take into account "weighted average tariff rates and of customs duties collected" while calculating "duties and other regulations".

[26] Integration was not as current by the time of at which GATT was founded as it became within the decades to come. Shortly before the GATT conference in 1947, the customs union BeNeLux and the customs union Lebanon–Syria were formed; they were nevertheless promptly again dissolved. Up to 1953, two trade agreement notifications had arrived at the GATT, the trade agreements of South Africa with South Rhodesia, and the free-trade area Nicaragua and El Salvador. In the scope of preferences, a peculiar negotiation constellation arose. Great Britain spoke against the preference claims of developing countries, but defended coincidently its own preferences in favour of the Commonwealth countries. And the USA passed off the draft agreements (Proposals and Suggested Charter) as their own. They allegedly granted certain facilities within the scope of quotas and preferences to the British before. Heilperin speaks in this context of "A tale of frustration": Heilperin, How the US Lost the ITO Conferences, in: FORTUNE, September 1949, p. 82.

[27] On the development of service trade regulation see Krajewski in this volume, p. 153 et seq.

In the Uruguay Round, the decision was made to accomplish an independent General Agreement on Trade in Services, which shares the general MFN obligation and also provides for an exemption for RTAs. Art. V GATS is to some extent comparable to Art. XXIV GATT, as regards the underlying policy assumptions and in relation to the specific conditions for the legality of integration agreements.[28]

Provisions for RTAs of Developing Countries

The preferences for economically weak countries and the establishment of free-trade areas between developing countries have their legal basis in Section IV GATT, the Generalized System of Preferences (GSP) and the Enabling clause.

In the 1950s, the so-called Haberler Report indicated the diverse trade problems of developing countries.[29] This report, the sparsely successful Dillon Round and the sustained harsh criticism of the United Nations Conference on Trade and Development (UNCTAD) led to a revision of the GATT in the first half of the 1960s. Part IV (Trade and Development), which is attached to the GATT and entered into force on 27 June 1966, is very abstract and includes — apart from one exception — essentially empty phrases of trade policy about the elevation of living standards and the development of economically weak countries. The one exception is the promise of industrialized countries, laid down in Art. XXXVI.8 GATT, to refrain from requesting reciprocity with third world countries in future trade negotiations.

Subsequently, the GATT members agreed to the GSP on 25 June 1971, which allows developing countries, in deviation from the MFN clause, to grant temporary preferences.[30] The GSP preferences, however, satisfied neither the industrialized nor the developing countries. They did not provide longer-term legal certainty. A further development of the GSP in the Tokyo Round came in the form of the Enabling clause, on which the GATT partners agreed on 28 November 1979.[31] The Enabling clause concerns non-reciprocal preferences, as well as RTAs between third-world countries: "Preferential tariff treatment accorded by developed contracting parties to products originating in developing countries in accordance with the GSP [. . .]; Regional or global arrangements entered into amongst less-developed contracting parties for the mutual reduction or elimination of tariffs and [. . .] non-tariff measures [. . .]".[32] On 13 April 1988, 48 developing countries of the

[28]A discrepancy in Art. XXIV GATT lies in the fact, that developing countries which constitute an integration area are not bound by the National treatment towards corporate bodies owned by third WTO members. In comparison to the Dunkel report: insertion of Art. V.3(b) GATS; omission of Art. V.6(b) GATS.

[29]GATT, Trends in International Trade, A Report by a Panel of Experts, 1958 (Haberler Report).

[30]GATT 1972, BISD 18/24 et seq., with the appendix: Protocol Relating to Trade Negotiations Among Developing Countries, Decision of 26 November 1971, in: GATT 1972, BISD 18/26 et seq.

[31]GATT 1980, BISD 26/203 et seq.

[32]Enabling clause para. 2.

"Group of 77" concluded at the UNCTAD conference in Belgrade the Agreement on the Global System of Trade Preferences Among Developing Countries (GSTP), which was notified to the GATT on the basis of the Enabling clause and came into effect on 1 January 1996.[33]

The Common Requirements

The contributions in this yearbook on regional trade agreements clarify impressively the variety and complexity of the various RTAs around the world. Whereas the Israel-Egypt Agreement, for instance, requires only mutual compliance with the MFN clause,[34] the Asian EPAs also govern questions such as free movement of persons, payments and capital transactions, etc.,[35] and the initial EU customs union has developed over time into a profound economic union coming close to a state. Many integration projects have eventually failed, as *Jeffrey Dunoff* reveals in his contribution about North American Regional Economic Integration, because of the political divergences of the partner countries.[36] Despite their different specific design, the integration agreements in force today are based on the requirements imposed upon countries by the WTO Agreements. These requirements mainly refer to the scope of the trade covered, the consideration for third countries and the transparency requirement.

"Substantially All the Trade"

Art. XXXIV:8 GATT authorizes the establishment of RTAs subject to the condition that the duties and other regulations are eliminated "with respect to substantially all the trade". For a customs union, Art. XXIV:8(a) refers to "substantially all the trade between the constituent territories of the union or at least with respect to substantially all the trade in products originating in such territories". The phrasing begs the

[33]Hummer/Weiss, *Vom GATT '47 zur WTO '94*, 1997, pp. 263 et seq.; the Group of 77 (G-77) was established on 15 June 1964 by 77 developing countries, signatories of the "Joint Declaration of the Seventy-Seven Countries". Although the members of the G-77 have increased to 130 countries, the name G-77 was retained because of its historic significance, http://www.g77.org.

[34]Broude, Regional Economic Integration in the Middle East and North Africa: A Primer, in this volume, pp. 269 et seq. The contribution of T. Broude shows particularly distinctly how different economic standards, cultures and policies clash in the Middle East and North Africa, and therefore aggravate the elaboration of common integration agreements.

[35]Wu, The ASEAN Economic community under the ASEAN Charter, its External Economic Relations and Dispute Settlement Mechanisms, in this volume, p. 331 et seq.

[36]Dunoff, North American Regional Economic Integration: Recent Trends and Developments, in this volume, p. 297 et seq.

question whether one can still speak of a customs union if only products originating in one of the participating countries fall within the tariff reduction. Art. XXIV:8(b) GATT is more precise in that regard. A free-trade area requires that "the duties and other restrictive regulations [. . .] are eliminated on substantially all the trade between the constituent territories in products originating in such territories".

The proposal to specify "substantially all the trade" quantitatively has not found its way into the GATT. "Substantially all the trade" refers not solely to the volume of trade or the commercial value, but to the sectors of trade as well, as laid down in Art. 3 of the Preamble of the Understanding on the Interpretation of Art. XXIV GATT. Art. V:1(a) GATS also speaks of "substantial sectoral coverage".[37]

According to *Kenneth W. Dam* and *Frank A. Haight*, the GATT is based on an illogical concept in using the phrase "substantially all the trade". The fact that a partial preferential system is not permitted, but the more coverage it has, the better, is absurd.[38] In contrast, *Frieder Roessler* defends the requirement "substantially all the trade" with two arguments. On the one hand, the requirement "substantially all the trade" makes it easier for governments to reject special exemptions in favour of national lobbying groups by referring to incurred international obligations. On the other hand, the application of "substantially all the trade" prevents circumventions of the MFN principle of the GATT by concluding sectoral agreements.[39]

Not Higher or More Restrictive Duties and Other Regulations

The second requirement that — according to the GATT — RTAs have to fulfil, establishes that, according to Art. XXIV:5(a) GATT, "the duties and other regulations of commerce imposed [. . .] shall not on the whole be higher or more restrictive than the general incidence of the duties and regulations of commerce applicable in the constituent territories prior to the formation of such union [. . .]". Art. XXIV:5(b) replicates the same condition for free-trade areas. The formulation is rather abstract, and permits various alternatives for interpretation.

The original GATT 1947 spoke of duties and other regulations in Art. XXIV:2 (b), which on the whole shall not "be higher or more stringent than the average level of the duties and regulations [. . .]". The previous formulation was modified during the first GATT revision on 24 March 1948, to the effect that duties and other

[37]With regard to the issue of the quantification of "substantially all the trade", cf. GATT 1958, BISD 6/99; GATT 1959, BISD 7/71; Farasat, India's Quest for Regional Trade Agreements: Challenges Ahead, Journal of World Trade 42 (2008) 3, p. 442; Herrmann, Bilateral and Regional Trade Agreements as a Challenge to the Multilateral Trading System, Aussenwirtschaft 63 (2008) III, p. 271.

[38]Dam, *The GATT Law and International Economic Organization*, 1970, p. 289; Haight, Customs Unions and Free-Trade Areas under GATT, Journal of World Trade Law 6 (1972) 4, p. 398.

[39]Roessler, The relationship between regional integration agreements and the multilateral trade order (Working paper), 1992, pp. 5 et seq.

regulations shall not be "higher or more restrictive than the general incidence of the duties and regulations [...]". The replacement of "average level of duties" by "general incidence of the duties" was based on the perception that a mathematical average does not, neither arithmetically nor weighted, constitute a convenient benchmark for the comparison of tariff levels. The Understanding on the Interpretation of Art. XXIV of the GATT (enacted in 1995) acknowledges in par. 2 (to Art. XXIV:5 GATT) that the evaluation of the general incidence of the duties and other regulations of commerce involves great difficulties, and stipulates "that for the purpose of the overall assessment of the incidence of other regulations of commerce for which quantification and aggregation are difficult, the examination of individual measures, regulations, products covered and trade flows affected may be required".

It is difficult to estimate whether and to what extent the founding countries of RTAs meet these requirements. Neither during the time of the GATT, nor of the WTO did a GATT or a WTO–partner successfully claim violations of these tariff regulations in a dispute settlement.

Notification

The third condition for the origination of integration areas is to be found in Art. XXIV:7(a) GATT and Art. V:7(a) GATS, supplemented by paragraphs 7 et seq. of the Understanding on the Interpretation of Art. XXIV GATT.

The GATT and the GATS demand of the prospective integration partners to notify the conclusion of interim agreements, customs unions and free-trade areas to the GATT and GATS Council. The Committee on Regional Trade Agreements (CRTA) has to examine, according to paragraphs 7 et seq. of the Understanding, whether the predefined schedules may be retained and whether the proposed integration regulations comply with the WTO provisions. The CRTA shall submit a report to the Council for Trade in Goods or to the Council for Trade in Services. The respective Council may make recommendations to the members as it deems appropriate. Art. XXIV:7(b) GATT concludes with the provision: "The parties shall not maintain or put into force, as the case may be, such agreement if they are not prepared to modify it in accordance with these recommendations". The GATS does not, in contrast to the GATT, contain a legal basis whereby the recommendations would be binding for the agreement partners.

The WTO provisions should prevent the defiance of WTO rules for an indefinite period of time in the cloak of interim agreements, or the establishment of RTAs that do not correspond with the WTO requirements. Of the approximately 200 agreements notified to the GATT and WTO so far, according to a compilation of the WTO, a mere 24 agreements were reported before their signing and entry into force, frequently barely a few days in advance. The notification of the remaining nearly 200 agreements happened after the signing of the agreements and after their entry into force.[40] Out of 36 interim agreements only two, namely the EC–Morocco Agreement and the LAFTA[41] were notified prior to conclusion or entry into force. *Shadan Farasat* points out that even India presently partakes in 12 EPAs, whereof only four agreements have so far been notified to the WTO. Up to July 2007, India had also not notified any of the interim agreements concluded within the previous 8 years.[42] In summary, one can conclude that the surveillance of RTAs provided for in the WTO Agreement does not occur in practice to the extent foreseen by the Agreements. A significant number of WTO members have concealed their integration propositions from surveillance by delaying notification.

Consequences

How does the growing quantity of RTAs impinge on the current world trade order and the development of global trade? Definite answers are difficult, insofar as each agreement features its specific peculiarities in legal form, in the extent of covered goods and services, capital expenditure and other economically relevant factors. The following conclusions confine themselves to an outline of a few aspects which are addressed in the subsequent contributions.

Repercussions on the World Trade Order

Today's world trade order is not what the founders of the GATT envisaged in the post-war era 60 years ago. The goal at that time was, as *James F. Byrnes*, US Secretary of State claimed in the "Proposals", an international trade order, "that the world may not separate into economic blocs".[43] In the sense of this orientation, the contrived post-war order concentrated on non-discrimination and general market liberalization. The existing customs unions and free-trade areas between the industrial countries were deemed to be exceptions which should expire in the longer term (hence in Part III of the GATT). And the Preferential agreements permitted for developing countries in Art. 15 of the Havana Charter were subjected to a time limitation, as well as the preferences granted under the GSP in accordance with

[40]Crawford/Fiorentino, The Changing Landscape of Regional Trade Agreements, WTO, Discussion Paper No. 8, 2005; Fiorentino/Verdeja/Toqueboeuf, The Changing Landscape of Regional Trade Agreements: 2006 Update, WTO, Discussion Paper No. 12, 2007; Jovanovic, *International Economic Integration, Limits and Prospects*, (2nd ed) 1998, pp. 362 et seq.

[41]Jovanovic, *International Economic Integration, Limits and Prospects*, (2nd ed) 1998, p. 362.

[42]Farasat, India's Quest for Regional Trade Agreements: Challenges Ahead, Journal of World Trade, 42 (2008) 3, p. 451, fn. 95.

[43]US Department of State, Proposals for Expansion of World Trade and Employment, Publ. 2411, November 1945, p. III.

Art. XXXVI:8 GATT. Nevertheless, in the course of GATT history an inversion of direction occurred. Instead of the disposal of existing RTAs, new agreements emerged. The time limitations of the GSP were also abolished through the Enabling clause of 1979. Integration politics of the GATT, criticized in the Leutwiler Report,[44] ended in the Uruguay Round with an alibi exercise in the form of the four-page-long Understanding on the Interpretation of Art. XXIV GATT of 1994, which is limited more or less to a repetition of the text of Art. XXIV GATT. Finally, even the integration provisions in Art. V and V^{bis} GATS do not constitute an exception (analogous to Art. XXIV GATT in Part III GATT), but rather a constituent of "general obligations". In that sense *Jackson* needs to be understood, when he states in his seminal work on the law of GATT with regard to Art. XXIV GATT: "As the debate on regional arrangements developed and the custom union and the free-trade clauses of Art. XXIV grew, these latter became the tail that wagged the dog".[45]

The unconventional configuration of RTAs, which frequently runs contrary to the law of the WTO, has — as WTO-Discussion paper No. 8 records — led "to a situation of great ambiguity with respect to the relationship between RTAs and the multilateral trading system".[46] Against this backdrop, the Ministers agreed in the fourth WTO Conference 2001 in Doha to launch negotiations "aimed at clarifying and improving disciplines and procedures under the existing WTO provisions applying to regional trade agreements. The negotiations shall take into account the developmental aspects of regional trade agreements".[47] The Committee on RTAs and the Negotiating Group on Rules, which was commissioned with the elaboration of recommendations, published on 1 August 2002 the "Compendium of Issues Related to Regional Trade Agreements".[48] The report carries out a detailed evaluation of RTAs and their relations to the WTO, without, however, making recommendations for the reorganization of the relations between RTAs and the WTO Agreements. Presently there is considerable need for reform within the WTO in some branches of law, as several contributions to this yearbook suggest. The problem of reciprocity, the opening of RTAs towards third countries and the unification and simplification of rules of origin are open to dispute.[49]

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[44]GATT, Trade policies for a better future, Proposals for action, 1985, pp. 20 and 41.

[45]Jackson, *World Trade and the Law of GATT*, 1969, p. 575, fn. 1.

[46]Crawford/Fiorentino, The Changing Landscape of Regional Trade Agreements, WTO Discussion Paper No. 8, 2005, p. 19, fn. 47.

[47]WTO, WT/MIN(01)/DEC/1, 20 November 2001, para. 29 (Ministerial Conference, Doha, 9–14 November 2001, Declaration).

[48]WTO, TN/RL/W/8/Rev. 1, 1 August 2002 (Compendium of Issues Related to RTAs).

[49]Cf. Senti, Reformbedarf der WTO im Bereich der Integrations- und Präferenzabkommen, Aussenwirtschaft 62 (2007) III, pp. 319–342.

Ramifications for the Economy

The most important goal which is pursued with RTAs is indeed the increase in the welfare of people within the participating countries. To capture and measure the effects on welfare is, however, exceptionally difficult. On the one hand, the agreements and the economic environments are different; on the other hand, it is not possible to determine how economic development would have proceeded without the conclusion of the agreements. The theoretical basic concept of RTA analysis relies on *Jacob Viner*. Viner distinguished in his works from the 1950s between "trade creation" and "trade diversion".[50] Trade creation addresses the price reduction of imports by reducing trade barriers. As a result, imports increase. Trade diversion describes the effect, that an agreement redirects imports from a third country to a member country of the RTA, because imports from a member country are more favourable due to the reduction of trade barriers than imports from an in fact cheaper third country on which duties are still imposed. *Richard D. Lipsy*[51] and *Harry G. Johnson*[52] went a step further by taking into account not only the production effects, but also the consumption effects of RTAs. Consumer benefits occur, according to *Lipsy* and *Johnson*, because consumers in an RTA are able to buy greater quantities at lower prices. In contrast, domestic producers suffer losses, because they must bear a markdown for their goods. Further losses are born by the country, which loses its customs revenues for previous imports from cheaper third countries. The actual welfare effects finally correspond with the discrepancy between the consumption effects, attributable to trade creation, and the decrease in welfare from trade diversion. The result may be positive, negative or even.[53]

In addition to trade creation and trade diversion effects, trade distortion effects must be considered. If the agreements are concluded for political or any other non-economic reasons and lead to administrative procedures at border clearance, which are accompanied by trouble and costs for traders (e.g. because of complicated rules of origin and delays), imports will decrease and consumers will sustain negative welfare effects.[54]

The following contributions of this yearbook explain clearly that all existing RTAs have their own history, and describe how they go beyond the GATT/WTO approach and how they differ as regards their form and substance. The essays about

[50]Viner, *The Theory of Customs Unions*, 1950.

[51]Lipsy, The Theory of Customs Unions: Trade Diversion and Welfare, Economica 24 (1957) 1, pp. 40–46.

[52]Johnson, The economic theory of customs union, Pakistan Economic Journal 10 (1960) 1, pp. 14–32.

[53]A clear and easily understood overview is to be found in: WTO, World Trade Report 2007, pp. 138 et seq. (with further references).

[54]This is for instance accurate if effectively all goods are transferred duty-free or at low customs tariffs from the market of an agreement partner, and surveillance of origin is initiated on all imported goods, because of the small third country stake.

the various agreements also confirm that RTAs economically only represent the second-best solution. The best solution would be free and non-discriminating world trade, which would — as established in the Proposals for Expansion of World Trade and Employment — make a substantial contribution, that "more ships will sail with fuller cargoes, more men will be employed, more goods will be produced, and more people will have better things to eat and wear and otherwise consume".[55]

[55]US Department of State, Proposals for Expansion of World Trade and Employment, Publ. 2411, November 1945, p. 4.

The European Union and Regional Trade Agreements

Marise Cremona

Introduction

The European Community currently has 24 regional trade agreements (RTAs) in force, a further eight agreed but not yet in force and eleven under negotiation.[1] Many of these agreements are with regional groupings of countries and so the number of countries covered by EC RTAs is already considerable and likely to grow.[2] They range from customs union agreements with neighbouring micro-States in Europe such as San Marino or Andorra, to the Stabilisation and Association Agreement (SAA) with the candidate State Croatia, the development-oriented Economic Partnership Agreement (EPA) with the Cariforum States and the free trade agreement with Mexico. They differ both in their ambition and coverage and in the degree to which the trade provisions are embedded in other non-trade and non-economic provisions. Although relatively few currently include substantial commitments in respect of services, a number of projected agreements will include

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[1]By RTA we mean here agreements that would require notification under either Article XXIV GATT or Article V GATS, therefore excluding agreements such as the current Partnership and Cooperation Agreements with the countries of the former Soviet Union, the Political Dialogue and Cooperation Agreement with the Andean Community and its members, and the Cooperation Agreement on Partnership and Development with India. The term RTA has been used to cover EC agreements both with a regional grouping of States and with a single State, for simplicity and reflecting the regional nature of the EC itself as a partner.

[2]If we include RTAs in force and those signed but not yet in force, the EU has RTAs with over 100 States. The Secretariat Report of the most recent WTO Trade Policy Review on the European Communities observed, "The EC's extensive network of RTAs, together with the large number of countries eligible for unilateral preferences, has confined the application of its exclusively MFN tariff to nine WTO Members, which accounted for some 30% of its total merchandise imports in 2005". WT/TPR/S/177/Rev.1, 15 May 2007, Summary Observations, para 9.

C. Herrmann and J.P. Terhechte (eds.), *European Yearbook of International Economic Law 2010*, European Yearbook of International Economic Law,
DOI 10.1007/978-3-540-78883-6_11,

services and the extension of some existing RTA commitments to services is also under negotiation.

Of the 24 RTAs currently in force, 21 entered into force since 1990.[3] The EC is clearly part of, and contributing to, the worldwide expansion in numbers of RTAs in the last two decades.[4] From the EC's perspective, the reasons for this expansion are varied. RTAs are seen as part of the framework within which countries can move towards accession to the EU; they provide the core of EU relations with its neighbours who are not themselves candidates or potential candidates; they have become, through the EPAs, the basis of the EU's development policy towards the African, Caribbean and Pacific parties to the Cotonou Convention; they represent, in negotiations with Mercosur, the Andean Community and ASEAN, a significant development in inter-regional relations. Significantly, however, the EU decided in 2006–2007 to launch a new series of bilateral trade negotiations with a number of countries identified as "strategic partners", including India, China, ASEAN and South Korea. The DG Trade communication, "Global Europe: Competing in the World", discusses the external aspects of EU competitiveness, in the context of the EU's broader competitiveness agenda, as presented in the Lisbon Strategy for Growth and Jobs.[5] The Commission, while claiming that "there will be no European retreat from multilateralism", also argued the value of free trade agreements in furthering the EU's market opening objectives. While the WTO provides the basic ground rules for trade relations as well as a framework for ongoing negotiation, FTAs can include issues not yet covered by the WTO, including investment, public procurement, competition and other regulatory issues. The Commission referred to the stalled Doha Round and while recognising the problems that FTA proliferation can cause for the multilateral system, defended the idea that under the right conditions FTAs could "build on" the WTO and "prepare the ground" for multilateral liberalisation, acting as a stepping stone rather than a stumbling block.[6]

In addition to its existing network of neighbourhood and development-oriented FTAs, the Commission saw the need to prioritise new FTAs with strategic trading partners based on economic criteria, in particular ASEAN, Korea, Mercosur, India, Russia and the Gulf Cooperation Council. These new FTAs should include extensive provisions on investment and services, regulatory convergence and in particular competition and enforcement of intellectual property rights as well as addressing

[3]This does not include the ten RTAs concluded since 1990 which have since been overtaken by accession to the EU itself.

[4]See for example Matsushita/Lee, Proliferation of Free Trade Agreements and Some Systemic Issues – In Relation to the WTO Disciplines and Development Perspectives, *The Law and Development Review* 1 (2008) 1; Sapir, Trade Regionalism in Europe: Towards an Integrated Approach, *Journal of Common Market Studies* 38 (2000), p. 151.

[5]"Global Europe: Competing in the World: A Contribution to the EU's Growth and Job Strategy", communication by DG Trade, 4 October 2006.

[6]See generally, World Bank Policy Research Report on Trade Blocs, 2000: http://www.worldbank.org/research/trade/trade_blocs.htm; Schiff/Winters, *Regional Integration and Development*, 2003; Bartels/Ortino (eds.), *Regional Trade Agreements and the WTO Legal System*, 2006.

sustainable development concerns including cooperation on labour standards and environmental protection. The Council of Ministers endorsed the communication's recommendations with respect to a new generation of FTAs, confirming also that "In setting geographical priorities for these agreements, economic considerations should play a primary role, notwithstanding other, political, considerations".[7] As a result, negotiations were launched with China in January 2007, with ASEAN, with South Korea and with Ukraine in May 2007, with India in June 2007, and with Russia in June 2008.

From this it will be seen that bilateral RTAs are very much part of the EU's current trade agenda, and indeed form part of the external dimension of a broader competitiveness strategy of market opening which also includes regulatory cooperation and transatlantic economic cooperation. This contribution does not aim to provide a summary of each of the EU's current and planned RTAs.[8] Rather it will outline the overall range of EU RTAs, their geographical/regional and policy dimensions, making a distinction between RTAs with candidate and potential candidate States; RTAs with neighbours; RTAs with a strong development dimension; and RTAs with a focus on global market access. Second, it will attempt to identify some themes and trends in recent EU RTAs from two perspectives. The first, here termed "deepening", refers to the way in which the EU seeks to deepen economic integration through RTAs, extending beyond the traditional removal of tariff barriers and quotas into regulatory policy, and beyond trade in goods to services and investment. The second, here termed "widening", refers to the embedding of economic integration into the wider relationship with the partner country or region. This takes a variety of forms: the trade dimension may form part of a broader agreement, such as an association agreement; the trade provisions may be linked to specific conditionalities or "essential elements" clauses with a security or human rights component; the RTA may incorporate a sustainable development perspective which attempts to integrate development, social, and environmental concerns into the trade liberalisation and market opening objectives.

Since its inception as the European Economic Community the EU has possessed the competence to conclude RTAs in the framework of its common commercial policy on the basis of Article 133 EC. In its original version, Article 133 covered trade in goods and very limited aspects of trade-related IPR and services.[9] However in 2000 the Treaty of Nice extended competence under this provision to cover trade in services and commercial aspects of intellectual property. While the "original" common commercial policy (essentially trade in goods and "GATS mode 1"

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[7]GAERC conclusions 13 November 2006.

[8]For a thorough comparative study of all the EC's bilateral agreements, see Maresceau, *Bilateral Agreements concluded by the European Community*, Recueil des cours de l'Academie de droit international. Collected Courses of the Hague Academy of International Law 309 (2006), pp. 125–451.

[9]ECJ *Opinion 1/94* [1994], ECR I-5267, especially paras 53, 71.

services[10]) is within the exclusive competence of the Community,[11] the newer dimensions added by the Treaty of Nice fall within shared competence and some types of agreement (those relating to trade in cultural and audio-visual services, educational services and social and human health services) must be concluded jointly by the Member States and the Community.[12] The Treaty of Lisbon would add foreign direct investment to Union competence under the common commercial policy as well as moving the whole of this policy field into exclusive competence.[13]

In addition to competence based on the common commercial policy, the EC Treaty provides for the conclusion of Association agreements,[14] and these may cover (without additional legal bases being necessary) all policy fields covered by the EC Treaty.[15] Thus RTAs may be concluded as Association agreements containing trade provisions alongside a wider range of commitments and an institutional structure which may include the creation of institutions with decision-making powers. There is no standard content for Association agreements and they can vary widely. If the Union wishes to conclude an RTA which goes beyond the scope of the common commercial policy but which is not an Association agreement, Article 133 may be combined with Article 181 EC in the case of a development agreement,[16] or Article 181a EC for a non-development cooperation agreement,[17] or a combination of several sectoral legal bases (such as those relating to transport, the environment or capital movements) where necessary combined with Article 308

[10]The GATS establishes four modes of supply of services; mode 1 entails the cross-border provision of services without commercial presence or the movement of either provider or recipient; GATS OJ 1994 L 336/191, Art. 1.

[11]ECJ *Opinion 1/75* [1975], ECR 1355.

[12]Art. 133(6) EC. For a discussion of the amendments to Art. 133 brought about by the Treaty of Nice see Krenzler/Pitschas, Progress or Stagnation? The Common Commercial Policy after Nice, EFA Rev. 6 (2001), p. 291; Cremona, A Policy of Bits and Pieces? The Common Commercial Policy After Nice Cambridge Yearbook of European Legal Studies 4 (2001) p. 61; Herrmann, Common Commercial Policy after Nice: Sisyphus would have done a better job, 39 CMLRev (2002) p. 7. For the implications of Article 133(6), see case C-13/07 *Commission v Council*, pending, on the accession of Vietnam to the WTO, opinion of AG Kokott, 26 March 2009.

[13]Arts. 3(1)(c) and 207(1) Treaty on the Functioning of the European Union (TFEU). In cases of exclusive competence only the Union may legislate and adopt legally binding acts; Member States may only do so where empowered by the Union or in implementation of Union acts: Art. 2(1) TFEU.

[14]Art. 310 EC provides that "The Community may conclude with one or more States or international organizations agreements establishing an association involving reciprocal rights and obligations, common action and special procedures". These agreements must be concluded unanimously by the Council and require the assent of the European Parliament: Art. 300(2) and (3) EC.

[15]Case 12/86 *Demirel* [1987] ECR 3719.

[16]See for example Council Decision 94/578/EC of 18 July 1994 concerning the conclusion of the Cooperation Agreement between the European Community and the Republic of India on Partnership and Development *OJ L 223, 27.8.1994, p. 23.*

[17]Art. 181a EC applies to economic, financial and technical cooperation with third countries.

EC,[18] where substantive commitments going beyond cooperation are envisaged.[19]

RTAs which cover only trade in goods fall within EC exclusive competence and would therefore be concluded by the EC alone. However, the majority of current RTAs include provisions on issues where competence is shared between the Community and its Member States, including services, IPR and investment and these will be concluded as mixed agreements (i.e. by both the EC and the Member States). In addition, Association agreements with their broad coverage are in practice concluded as mixed agreements. Thus the majority of recent RTAs are mixed agreements, requiring conclusion by the EC but also ratification by each Member State before they can come into force. Since this process can take some time, even years, it is common practice to extract the trade and trade-related provisions of the agreement into an Interim Agreement which can be concluded by the EC alone and which will cease to have effect once the full agreement comes into force.[20] Under Article 300(2) EC it is also now possible for the Council, when adopting a decision to sign an agreement, to decide that certain of its provisions may be provisionally applied before they enter into force.[21]

Types of EU RTA

In what follows the EU's RTAs have been grouped according to their broad purpose and policy context. Other categorisations would be possible, of course, based on types of agreement (association agreement, partnership agreements, simple trade agreements, etc.), on degrees of integration (customs union, free trade area, free trade area plus, etc.) or on geography. As we will see, a purpose or policy-based approach does in fact also reflect (although it does not precisely map onto) these

[18]Art. 308 EC applies where action is necessary to achieve, in the course of the operation of the common market, an objective of the EC Treaty and the Treaty has not elsewhere provided the necessary powers; action is taken by the Council acting unanimously on a Commission proposal and after consultation of the European Parliament.

[19]See for example Council Decision 98/504/EC of 29 June 1998 concerning the conclusion of the Interim Agreement on trade and trade-related matters between the EC and Mexico OJ L 226, 13.8.1998, p. 24, which is based on Art. 57(2), 66 and 113 EC (under current numbering Arts. 47 (2), 55 and 133).

[20]Examples would include the Interim Agreements with Albania (OJ 2006 L 239), Montenegro (OJ 2007 L 345) and Bosnia–Herzegovina (OJ 2008 L 169) pending the coming into force of the SAAs with these countries.

[21]For an example see Council Decision 2002/979/EC of 18 November 2002 on the signature and provisional application of certain provisions of an Agreement establishing an association between the European Community and its Member States, of the one part, and the Republic of Chile, of the other part OJ L 352, 30.12.2002, p. 1. This provided for the provisional application of the trade, procurement, competition and some cooperation provisions of the (mixed) association agreement. The full agreement came into force in 2005: Council Decision 2005/269/EC of 28 February 2005 OJ L 84, 2.4.2005, p. 19.

other distinctions. It also brings out a fundamental aspect of the EU's approach, which is the extent to which the EU sees trade policy both as an aspect of its overall foreign policy and as an instrument with which other policy objectives may be achieved. That said, although an indication of the policy context for the EU's relationships with these groups of countries is given it is not possible in a contribution of this length to discuss those policies in any detail.

Candidates and Potential Candidates

There is of course no requirement that prospective members of the EU should first partially integrate into the Union by way of an RTA. Nevertheless, all new members subsequent to the accession of Denmark, the UK and Ireland have in fact acceded to the Union from the contractual basis of a prior agreement, whether an association agreement or a free trade agreement, and it is fair to say that this is likely to be the expectation for the future. Indeed, as is well known, the Ankara agreement with Turkey, one of the earliest association agreements concluded in 1963, contains a clause which commits the parties to examine the possibility of Turkish accession "as soon as the operation of this Agreement has advanced far enough to justify envisaging full acceptance by Turkey of the obligations arising out of the Treaty establishing the Community".[22] The EU/EC Treaties themselves, although they do not make an agreement with a candidate State part of the accession procedure, nevertheless now expressly envisage the possibility, Article 181a(2) EC providing that such agreements must be concluded by the Council of Ministers by unanimous vote.[23] In the case of the most recent enlargements, the Europe Association Agreements with the ten countries of central and eastern Europe that are now EU Member States, and the institutional structures they established, became an integral part of the 1997–2007 pre-accession process.[24]

No later agreement contains a clause similar to Article 28 of the Ankara Agreement, although the SAAs with the countries of the Western Balkans[25] do

[22]Ankara Agreement, OJ 1973 C 113/2, Art. 28. Turkey became a candidate state in December 1999 and negotiations were opened in October 2005.

[23]It should be made clear that these agreements, concluded with the EC, are quite separate from the treaties of accession which are concluded between the acceding State(s) and all existing Member States: see Article 49 TEU.

[24]On the reorientation into pre-accession instruments of the Europe Association Agreements with the states of central and eastern Europe, see Inglis, The Europe Agreements compared in the light of their pre-accession reorientation, CMLRev. 37 (2000) p. 1173; Maresceau, Pre-Accession, in: Cremona (ed.), *The Enlargement of the European Union*, 2003.

[25]SAAs are Association agreements concluded as mixed agreements by both the EC and its Member States. SAAs with Croatia and the former Yugoslav Republic of Macedonia are in force; SAAs have been concluded with Albania, Montenegro and Bosnia–Herzegovina and Interim Trade Agreements are in force; an SAA and Interim Agreement with Serbia have been signed but are not yet in force.

refer in their Preambles to the "potential candidate" status of the Western Balkan partners. The EU's statements on the Stabilisation and Association Process (SAP) and EU policy towards the Western Balkans make it clear that the SAAs are accession-oriented agreements,[26] and the financial instrument that applies to the SAA States is the Regulation for pre-accession assistance (IPA).[27] Of the SAP States, so far Croatia and the former Yugoslav Republic of Macedonia are candidate States. The accession process is governed by the EU Treaty and possessing "potential candidate" status does not of course commit the States concerned to apply for membership; it does however represent a political commitment on the part of the EU to assist the States concerned to prepare for accession.

The SAAs are primarily free trade agreements applicable to trade in goods with asymmetric timetables for liberalisation alongside provision for deeper integration. Thus they also include a degree of liberalisation of services, with national treatment for the establishment of companies, subsidiaries and branches, provision for intra-corporate transferees and the possibility of future extension to the establishment of nationals of the parties for the purpose of self-employed activities and the provision of services on a temporary basis. They include provisions on the liberalisation of capital, the non-discriminatory treatment of legally resident migrant workers, coordination of social security provision, competition policy and intellectual property. Two features of the SAAs are worth emphasising. First is their orientation towards preparation for possible future accession to the EU, already mentioned. This manifests itself not only in the "deep integration" aspect of the agreements, with provisions on all four single market "freedoms" (although not achieving full freedom in each sector), but also in the alignment to "Community standards" in fields such as customs, technical regulations, consumer protection, working conditions (health and safety, equal opportunities), banking and financial services, the information society, electronic communication services, as well as the provision on approximation of laws. From the perspective of accession the provisions on "justice, freedom and security" are novel and important with an emphasis on compliance with international as well as European standards; they include a commitment to reinforce the institutions of justice and law enforcement, cooperation on border control, asylum and migration, including the possibility of readmission agreements, cooperation on money laundering, crime and counter-terrorism.

The second important dimension of the SAAs derives from their place as a central component of the SAP and relates to the promotion of regional stability. Thus we find regional peace and stability and the development of good neighbourly relations as an essential element of the agreements and a focus for political

[26]Commission Communication on the Western Balkans and European Integration COM(2003) 285, 21 May 2003; Thessaloniki Agenda, External Relations Council 16 June 2003, European Council Conclusions, Thessaloniki 19–20 June 2003, and EU–Western Balkans Summit Declaration, Thessaloniki, 21 June 2003; Commission Communication "The Western Balkans on the road to the EU: consolidating stability and raising prosperity", COM (2006) 27, 27 Jan 2006.

[27]Council Regulation 1085/2006/EC of 17 July 2006 establishing an Instrument for Pre-Accession Assistance (IPA) *OJ L 210, 31/07/2006 p. 82*.

dialogue, and substantive commitments to regional cooperation and integration, in particular through agreements with other countries of the region, especially those that have also signed an SAA, covering not only trade,[28] but also services, capital movements, the movement of people and cooperation in justice and home affairs.

The Ankara Agreement with Turkey[29] is a much older form of agreement and does not include any provision for political dialogue or justice and home affairs cooperation. Two features of this agreement are of particular interest in the context of this overview of current EU RTAs. The first is that the Ankara Agreement itself has a programmatic character, providing a broad framework for future integration,[30] subsequent developments taking place both through additional Protocols and through decisions of the Association Council. Thus, decisions on the movement of persons have in practice created important individual rights.[31] The second feature is a further product of this process: unusually, the RTA with Turkey takes the form of a customs union, established by Association Council decision in 1995.[32] It thus provides for Turkish alignment with the EC's common customs tariff and external trade policy including preferential trade relations as well as approximation of technical standards, IPR and competition policy. The RTA with Turkey is thus deep but sectorally rather limited.

The pre-accession dimension of the SAAs and the Ankara Agreement entails that although they are a contractual cornerstone of the relationship between the candidate and potential candidate countries and the EU, they operate alongside other accession instruments, notably the Accession Partnerships, which set priorities in the process of alignment to the EU acquis that is now a pre-condition for accession. The institutional frameworks established by the agreements provide the structure through which the Accession Partnerships are monitored. These are distinctive features of these RTAs. Nevertheless the elements of "deep integration" that they contain, going beyond the minimum requirements for FTAs, customs unions and economic integration agreements under Articles XXIV GATT and Article V GATS, are not limited to these accession-oriented RTAs.

[28]A Memorandum of Understanding on Trade Facilitation and Liberalisation between the countries of the Western Balkans was signed on 27 June 2001 and in 2007 a reformed CEFTA (Central and Eastern European FTA) came into force.

[29]OJ 1973 C 113/2.

[30]Cf. Case 12/86 *Demirel* [1987] ECR 3719.

[31]See for example C-192/89 *Sevince* [1990] ECR I-3461; C-228/06 *Soysal*, 19 February 2009. For a recent full discussion see Peers, EU Migration Law and Association Agreements, in: Martenczuk/Van Thiel (eds.), *Justice, Liberty, Security: New Challenges for EU External Relations*, 2008.

[32]Decision No 1/95 of the EC–Turkey Association Council, OJ 1996 L 35/1, came into force 1 January 1996.

Neighbours

The EU's network of RTAs with its neighbours, outside the pre-accession context, is complex and varied. There is no room in a contribution of this kind to discuss, even in outline, each agreement and instead some distinctive features will be identified. A first rather obvious but important point is that the classification (by the EU) of European non-Member States into "potential candidates" and others does not in fact say anything about the legal position of the latter as regards EU membership. Were a European state among this group of neighbours to decide to apply for membership (be it Iceland or Ukraine), its application would be subject to the procedures of Article 49 TEU in the same way as that of Croatia or Turkey. Indeed one of the agreements to be considered in this section, the European Economic Area Agreement (EEA), was a stepping stone to membership for Austria, Finland and Sweden. That said, none of the RTAs considered here – unlike the SAAs – have a specific accession orientation.

The EU's agreements with its neighbours are rather different from each other. They may be multilateral, bilateral or bilateral in a multilateral policy framework; and they offer varying degrees of integration: an extension of the full four freedoms, intensive sectoral integration, deep integration associations, or cooperation agreements with potential for further development. We will consider them in four categories:

1. The EEA with Norway, Iceland and Liechtenstein is a multilateral agreement which is institutionally structured to operate bilaterally, the EFTA parties on the one hand, the EC and its Member States on the other. It establishes a FTA but goes beyond this to extend the four freedoms to the EEA partners, also establishing a parallel competition and state aids enforcement mechanism. The EEA partners are part of the Schengen border-free area for the movement of people, and the EEA envisages the dynamic "tracking" of new internal market legislation by the EFTA parties; however they do not participate in the agriculture and fisheries policies, in external trade or other external policies, in economic and monetary union, nor in the common foreign and security policy and justice and home affairs (e.g. criminal cooperation). Thus the EEA is notable first for its deep level of economic integration which seeks not only to "mirror" EU law at a particular moment but to evolve in parallel both legislatively and judicially, and second for the exclusion (as compared with full EU membership) of certain key elements of the current *acquis*.

2. The RTA with Switzerland takes a very different institutional form, although its content is rather similar. A free trade agreement was concluded in 1972 covering trade in industrial goods.[33] In 1999 (and following the Swiss decision not to ratify the EEA) this was supplemented by a series of bilateral sectoral agreements, on free movement of persons, air transport, transport of goods and passengers by rail and road, scientific and technological cooperation, public procurement, trade in

[33] OJ 1972 L 300/189.

agricultural products, and mutual recognition.[34] This package of bilateral agreements was unusual in that the agreements were intended to come into force together and each one depends on the others coming into, and remaining, in force. In 2004 a further series of bilateral agreements was signed, without this element of linkage, on the adoption by Switzerland of the Schengen acquis,[35] participation in the European Environment Agency,[36] the Media Programme,[37] statistical co-operation,[38] customs and tax fraud and money laundering,[39] and the taxation of savings.[40] In fact these agreements are only some among a large number of specific bilateral agreements between the EU and Switzerland. The only RTA in the strict sense of requiring Article XXIV GATT notification is the 1972 FTA; no general agreement on services liberalisation has been reached. However the RTA operates within a wider framework of agreements designed to support economic integration.

Compared with the other "neighbour" RTAs and with the SAAs, the EEA and the Swiss RTA do not combine economic integration with political or wider regional security objectives. They have a more purely economic focus although one should not ignore the wider social importance of the extension of the free movement of persons to both the EEA and Switzerland.

3. The third category of RTA in this group are the Euro–Mediterranean Association Agreements (EMAs), mixed association agreements between the EC, its Member States and other countries taking part in the Barcelona Conference in November 1995. EMAs with Tunisia, Morocco, Jordan, Israel, Algeria, Egypt, Lebanon, and an Interim Agreement for the benefit of the Palestinian Authority for the West Bank and the Gaza Strip are in force.[41] The EMAs refer in their Preambles to the establishment of a long-term relationship "based on reciprocity, partnership and co-development". There is no prospect of membership of the Union: they are designed to establish a framework for political dialogue, to lead

[34]The agreements were signed in 1999 and concluded in 2002: Council Decision 2002/309/EC OJ 2002 L 114.

[35]The agreement was concluded by both the EC and the EU with two separate decisions: Council Decision 2008/146/EC OJ L53 of 27/02/2008, p. 1 and Council Decision 2008/149/JHA OJ L 53, 27.2.2008, p. 50.

[36]OJ 2006 L 90/36.

[37]OJ L 90 of 28/03/2006, p. 22.

[38]OJ L 90 of 28/03/2006, p. 1.

[39]OJ L 46 of 17/02/2009, p. 6.

[40]OJ L 385 of 29/12/2004, p. 28.

[41]Euro–Med Agreement with Palestinian Authority OJ 1997 L187/3; Tunisia OJ 1998 L97/1; Morocco OJ 2000 L70/1; Israel OJ 2000 L147/3; Jordan OJ 2002 L129/3; Egypt OJ 2004 L304/39; Algeria OJ 2005 L265/2; Lebanon OJ 2006 L143/2. The agreement with Syria was signed in October 2004, its conclusion is dependent on compliance with UNSCR 1559 and at present the 1977 Cooperation Agreement is still in force. See further Edwards/Philippart, The Euro–Mediterranean Partnership: Fragmentation and Reconstruction, EFA Rev 2 (1997), p. 465; Philippart, The Euro–Mediterranean Partnership: A Critical Evaluation of an Ambitious Scheme, EFA Rev 8 (2003), p. 201; Pardo/Zemer, Towards a New Euro–Mediterranean Neighbourhood Space, EFA Rev 10 (2005), p. 39.

to a free trade area and the possibility of future liberalisation of trade in services and movement of capital. The provisions on establishment and services reaffirm the parties' existing obligations under the GATS (reciprocal MFN treatment), but the parties "agree to widen the scope of the Agreement to cover the right of establishment . . . and liberalisation of the provision of services" and negotiations are in progress with Egypt, Israel, Morocco and Tunisia. Further liberalisation of trade in agricultural, processed agricultural and fisheries products is also being negotiated on a bilateral basis. The provisions on approximation of laws are less developed than (for example) those found in the SAAs, and are put in the context of economic cooperation, rather than economic integration with the EU; specific examples of priority fields are not given, nor is mention made of specific technical assistance.[42] The EMAs are also intended to encourage regional integration and a significant aspect of the Barcelona Process has been its multilateral dimension, including the objective of creating a network of FTAs between the Mediterranean states, the aim being to lead eventually to a Euro–Mediterranean FTA, although the original objective of achieving this by 2010 will not be met.

The EMAs are more varied in scope and depth than the SAAs, partly because they have been negotiated over a longer period of time and partly because some of the Mediterranean partner countries already had association agreements with the EC with provisions, *inter alia*, covering non-discriminatory treatment for migrant workers; there was therefore an *acquis* to be built upon in these cases. The EMAs with the Maghreb states, although not granting any rights of residence or access to employment, contain equal treatment provisions for legally resident migrant workers while the agreements with Jordan and Lebanon are much more limited in this area, making issues of equal treatment and social security for migrant workers a matter of future dialogue. Significantly, the more recent agreements, such as the agreement with Lebanon, contain readmission clauses for illegal immigrants.[43]

The Euro–Mediterranean Agreements thus operate in the context of the prior history of relations with the Mediterranean countries, which goes back to the early years of the European Community, as well as within the multilateral framework of the Barcelona Process and ENP. They illustrate well the way in which RTAs may fit within a broader policy context that changes over time. Cooperation agreements had been concluded with many of the countries of the region in the late 1960s and then in the 1970s as part of a "global Mediterranean policy".[44] Then the EMAs

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[42]See for example Euro–Med Agreement with Morocco, Article 52; Euro–Med Agreement with Lebanon, Article 49.

[43]See Euro–Med Agreement with Lebanon, Articles 68 and 69.

[44]Morocco and Tunisia had already concluded association agreements in 1969: OJ [1969] L 197; OJ [1969] L 198; English version OJ [1973] L 239. Association agreements were then concluded with a number of Mediterranean non-member states during the 1970s: both the Mashreq (Egypt, Jordan, Lebanon, Syria) and the Maghreb (Algeria, Morocco, Tunisia). For a discussion, see Pace, The Mediterranean Policy of the EU: From the Treaties to Euro–Mediterranean Partnership, in: Xuereb/Pace (eds.), *Economic and Legal Reform in Malta*, 1995; Martines, *The Cooperation Agreements with the Maghreb Countries*, 1994.

replaced these, initially forming part of the Barcelona Process, launched by the Barcelona Declaration in 1995,[45] with its three areas of cooperation (political dialogue; free trade and economic cooperation; and human, social and cultural dialogue), a fourth dimension of cooperation (migration, social integration, justice and security) being added in 2005. Since 2004 the EMAs have also formed part of the European Neighbourhood Policy (ENP),[46] and in July 2008 the Barcelona Process was re-launched as the Union for the Mediterranean.[47] The Barcelona Process was indeed one of the first conscious attempts by the Union to develop a coherent policy towards a regional grouping that would bring together a full range of policy fields,[48] and the ENP has continued that development, with Action Plans covering all three pillars.

4. The fourth category of agreement is the Partnership and Cooperation Agreements (PCAs) with the states of the former Soviet Union. PCAs are in force with Ukraine, Moldova, Armenia, Azerbaijan, Georgia, Russia, Kazakhstan, the Kyrgyz Republic, and Uzbekistan.[49] It should be said at once that these agreements are not RTAs in terms of Article XXIV GATT (or Article V GATS), since as far as trade is concerned they offer only MFN treatment with reciprocal abolition of quantitative

[45]Barcelona Conference Declaration and Work Programme 27–28 November 1995, Bull EU 11-1995. The Declaration envisages a new Euro–Mediterranean partnership with three dimensions: a structured political and security partnership; an economic and financial partnership based on the introduction of a FTA by 2010, economic cooperation, and increased financial assistance from the EU; and partnership with a social, cultural and human dimension.

[46]For a detailed analysis of the ENP and the EU's relations with individual ENP partners and other neighbours, see Blockmans/Lazowski, *The European Union and Its Neighbours: A Legal Appraisal of the EU's Policies of Stabilisation, Partnership and Integration*, 2006. See also Cremona, The European Neighbourhood Policy: More than a Partnership? in: Cremona (ed.), *Developments in EU External Relations Law*, 2008.

[47]Joint declaration of the Paris summit for the Mediterranean, Paris, 13 July 2008, doc. 11887/08 (Presse 213); Final Statement of Union of the Mediterranean Ministers of Foreign Affairs, Marseille, 3–4 November 2008.

[48]The programme of Europe Agreements concluded with the central and eastern European states might be regarded as the first such attempt. Indeed, the decision to launch the Euro-Mediterranean policy, taken at Essen in December 1994, was linked to the pre-accession strategy being developed for CEESs: the European Council stated that "the European Union, recognising the need for balance in its relations with all its neighbours, is also developing a programme to establish a Euro–Mediterranean Partnership . . .".

[49]Ukraine PCA OJ 1998 L49/1; Moldova PCA OJ 1998 L181/1; Armenia PCA OJ 1999 L239/3; Azerbaijan PCA OJ 1999 L246/3; Georgia PCA OJ 1999 L205/3; Russia PCA: OJ 1997 L 327/1; Kazakhstan PCA OJ 1999 L 196/3; Kyrgyzstan PCA OJ 1999 L 196/48; Uzbekistan PCA OJ 1999 L 229/3. The Turkmenistan PCA was signed in 1998 but is not yet in force: COM(97) 693. The Tajikistan PCA was signed in 2004 but is not yet in force: COM (2004) 521. The Belarus PCA was signed in 1995 but formal conclusion is suspended as a result of the political situation and lack of democracy: COM (95) 44; see also Council Common Position 2006/276/CFSP on Belarus OJ [2006] L101/5, amended by Common Position 2006/362/CFSP OJ [2006] L134/45 and renewed by Common Position 2007/173/CFSP OJ [2007] L79/40. See also Commission non-paper, "What the European Union could bring to Belarus", 21/11/2006.

restrictions and safeguard, anti-dumping, and "infant-industry" clauses.[50] Their interest here is two-fold. First, although they do not establish a free trade area, the PCAs with Russia, Ukraine, Moldova and Belarus include a clause envisaging the possibility of future negotiations for a free trade agreement; the other PCAs do not.[51] In addition to the trade provisions, there are provisions on MFN and/or national treatment for branches and subsidiaries of EU and PCA partner companies, liberalisation of current payments, and a non-discrimination clause with respect to the working conditions of legally employed nationals.[52] Potentially far-reaching, and providing a basis for more specific commitments in the ENP Action Plans, are the clauses on approximation of laws. In sum, although the PCAs are not FTAs they have a considerable amount of potential, which has not in fact been fully exploited over their lifetime.

Second, the PCAs were concluded for 10 years and so are beginning to come to the end of their life. When considering their replacement we need to differentiate between (1) Russia; (2) the five central Asian PCA states; and (3) the six states that belong to the ENP (Armenia, Azerbaijan, Belarus, Georgia, Moldova and Ukraine). Russia is outside the ENP and its overall relations with the EU are managed within the four so-called "common spaces", on trade and economic relations; freedom, security and justice; external security and research, education and culture.[53] Negotiations for a new EU–Russia Agreement to replace the PCA have opened but are not likely to move quickly. In June 2007 the European Council adopted a Strategy on a new partnership with the central Asian states (Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan and Uzbekistan).[54] The emphasis is on political dialogue and technical and financial assistance, focussed on energy, the rule of law, human

[50]These agreements, as they come into force, replace the EEC–USSR Trade and Economic and Commercial Cooperation Agreement of December 1989, OJ [1990] L68/1. This is essentially an MFN agreement with respect to tariffs, with a Joint Committee as a basis for trade discussions; it still survives as it is applied bilaterally with the successor states of the former Soviet Union until replaced by a new agreement (PCA or Interim Agreement). See further Hillion, Partnership and Cooperation Agreements between the EU and the New Independent States of the Ex-Soviet Union, EFA Rev 3 (1998), p. 399.

[51]For example, compare EC–Ukraine PCA Art 4 and EC–Armenia PCA, Art 4.

[52]The difference in wording here between PCAs could be significant. In case C-265/03 *Simutenkov*, Art 23(1) of the EC–Russia PCA which provides that the parties "shall ensure" non-discriminatory treatment was held by the Court of Justice to be directly effective. The Court had no difficulty in holding that, despite references to implementation, Article 23(1) "has direct effect, with the result that individuals to whom that provision applies are entitled to rely on it before the courts of the Member States" (para 29). In contrast, Article 24 of the PCA with Ukraine provides that the parties "shall endeavour to ensure" non-discriminatory treatment, a phrase which may well fall short of an unconditional prohibition. The PCAs with Armenia, Georgia, and Azerbaijan follow the Ukraine PCA wording.

[53]EU–Russia Common Spaces Progress Report, March 2007. See also Commission Communication, Review of EU–Russia relations, COM(2008) 740, 5 November 2008.

[54]Conclusions of the European Council, 21–22 June 2007. See also Joint Progress Report by the Council and the European Commission to the European Council on the implementation of the EU Central Asia Strategy, 24 June 2008.

rights and education. Trade relations will remain based on MFN commitments and GSP preferences,[55] together with support for WTO accession for those of the group who are not yet members[56] and support for the development of regional infrastructure for transport, trade and energy. The approach thus combines bilateral and regional elements but there is no immediate prospect of an RTA.

For the ENP states, the replacement of the PCAs provides an impetus for the construction of a new form of agreement that would take its place within the framework of the ENP while upgrading the level of legal commitment. In March 2009 the European Council endorsed a Commission Communication and adopted a Declaration proposing a new initiative towards the six eastern ENP states – the Eastern Partnership.[57] One aim of the bilateral track proposed is the replacement, subject to political conditionality, of the existing PCAs with new association agreements. The likely shape of these agreements reflects the EU's current thinking on "deep integration", designed to establish a high level of regulatory cooperation outside the context of a membership perspective. The Commission refers to these future association agreements as "deep and comprehensive FTA" agreements.[58] They will allow for differentiation between partners in terms of the speed of the integration process, but the Commission argues that all the ENP partners should have "the same perspective" in terms of regulatory convergence and market access, thus supporting the cohesion of the ENP framework and more specifically allowing for the possibility that what is at present a series of bilateral agreements might in due course evolve into a Neighbourhood Economic Community.[59] For the PCA states, the immediate goal would be to move towards a free trade agreement. Negotiations with Ukraine were launched in February 2007,[60] and the Union has now declared its readiness to negotiate deep FTAs with Armenia, Georgia,

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[55]Council Regulation 980/2005/EC applying a scheme of generalized tariff preferences, OJ [2005] L169/1.

[56]At present only Kyrgyzstan is a WTO member.

[57]Commission Communication on the Eastern Partnership, COM (2008) 823, p. 3 December 2008; European Council conclusion and Declaration on the Eastern Partnership, 20 March 2009. A Joint Declaration with the Eastern partners is envisaged at a launching summit on 7 May 2009. Although the ENP remains as a framing policy structure, the launch in 2008–2009 of both the Union for the Mediterranean and the Eastern Partnership demonstrate the need for differentiation between the two regional groupings covered by the ENP.

[58]Commission Communication on the Eastern Partnership, COM (2008) 823, p. 3.

[59]Commission Communication on Strengthening the ENP, COM (2006) 726, at p. 5. See further Commission non-paper on ENP – A Path Towards Further Economic Integration, available on http://ec.europa.eu/world/enp/strengthening_en.htm.

[60]GAER Council Conclusions of 22 January 2007. See further Emerson, *The Prospect of Deep Free Trade between the EU and Ukraine*, 2006; Hillion, Mapping out the New Contractual Relations between the European Union and its Neighbours: Learning from the EU–Ukraine "Enhanced Agreement", EFA Rev 12 (2007), p. 169; Hillion, A New Framework for the Relations between the Union and its East European Neighbours, in: Cremona/Meloni (eds), The European Neighbourhood Policy: A Framework for Modernization? EUI Working Papers LAW 2007/21.

Moldova, Azerbaijan and Belarus, subject to WTO accession,[61] political conditionality and economic and political preparedness on the side of the partner countries. The "deep and comprehensive" FTAs would also include commitments in relation to regulatory approximation, the possibility of mutual recognition and conformity assessment agreements for industrial products and sanitary and phytosanitary standards as well as agreements on geographical indications, and some liberalisation of establishment, services and capital. Progress towards these deep FTAs will be supported bilaterally by the successors to the ENP Action Plans as well as by the multilateral dimension of the Eastern Partnership, one of whose "thematic platforms" will be "Economic integration and convergence with EU policies" with the aim of also encouraging bi- and/or multi-lateral RTAs between the partner states.

As we have seen and as we would expect, the EU's relations with its neighbours are highly differentiated but certain common features appear. With the exception of Russia and Switzerland, relations are managed on a regional basis (EEA, ENP, Union for the Mediterranean, Eastern Partnership) whose scope goes beyond trade to encompass broader economic development, transition and regulatory reform, political and internal and external security objectives. Apart from the EEA, the contractual RTA basis of these regional frameworks is currently bilateral but the EU encourages the regional / multilateral dimension, including RTAs. Current RTAs are at very different levels of integration and with a number of states there is not yet any free trade agreement. However the EU clearly supports an evolution of its RTAs with these countries towards a deeper level of economic integration, including commitments in relation to services, establishment and capital and regulatory approximation. In turn these commitments will be embedded in a political conditionality-based framework emphasising the EU's rule of law, human rights and security concerns.

Development

A substantial proportion of the EU's RTA partners are developing countries, and although it is true that many developing countries do not have RTAs with the EU, relying instead on the EU's GSP system, the network of development-oriented RTAs is increasing with the negotiation of six EPAs with the 78 ACP parties to the Cotonou Convention. We can distinguish between two broad groups of RTAs with developing countries: those which do not have an overt development focus, such as the FTAs with Mexico and Chile, and those which are explicitly aimed at

[61] Armenia, Georgia, Moldova and Ukraine are already WTO members.

development as well as trade integration, in particular the FTA with South Africa[62] and the EPAs.

While the EU has FTAs with both Mexico and Chile, they take rather different forms. The agreement with Chile is a (mixed) association agreement based on Article 310 EC;[63] it came into force in 2005 although its trade provisions had been provisionally applied since 2002.[64] This agreement has both "deep" and "wide" characteristics. As a deep FTA it envisages not only the establishment of an Article XXIV GATT-compatible FTA but also liberalisation of services in line with Article V GATS,[65] liberalisation of capital, provisions on investment, procurement, competition and intellectual property and cooperation on technical standards and sanitary and phytosanitary measures. A further characteristic of this agreement which may be said to form a part of its deeper free trade character is its emphasis on regional integration. There are frequent references to the regional dimension of cooperation, on environment, for example, but in addition one of the general cooperation provisions is devoted to regional integration, and in particular the relationship between the EU–Chile RTA and Mercosur. Under Article 49(1), both parties are to "use all existing cooperation instruments to promote activities aimed at developing an active and reciprocal cooperation between the Parties and the Mercado Común del Sur (Mercosur) as a whole". The agreement is thus presented as part of the EU's support for regional integration among this group of Latin American countries, and initiatives are envisaged on promotion of trade and investment, regional development and communications infrastructure. This feature is distinctive, since the RTA in question is not with a regional grouping (compare the EPAs or the EU's agreement with Mercosur, considered below) but with a single country that is itself a member of an RTA (Mercosur). In terms of "widening", the RTA with Chile contains provisions which go beyond trade and investment into the realm of the second and third pillars of the EU, reflecting the fact that the agreement is termed a "Political and Economic Association". As well as an "essential elements" clause referring to democratic principles, fundamental human rights and the rule of law, the provisions on political dialogue refer to "the

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[62]This FTA was signed in 1999 and came into force in 2005: Council Decision 2004/441/EC of 26 April 2004 concerning the conclusion of the Trade, Development and Cooperation Agreement between the European Community and its Member States, on the one part, and the Republic of South Africa, on the other part OJ 2004 L 127/109. It will not be further discussed here as South Africa has joined the negotiations for an EPA as part of the SACD group.

[63]Council Decision 2005/269/EC of 28 February 2005 on the conclusion of the Agreement establishing an association between the European Community and its Member States of the one part, and the Republic of Chile, of the other part *OJ L 84, 2.4.2005, p. 19.*

[64]Council Decision 2002/979/EC of 18 November 2002 on the signature and provisional application of certain provisions of an Agreement establishing an association between the European Community and its Member States, of the one part, and the Republic of Chile, of the other part *OJ L 352, 30.12.2002, p. 1.*

[65]All GATS service modes are covered but some sectors are excluded, including financial, audiovisual, maritime cabotage and some air transport services. However there are separate provisions on telecommunications, maritime transport and financial services.

promotion, dissemination, further development and common defence of democratic values", as well as cooperation in the field of foreign and security policy and cooperation against terrorism. There is also provision for cooperation on drugs, money laundering and drug-related organised crime and a clause on illegal immigration and readmission.

The agreement with Mexico is an Economic Partnership, Political Coordination and Cooperation Agreement (known as the "Global Agreement") and came into force in 2000;[66] it is a mixed agreement with a multiple legal basis – on the Community side – of Articles 44(2), 47, 55, 57(2), 71, 80(2), 133 and 181 EC. Its free trade provisions have been given effect by a decision of the EC–Mexico Joint Council established by the agreement.[67] A further Joint Council Decision on liberalisation of services is envisaged but not in force. The RTA was negotiated against the background of NAFTA, as is clear from the Commission's presentation of the FTA, where parity with NAFTA is stressed.[68] The agreement contains some elements of deeper integration, including provisions on (future) services liberalisation and detailed provisions in Decision 2/2000 on procurement and competition cooperation. It also contains elements of "widening", including an essential elements clause, political dialogue, cooperation on combating drug trafficking, money laundering and chemical precursors, refugees, and human rights and democracy.

The most significant development-oriented RTAs concluded and under negotiation by the EU are the EPAs with the six regional groupings of African, Caribbean and Pacific states. The trade provisions in the Cotonou Convention between the EU and 78 ACP states, which envisaged non-reciprocal preferences for the ACP States, received a time-limited WTO waiver which expired at the end of 2007 with a view to the negotiation of revised trade provisions intended to take effect from 2008. EPAs are being negotiated within the framework of Cotonou with a view to replacing those trade provisions with WTO-compatible agreements involving reciprocal although asymmetric trade liberalisation.[69] The first of the EPAs to be agreed is the EPA with the CARIFORUM group of countries,[70] initialled on 16 December 2007. Until full EPAs are negotiated with the other groups of ACP States, a number of interim EPAs have been agreed and are being provisionally

[66]Council Decision 2000/658/EC of 28 September 2000 concerning the conclusion of the Economic Partnership, Political Coordination and Cooperation Agreement between the European Community and its Member States, of the one part, and the United Mexican States, of the other part OJ 2000 L 276/44.

[67]Decision no 2/2000 of the EC/Mexico Joint Council of 23 March 2000.

[68]See statement of Commissioner Lamy, 3 June 2000, available on http://ec.europa.eu/trade/issues/bilateral/countries/mexico/ftapr_en.htm.

[69]EPAs are being negotiated with the Caribbean, West Africa, Central Africa, Eastern and Southern Africa, the SADC and the Pacific. For the EU's perspective on the EPAs see the Explanatory Memorandum to the Commission's draft mandate of 9 April 2002, available on http://trade.ec.europa.eu/doclib/docs/2006/september/tradoc_112023.pdf.

[70]Antigua and Barbuda, Bahamas, Barbados, Belize, Dominica, the Dominican Republic, Grenada, Guyana, Haiti, Jamaica, Saint Lucia, Saint Vincent and the Grenadines, Saint Christopher and Nevis, Suriname, and Trinidad and Tobago.

applied,[71] and a Regulation on market access implementing these agreements has been adopted.[72]

The EPAs are controversial both in terms of the broader debate over the links between development and regional integration,[73] and in terms of the degree to which the provisions negotiated by the EU are genuinely development-friendly.[74] The EU argues both that regional integration is conducive to development,[75] and that in addition to being FTAs the EPAs are also, or even essentially, development instruments; the former Trade Commissioner has referred to their "powerful" development rationale.[76] Under Article 37(7) of the Cotonou Convention, EPA negotiations "shall take account of the level of development and the

[71]See for example Council Decision 2009/152/EC of 20 November 2008 on the signature and provisional application of the interim agreement with a view to an Economic Partnership Agreement between the European Community and its Member States, of the one part, and the Central Africa Party, of the other part, OJ 2009 L 57/1. The interim agreements do not necessarily include all countries in the respective regions; for example, the interim agreement with Central Africa covers only Cameroon, with the other seven states of the region remaining under the GSP.

[72]Council Regulation 1528/2007 of 20 December 2007 applying the arrangements for products originating in certain states which are part of the African, Caribbean and Pacific (ACP) Group of States provided for in agreements establishing, or leading to the establishment of, Economic Partnership Agreements, OJ 2007 L 348/1. 36 of the 78 ACP States are covered by this Regulation at present; its operation will be extended as other ACP states conclude EPAs or interim EPAs with the EC. For those not covered by this Regulation, the GSP Regulation will apply, thus for LDCs there is duty free access to the EU for all exports under the "Everything But Arms" (EBA) policy. South Africa remains covered by its bilateral FTA: see above note 62.

[73]See for example Schiff/Winters, *Regional Integration and Development*, 2003; Schiff/Winters, Regionalism and Development. The Implications of World Bank Research for ACP and Latin American Countries, Journal of World Trade 36 (2002) 3, p. 479. On WTO law and development, see further Moon, The WTO-Minus Strategy: Development and human rights under WTO law, (March 2008) *University of New South Wales Faculty of Law Research Series 2008,* Working Paper 10, available at http://law.bepress.com/unswwps/flrps08/art10.

[74]See Desta, EC-ACP Economic Partnership Agreements and the Question of WTO Compatibility: An Experiment in North–South Regional Integration Agreements? Common Market Law Rev. 43 (2006), p. 1343; Perez, Are Economic Partnership Agreements a First-Best Option for the ACP Countries? Journal of World Trade 40 (2006) 6, p. 999; Van Hoestenberghe/Roelfsema, Economic Partnership Agreements between the EU and groups of ACP countries: Will they promote development?, UNU-CRIS Occasional Papers, 0-2006-27; Thallinger, From Apology to Utopia: EU-ACP Economic Partnership Agreements Oscillating Between WTO Conformity and Sustainability, European Foreign Affairs Rev. 12 (2007), p. 499.

[75]For the argument that trade and development can be mutually supportive, see for example the Commission Communication, Trade and Development: assisting developing countries reap the benefits of open trade, COM (2002) 513. See also Pascal Lamy, WTO Director General, calling in the Emile Noel Lecture at the New York University Law School, 30 October 2006, for a new "Geneva Consensus", available at http://www.wto.org/english/news_e/sppl_e/sppl45_e.htm.

[76]Commission Mandelson, speech at a seminar on European Partnership Agreements, European Parliament, 17 April 2008, available at http://ec.europa.eu/commission_barroso/mandelson/speeches_articles/sppm200_en.htm.See also the Kigali Declaration on development-friendly EPAs, adopted by the ACP–EU Joint Parliamentary Assembly meeting in Kigali, Rwanda from 19 to 22 November 2007.

socioeconomic impact of trade measures on ACP countries, and their capacity to adapt and adjust their economies to the liberalisation process". According to the Commission, the EPAs extend the criteria for FTA compatibility with the WTO further than ever before in terms of coverage and asymmetry of obligations, its benchmark being immediate 100% liberalisation of EU trade and at least 80% liberalisation of ACP trade over 15 years.[77] We will not enter into this debate here, but will rather point to some of the innovatory aspects of the EPAs from the point of view of EU policy.

First there is the regional dimension. The EPAs are being negotiated with six regional groupings, in some cases but not all based on pre-existent regional integration arrangements.[78] The EU's approach is based on a South–South–North model which, it is argued, combines the benefits of a North–South RTA (access to large and developed markets, promotion of FDI, technology transfer, impacts on good governance and credibility), with those of a South–South RTA (such as the creation of markets large enough to attract FDI).[79] As Rossi has argued, the South–South element in these agreements may contribute to intra-regional stability and security as well as (and through) economic development.[80]

A second innovatory feature for an EU RTA is the emphasis on development, and in particular sustainable development. Taking the EPA with CARIFORUM as an example, general provisions on development cooperation are combined with specific provisions in the sectoral chapters of the agreement, and a Joint Declaration commits €165 million over six years, according to priorities set in Regional Aid for Trade packages. The trade provisions of the Agreement are headed "Trade Partnership for Sustainable Development" and Article 3 spells out what this should mean:

1. The Parties reaffirm that the objective of sustainable development is to be applied and integrated at every level of their economic partnership…
2. The Parties understand this objective to apply in the case of the present Economic Partnership Agreement as a commitment that:
   (a) the application of this Agreement shall fully take into account the human, cultural, economic, social, health and environmental best interests of their respective population and of future generations;

[77]European Commission, DG Trade, "An Overview of the Interim Agreements", available on http://trade.ec.europa.eu/doclib/docs/2009/january/tradoc_142188.pdf.

[78]The overlapping nature of regional integration arrangements in Africa has in some cases made for complexity and the EPA groups do not always coincide with existing RIAs; for example, of the 15 members of the Southern African Development Community (SADC), seven are negotiating an EPA as the SADC group, while the other eight are negotiating in either the Central Africa or the Eastern/Southern Africa EPA groups.

[79]Rossi, EU Regional Trade Agreements' Role in the Prevention of Conflict and in Increasing Intra-regional and Global Security and Stability: An Economic Perspective, in: Kronenberger/ Wouters (eds.), *The European Union and Conflict Prevention: Policy and Legal Aspects*, 2004, p. 173 and p. 179.

[80]Ibid. p. 179.

(b) decision-taking methods embrace the fundamental principles of ownership, participation and dialogue.

3. As a result the Parties agree to work cooperatively towards the realization of a sustainable development centred on the human person, who is the main beneficiary of development.

How does this commitment translate into actual provisions? The agreement is too extensive to be able to examine it thoroughly here, but we can highlight two examples. First is the notable asymmetry in liberalisation commitments, not only in the timetable for liberalising trade in goods but also in the coverage and commitments relating to services and investment. Second, for the first time, an EU agreement contains substantive provisions on investment. These provisions not only provide for market access and national treatment; they also, in an innovative provision, contain a commitment on investor behaviour. The parties are to ensure through national legislation that investors do not engage in corruption or "manage or operate their investments in a manner that circumvents international environmental or labour obligations" and that they act in accordance with core labour standards.[81] In addition the parties commit to ensuring that FDI is not encouraged by lowering domestic environmental or labour legislation and standards or by relaxing core labour standards.[82] This commitment is repeated later in the chapter on the social aspects of cooperation.[83] The provisions on investor behaviour are innovative;[84] the relationship between these provisions and those found in bilateral investment treaties (BITS) between individual ACP states and individual Member States may pose challenges, especially since the agreement appears to give priority to "more favourable treatment" for investors granted by such BITS.[85]

The third innovatory feature of the EPAs is that they are the first example of a deep FTA in the EU's practice. The CARIFORUM EPA contains detailed provisions on the different modes of supply of services including substantive provisions on market access and national treatment,[86] and regulatory provisions on specific service sectors, including computing, telecommunications, financial services,

[81] Article 72 of the CARIFORUM EPA. These core labour standards are further elaborated, in accordance with ILO Declaration on Fundamental Principles and Rights of Work of 1998, referred to in the text, in ILO Conventions concerning freedom of association, the elimination of forced labour, the abolition of child labour and the elimination of discrimination in the work place.

[82] Article 73 of the CARIFORUM EPA.

[83] Article 191–193 of the CARIFORUM EPA.

[84] Sauvé/Ward, Services and Investment in the EC-CARIFORUM EPA: Innovation in Rule-Design and Implications for Africa, in: Faber/Orbie (eds.), *Beyond Market Access for Economic Development: EU–Africa Relations in Transition*, 2009.

[85] See Article 71 of the CARIFORUM EPA; it is not clear to what extent the rights given to investors in bilateral BITS may, by virtue of this clause, prevail over the investor behaviour obligations laid down in Article 72 (thanks to Angelos Dimopoulos for this point).

[86] Detailed examination of each EPA is needed to ascertain the extent to which each party's commitment exceed those under GATS; Sauvé and Ward conclude that the CARIFORUM EPA "represents a significant improvement on the current GATS commitments of both the CARIFORUM states as well as EC Members"; op.cit. note 84, at p. 5.

tourism and e-commerce. The EU regards commitments relating to government procurement, competition and intellectual property rights as important elements of its new generation of RTAs[87] and they are found in the CARIFORUM EPA. The competition provisions are extensive, combining provisions on anti-competitive conduct affecting the agreement; on the establishment of competition laws and enforcement authorities at national level; and on cooperation between competition authorities. As well as general provisions on competition there are also specific competition-related provisions for certain sectors, including tourism and telecommunications and in this the EPA goes beyond existing FTA competition provisions.[88]

The CARIFORUM EPA thus demonstrates a significant evolution in EU trade policy, in combining an emphasis on deeper integration with a concern to create a WTO-compatible RTA which is deliberately designed to further development. The African EPAs are likely to differ in terms of specific commitments and they might not go as far as the CARIFORUM EPA in relation to services, but the overall approach will follow a similar pattern.

Global Market Access

Not all the EU's RTAs are concerned with preparation for accession, relations with neighbours or with development. As has already been mentioned, during 2006–2007 the EU decided to launch a series of negotiations (with China, ASEAN, South Korea, India, Central America) designed to lead to a new generation of RTAs. In addition, inter-regional RTA negotiations were already underway with Mercosur, the Andean Community and the Gulf Cooperation Council. These RTAs are primarily concerned with market access, building on and extending WTO commitments rather than being embedded in broader foreign policy objectives. In addition, a Trade and Cooperation Agreement with Iraq has been under negotiation since 2006. Here of course, broader political issues are at play, and since Iraq is not yet a member of the WTO the agreement would be designed to establish a basic level of trade cooperation and to facilitate WTO accession.[89] In many cases

[87]"Global Europe: Competing in the World: A Contribution to the EU's Growth and Job Strategy", communication by DG Trade, 4 October 2006.

[88]Sauvé and Ward, op.cit. note 84, p. 19.

[89]Commission Communication "The European Union and Iraq: A Framework for Engagement" COM (2004) 417, 9 June 2004; Commission Communication "Recommendations for renewed European Union engagement with Iraq" COM (2006) 283 final, 7 June 2006.

(India,[90] China,[91] ASEAN,[92] Mercosur,[93] the Andean Community,[94] Central America,[95] the Gulf Cooperation Council[96]), the RTAs under negotiation are designed to build upon existing agreements; in other cases (South Korea, Iraq) there is no existing contractual relationship.

These negotiations need to be seen in the context of the lack of progress with the Doha Development Round within the WTO coupled with a US policy of concluding bilateral trade agreements; they thus have a primarily economic focus. As indicated in the Commission's Communication on Global Europe,[97] these RTAs are intended to address issues which are currently outside the scope of the WTO including investment, public procurement, competition and other regulatory issues and IPR enforcement; they will also seek to build upon existing WTO commitments, for example in the field of services, and to concentrate on improving market access. Inevitably, for each negotiation and agreement there are different specificities and negotiations with regional groupings such as ASEAN, the GCC and Mercosur tend to move more slowly. In the case of Mercosur, for example, agricultural trade and sanitary, phytosanitary and environmental standards are important.[98] Negotiations have been stalled for some time but recent initiatives by Spain and Argentina (due to hold the EU and Mercosur presidencies respectively in 2010) may lead to a renewed effort to finalise the agreement. In the case of the GCC, the political

[90]EC–India Cooperation Agreement on Partnership and Development OJ 1994 L 223/23.

[91]Agreement on Trade and Economic Cooperation between the European Economic Community and the People's Republic of China *OJ 1985 L 250/2;* Agreement between the European Community and China on cooperation and mutual administrative assistance in customs matters *OJ 2004 L 375.19.*

[92]Cooperation Agreement between the European Economic Community and the member countries of the Association of South-East Asian Nations (Indonesia, Malaysia, the Philippines, Singapore, Thailand, Brunei-Darussalam, Vietnam, Laos, Cambodia) *OJ 1980 L 144/2. There is also a framework for dialogue and regulatory cooperation with ASEAN, the* Trans-Regional EU–ASEAN Trade Initiative (TREATI).

[93]Inter-regional framework cooperation agreement between the European Community and its Member States, of the one part, and the Southern Common Market and its Party States, of the other part OJ 1999 L 112/65.

[94]Proposal for a Council Decision on the conclusion of a Political Dialogue and Cooperation Agreement between the European Community and its Member States, of the one part, and the Andean Community and its member countries, the Republics of Bolivia, Colombia, Ecuador, Peru and the Bolivarian Republic of Venezuela, of the other part COM (2003) 695 final.

[95]The Central American Region (Panama, Guatemala, Costa Rica, El Salvador, Honduras, Nicaragua) has a Framework Cooperation Agreement with the EC (*OJ 1999 L 63/39); a* Political Dialogue and Cooperation Agreement is not yet in force (COM (2003) 677).

[96]The Gulf Cooperation Council (United Arab Emirates, Bahrain, Saudi Arabia, the Sultanate of Oman, Qatar and Kuwait) has a non-preferential Cooperation Agreement with the EC (1989 OJ 1989 L 54/3).

[97]"Global Europe: Competing in the World: A Contribution to the EU's Growth and Job Strategy", communication by DG Trade, 4 October 2006.

[98]Schneider, The EU–Mercosur Free Trade Agreement: The Implications for Trade in Agriculture, CEPS Policy Brief No.107, June 2006.

dimension of the projected RTA, including the human rights essential elements clause, is a point of difficulty. The political dimension is also an issue in the negotiations with India, which are reaching a climax in early 2009. In contrast the RTA with South Korea has progressed relatively smoothly and negotiations were expected to be completed in spring 2009, with some outstanding specific trade issues such as rules of origin and import duties on cars.

Conclusion: Recent Trends in EU RTAs

What conclusions can be drawn from this very brief survey of the EU's current RTA practice? Firstly, we have seen that the EU is seeking to develop a new generation of deep RTAs which would go beyond a free trade area for goods to include trade in services, investment, public procurement, regulatory barriers, standards, competition and IPR. This tendency is visible in all new RTAs, not only in those driven primarily by market access concerns but also those with a strong development dimension and the RTAs the EU is negotiating with its neighbours and potential members. In many cases, financial technical assistance to support not only market opening but also regulatory reform is an important part of the overall package. This tendency towards "deepening" has a double rationale: on the one hand, the EU sees progress in these areas as an important mechanism for improving the market access opportunities of its own producers of goods and services; on the other it is linked to the EU's conception of the way in which regional integration can underpin sustainable economic development and transition to an effective market economy. Although these two rationales may work in synergy, clearly they may also be in tension with each other.

Secondly, we have seen the extent to which the EU links its RTA with its broader foreign policy agenda. This takes places in two ways (which are not mutually exclusive). First, the RTA may be embedded in a wider policy context, whether the neighbourhood policy or enlargement policy, therefore serving broader political objectives, including regional security. Second, the EU has developed an extensive practice of seeking to include standard clauses in its RTAs that are not directly trade related in order to serve specific policy agendas. Since the early 1990s, clauses committing the parties to uphold democracy, human rights and the rule of law have been standard, although not always uncontroversial. More recently, these have been added to, with clauses on illegal migration and readmission, terrorism, and weapons of mass destruction. There is an obvious danger that a prospective agreement will become weighed down with standard clauses which do not necessarily have much practical effect but which create a rigidity in the negotiations and which also weigh heavily in the scales as part of the EU's "demand".

We can also point to links between this deepening and widening: deeper integration is likely to assist the EU's wider objectives, including its policy towards its neighbours and its sustainable development objectives. However the point has been made that the EU must take care not to see economic integration primarily as a political instrument designed to serve political objectives.[99]

Thirdly, we have seen the importance of the regional dimension in the EU's RTA policy. Increasingly the EU seeks to establish inter-regional relations, but perhaps more significantly it also seeks to encourage intra-regional integration through its region-to-region agreements. The process of negotiation with the EU may stimulate progress in intra-regional integration, as happened with the GCC for example, to some extent also with Mercosur, and as part of the EPA process.[100] We have seen that the EU sees its South–South–North model for development-oriented RTAs as producing benefits. It is also true, however, that inter-regional RTAs are more complex and slower to negotiate and it is significant that even the Interim EPAs have in most cases not been concluded with every member of the EPA region in question.

Finally, there is the WTO dimension. The EU has developed the position that it will wait to conclude an RTA until a country has become a member of the WTO. WTO commitments and disciplines provide a basis for regional free trade, and this position also makes clear the EU's support for the multilateral process: the bilateral RTA is not seen as an alternative to WTO membership. Second, the EU lays great emphasis, rhetorically but also substantively, on WTO compliance. Problems arise where, as in the case of the EPAs, there is genuine doubt as to how much flexibility and differentiation is permitted in a WTO-compatible RTA. The EU does not see its extensive network of RTAs as a threat to the WTO system, but this potential danger is one reason for its move towards deep free trade; such "WTO-plus" RTAs can more readily be seen as complementary to the multilateral agenda. Indeed, for the EU one advantage of its deep free trade approach is that it is bilaterally and regionally building support within the WTO for its own regulatory positions.

[99]Rossi, op.cit. note 79 at p. 187.

[100]Desta, EC-ACP Economic Partnership Agreements and the Question of WTO Compatibility: An Experiment in North–South Regional Integration Agreements? Common Market Law Review 43 (2006), p. 1343.

Regional Economic Integration in the Middle East and North Africa: A Primer

Tomer Broude

Introduction

The Middle East and North Africa (MENA) is not a region easily associated with economic integration. It more readily conjures up images of geopolitical discord, state-led economies, authoritarian regimes and oil Sheikdoms that fear the reverberations of political liberalization that might come with economic openness.[1] Indeed, early attempts at regional integration from the 1950s until the 1980s failed unequivocally,[2] and only in the last few years can it be said that any real progress has been made. The economic gains anticipated from MENA integration, by any estimate, are evidently not so dramatic[3] as to have overcome domestic and regional

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[1]Moreover, international economic liberalization and the capitalist system pose fundamental challenges not only to governments, but to other traditional sources of social authority and legitimacy in the region; see Tripp, *Islam and the Moral Economy: The Challenge of Capitalism*, 2006.

[2]For a brief history of early regional integration efforts in MENA, see Zarrouk, The Greater Arab Free Trade Area: Limits and Possibilities, in: Hoekman/Zarrouk (eds.), *Catching up with the Competition: Trade Opportunities and Challenges for Arab Countries*, 2000, p. 285; and see Sect. 4 *infra*.

[3]Estimates differ between studies, but it is generally acknowledged that the rate of intra-regional MENA trade in proportion to total international trade with the region is very low, in most countries remaining at single digit figures – the lowest among all world regions except for South Asia (World Bank, *Middle East and North Africa Region, 2008 Economic Developments and Prospects: Regional Integration for Global Competitiveness*, 2009, p. 36). It is also a common, though more controversial finding that the economic benefits of regional integration are limited. See, e.g., Péridy, Toward a Pan-Arab Free Trade Area: Assessing Trade Potential Effects of the Agadir Agreement, The Developing Economies 43 (2005) 3, p. 32. One recent study of a MENA sub-region found that trade liberalization might double intra-regional trade, it would still remain at the modest level of 10% of total trade, see Tovias/Kalaycioglu/Dafni/Ruben/Herman, What Would

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political obstacles; and at the same time, in no other region of the world is the project of regional economic integration so politicized, in the sense that it is driven more by the idea of peace and stability through trade than by rational economic logic.[4]

On this mixed background, there is some reason to hope that the next decade, perhaps even the next few years, will see more effective regional integration turn into a reality. The aftermath of the events of September 11, 2001, produced an uncertain regional environment,[5] but ultimately provided an impetus for change, inter alia through the acceleration of the regional liberalization process creating the Greater Arab Free Trade Agreement (GAFTA) in 2005,[6] and the 2004 Agadir Agreement for the establishment of a Free Trade Zone between the Arabic Mediterranean Nations (the "Agadir Agreement").[7] The 2008 international financial crisis and the drop in oil prices – 50% in a matter of months[8] – is forcing oil-based economies to take economic diversification more seriously. The crisis of multilateralism in the World Trade Organization's (WTO) Doha Round and the global proliferation of free trade agreements should encourage MENA states to pursue regional trade agreements (RTAs) both within the region and with extra-regional partners. And if the new United States (US) administration under President Obama is to keep its election promises of minimizing direct military engagement in the region, it will have to strengthen other modes of political influence, and improve upon the Bush administration's economic initiatives in MENA.[9]

Normalization of Economic Relations between Mashrek Countries, Turkey and Israel Imply? The World Economy 30 (2007) 4, p. 665 (683).

[4]Much of the discourse sees MENA regional economic integration as a source of peace and political stability, in a pragmatic, Kantian mindset. See, e.g., Arnon/Bamya, *Economic Dimensions of a Two-State Agreement between Israel and Palestine*¸ 2007; Lawrence, *A US–Middle East Trade Agreement: A Circle of Opportunity?* 2006, pp. 4–7; for a critique of the peace-through-trade logic in the EU's regional policy, see Broude, Between *Pax Mercatoria* and *Pax Europea*: How Trade Dispute Procedures Serve the EC's Regional Hegemony, in: Ala'i/Broude/Picker, *Trade as the Guarantor of Peace, Liberty and Security? Critical, Historical and Empirical Perspectives*, 2006.

[5]See Harders, Analyzing Regional Cooperation after September 11, 2001: The Emergence of a New Regional Order in the Arab World, in: Harders/Legrenzi (eds.), *Beyond Regionalism? Regional Cooperation, Regionalism and Regionalization in the Middle East*, 2008, p. 33.

[6]In accordance with the League of Arab States (Arab League) Declaration on Pan-Arab Free Trade Area (Economic and Social Council's Resolution No. 1317 – O.S. 59, Executive Program of the Agreement on Facilitating and Developing Inter-Arab Trade for Establishing Pan-Arab Free Trade Area, 1997), p. 14, full liberalization (in accordance with the relevant legal documents) was to be achieved by July 21, 2007; however, the process was expedited and formally completed on January 1, 2005, creating the GAFTA; see Sect. 6 *infra*.

[7]Signed on February 25, 2004 by Jordan, Tunisia, Egypt and Morocco; see Sect. 6 *infra*.

[8]See Mouawad, OPEC Ponders Choices as Oil Prices Plummet, New York Times, October 21, 2008.

[9]Referring here to the "Middle East Free Trade Area Initiative" announced by President Bush in 2003, which has ultimately led only to a small number of trade agreements between the USA and MENA partners and some limited progress on cumulation of origin between Israel, on one hand, and Jordan and Egypt, on the other hand, in the specialized context of "Qualified Economic Zones" (QIZ), with little effect on regional integration as such; for a critique see Momani, A Middle East Free Trade Area: Economic Interdependence and Peace Reconsidered, World Politics 30 (2007) 11, p. 1682.

This chapter of the first issue of the EYIEL is therefore quite timely. It will serve as a largely descriptive primer framing regional integration in the MENA region, with the hope that future developments will allow for more detailed analyses of particular legal and policy problems in subsequent issues. The chapter will be constructed as follows. First, it will define the MENA region and provide a brief overview of its economic characteristics. Then it will survey the region's states' participation in the multilateral trading system, the WTO. It subsequently surveys bilateral trade arrangements within the region. Next, the article will review some of the initiatives to promote plurilateral economic integration at the sub-regional and regional levels, from the historical to the contemporary, followed by brief conclusions.[10]

An Overview of the Economics of MENA as a Region

Regional Characterization and Delimitation

The "Middle East" is very much an invented term,[11] and as such lends itself to fluid definition and delimitation. In simple geographical terms, it does not adhere to obvious continental or other boundaries.[12] In economic terms, it is possible to reduce the region's main characteristics to "three simple facts: little rain, much oil, and increasingly many (and therefore young) people,"[13] but as we shall see in this section, these facts do not apply with even force throughout the region. A historic definition that builds on the territories of "the great Arab, Persian and Turkic empires of Islam"[14] would be so expansive as to include modern states whose more recent history sets them apart (such as former Soviet republics in central Asia, on one hand, and ex-colonies in North Africa). The region's population is overwhelmingly Moslem by religion, but this is not a helpful defining factor given the diversity of faith in the region, both within Islam and without it, as well as the large Moslem populace that does not live in the region. Perhaps the closest we

[10]Clinging to its immediate mandate, the chapter deliberately focuses on economic integration *within* the region, additionally granting specific contextual attention to the MENA states' participation in the WTO, and more selectively to the broader environment of EU and US influences, which deserve more detailed analysis; on the latter, see Al Khouri, EU and US Free Trade Agreements in the Middle East and North Africa, Carnegie Endowment for International Peace, Carnegie Papers No. 8, 2008; Lawrence, *A US–Middle East Trade Agreement: A Circle of Opportunity?* 2006, pp. 81–89.

[11]See Lewis, *The Shaping of the Modern Middle East*, 1994, p. 3.

[12]Although it has been defined as a region "that embraces an area fringed by five seas: Mediterranean, Black, Caspian and the Red seas and the Persian or Arabian Gulf" (see Çarkoğlu/Eder/Kirişci, *The Political Economy of Regional Cooperation in the Middle East*, 1998, p. 7).

[13]Richards/Waterbury, *A Political Economy of the Middle East*, (3rd ed.) 2008, p. 44.

[14]Lewis, *The Shaping of the Modern Middle East*, 1994, p. 21.

can come to a single defining element is the Arab ethnicity of the vast majority of the MENA population, and indeed US policy aimed at cooperation within a "Greater Middle East Initiative" has met with regional opposition because it understates the Arab character of the region and dilutes it by including states such as Pakistan, Afghanistan and even some states in the Caucasus.[15]

Indeed, to large extent it is regional integration between the Arab states that we will focus on here. The World Bank's definition of the MENA region includes: Algeria, Bahrain, Djibouti, Egypt, Iran, Iraq, Israel, Jordan, Kuwait, Lebanon, Libya, Malta, Morocco, Oman, Qatar, Saudi Arabia, Syria, Tunisia, United Arab Emirates, West Bank and Gaza and Yemen.[16] From this list we will exclude Malta, which has been a member of the EU since May 1, 2004; Turkey, that focuses its economic integration efforts on Europe; and Iran, an important regional outlier, whose radical political positions and subsequent international seclusion make it a disturbing factor in regional integration. Israel will be included, however, not only because it is located in the center of the region, but also because of its economic importance and interest in playing a role in regional integration; this is despite the obvious barrier to regional integration posed by the ongoing Arab–Israeli conflict.[17]

The MENA region as thus defined therefore extends from Morocco in the west to Iraq and Oman. This is a region with a population of approximately 280 million people, and a cumulative nominal GDP of approximately US $1,457 billion.[18] It is a region of whose economy is very diverse;[19] nevertheless the following paragraphs will sketch some of the defining elements of MENA's political economy insofar as they are relevant to regional economic integration.

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[15]Harders, Analyzing Regional Cooperation after September 11, 2001: The Emergence of a New Regional Order in the Arab World, in: Harders/Legrenzi (eds.), *Beyond Regionalism? Regional Cooperation, Regionalism and Regionalization in the Middle East*, 2008, p. 33, (pp. 34–35).

[16]See World Bank website, http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/MENAEXT/0,,menuPK:247619~pagePK:146748~piPK:146812~theSitePK:256299,00.html.

[17]Without downplaying the importance of the Arab–Israeli conflict, it is by no means the only source of regional political discord and military tension in the region. In fact, the Middle East has for the last few decades held the position of most conflict-prone region in the world (Gleditsch/Wallensteen/Erikkson/Sollenberg/Strand, Armed Conflict 1946–2001: A New Dataset, Journal of Peace Research 39 (2002) 5, p. 615, (pp. 615–617). Central conflicts have included civil war in Yemen in the 1960s (with Egyptian and Saudi Arabian involvement) and 1990s, the Iran–Iraq war in the 1980s; the Iraqi invasion of Kuwait and the following first Gulf War in the early 1990s; Kurdish insurrection in the territories of Iraq, Turkey, Iran and Syria; civil war in Lebanon from 1976; civil war in Algeria in the 1990s and significant civil unrest in other MENA countries on the basis of social and religious fault lines.

[18]2007 Figures based on World Bank, *Middle East and North Africa Region, 2008 Economic Developments and Prospects: Regional Integration for Global Competitiveness*, 2009, pp. 103–104, excluding Iran and with additional data for Israel.

[19]This is true even with respect to MENA sub-regions such as the Mashrek: see Tovias/Kalaycioglu/Dafni/Ruben/Herman, What Would Normalization of Economic Relations between Mashrek Countries, Turkey and Israel Imply? The World Economy 30 (2007) 4, p. 665 (682).

Basic Economic Indicators, Development and Poverty

None of the national economies of the MENA region is especially large on a global scale; this is certainly true if the oil sector is excluded. Moreover, there is great variance in the relative size of national economies, from Djibouti's US $0.8 billion and Jordan's US $16 billion to Algeria's US $134 billion and Saudi Arabia's US $375 billion, with several steps in between.[20] Great disparities also exist in the region's GDP per capita distribution, from very high (UAE – US $49,116; Kuwait – US $46,638; Israel – US $24,405; Saudi Arabia – US $22,053) to low (Djibouti – US $1,965; Yemen – US $2,262; Morocco – US $3,915; Egypt – US $4,953; Jordan – US $4,654).[21] These disparities in themselves demonstrate the low degree of existing regional economic integration. Moreover, it is important to note that none of the MENA states are classified by UNDP as Low Human Development states, and only Djibouti and Yemen are classified as Least-Developed Countries;[22] indeed, "compared with other parts of the developing world, abject poverty is not especially prevalent, even in countries in the region without large oil reserves."[23] Nevertheless, an orthodox view that builds on the structural characteristics of most MENA economies holds that "many of the major problems and questions affecting the Middle East today can and should be approached in much the same way as one would approach the problems of any set of LDCs."[24]

Water Scarcity

MENA is the world's driest region, with three-quarters of its surface characterized as desert. In most of the region rainfall is very scarce and much of Algeria, Libya, Egypt, Saudi Arabia, Oman, Qatar, and the UAE receive less than 100 mm of rain on average every year.[25] Water availability per person is around 1,200 m^3 per year,

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[20]GDP data is from 2007, based on World Bank, *Middle East and North Africa Region, 2008 Economic Developments and Prospects: Regional Integration for Global Competitiveness*, 2009, p. 103.

[21]All GDP per Capita figures are Purchasing-Power Parity 2006 according to UNDP Human Development statistics available on the UNDP website at http://hdr.undp.org/en/statistics/.

[22]For an interesting critique of the measurement of development in the Middle East, contrasting World Bank and UNDP approaches, see Fakhri, Images of the Arab World and Middle East: Debates about Development and Regional Integration, Sept. 1, 2007, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1096680.

[23]Lawrence, *A US–Middle East Trade Agreement: A Circle of Opportunity?* 2006, p. 4.

[24]Richards/Waterbury, *A Political Economy of the Middle East*, (3rd ed.) 2008, p. 7.

[25]In Iraq, Lebanon, Jordan, Syria, Algeria, Libya, Morocco and Tunisia, as a whole, 74% odd arable land receives less than 400mm rainfall a year; see Hazell/Oram/Chaherli, Managing Droughts in the Low-Rainfall Areas of the Middle East and North Africa, EPTD Discussion Paper No. 78, International Food Policy Research Institute, September, 2001, p. 2, available at http://www.ifpri.org/divs/eptd/dp/papers/eptdp78.pdf.

compared with the worldwide average of 7,000 m^3.[26] Population tends to concentrate around central water sources, such as major rivers (the Nile, Euphrates and Tigris) or aquifers. Richards and Waterbury identify five key water problems in the region: (1) water scarcity; (2) water quality; (3) increasing unsustainability of agricultural sectors, clashing with entrenched agricultural interests of a large proportion of the population; (4) poor prospects of governmental water management; and (5) international tension associated with transboundary water sources such as rivers and aquifers.[27] These are problems evident throughout the entire region, albeit with locale-specific manifestations. Water constraints are in themselves important reasons to seek solutions through regional cooperation; most significant for regional economic integration, however, is the impact of water scarcity on the agricultural sector, as will be discussed briefly below.

Oil: Abundance and Disparity

The MENA region as defined here (i.e., without Iran) holds about half of the world's proven oil reserves. Saudi Arabia alone accounts for almost one-quarter of the earth's oil resources.[28] Consequently, in some MENA countries such as Algeria, Saudi Arabia, Kuwait and Syria, fuel exports have a very high proportion to GDP.[29]

Moreover, this abundance of hydrocarbon mineral riches is by no means distributed evenly within the region. Most of the oil is located in Saudi Arabia, Iraq and Kuwait and other Gulf states, with substantial but relatively smaller reserves of oil and natural gas in Algeria and Syria. Thus, despite the region's general association with energy resources, its economies are divided into major fuel-exporters, on one hand, in which more than 90% of total exports are energy resources, and fuel-importers, on the other hand, such as Jordan, Lebanon, the West Bank and Gaza, Israel, and Morocco. On both sides of this divide, fuel availability is a significant economic factor. Oil exporters have become highly dependent on oil revenues, classic examples of rentier states, increasingly vulnerable to ongoing dramatic shifts in the energy market. Fuel importers, in contrast, find it difficult to supply their energy needs in industry and infrastructure development.

[26] Çarkoğlu/Eder/Kirişci, *The Political Economy of Regional Cooperation in the Middle East*, 1998, p. 57.

[27] Richards/Waterbury, *A Political Economy of the Middle East*, (3rd ed.) 2008, pp. 165–176.

[28] BP Statistical review of World Energy, 2007, http://www.tsl.uu.se/uhdsg/Data/BP_Stat_2008.xls.

[29] Noland/Pack, *The Arab Economies in a Changing World*, 2007, p. 121.

Population Dynamics and Unemployment

Another feature of the region as a whole is a high rate of population growth – higher than in any other region of the world except Sub-Saharan Africa.[30] The region's population has grown from an estimated 100 million people in the 1950s, to almost 300 million today, and some projections expect it to climb to 500–600 million in 2025.[31] These numbers also illustrate a rapid growth in region's labor force, as the younger, economically active age groups grow faster than others.[32] On average, for every 100 that exited the working age population in MENA, during 1995–2010, 525 entered it.[33]Economic development has not kept pace with the demand for work, bringing ever growing unemployment, reaching close to 14% in the 2000–2004 period, making the creation of jobs a crucial and urgent need in the region.[34]

However, like other issues, the difficulties of demographic dynamics are not homogenous throughout the MENA region. A distinction within the region should be between labor-abundant economies and labor-importing economies – the latter with even higher population growth rates than the former; and a further distinction can be drawn between resource-rich and resource-poor states, who face different challenges in creation of employment opportunities,[35] and indeed may harbor different interests with respect to regional integration.

Significant Non-energy Sectors in the MENA Region's Economy

In terms of employment and resource allocation (such as water distribution and subsidization), agriculture plays a significant role in many MENA countries. This compares unfavorably, however, with agriculture's relatively low contribution to GDP. For example, in Morocco, 47.1% of the population is employed in

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[30]For data on population growth, see World Bank, *World Development Indicators*, 2006.

[31]Estimates differ between sources, ranging from 562 million to 639 million; see Richards/ Waterbury, *A Political Economy of the Middle East*, 2008, (3rd ed.) pp. 165–176.

[32]For an analysis of the effects of population growth in MENA on age groups, see Williamson/ Yousef, Demographic Transitions and Economic Performance in the Middle East and North Africa, in: Sirageldin (ed.), *Human Capital: Population Economics in the Middle East*, 2002, pp. 16–31, (pp. 18–22).

[33]Jalali/Roudi, Globalization and Unemployment in MENA, in: Sirageldin (ed.), *Human Capital: Population Economics in the Middle East*, 2002, pp. 194–201. See also Rivlin/Gal, *Economic and Demographic Developments in the Middle East and North Africa, 1980–2000*, 2004, pp. 6–26.

[34]Noland/Pack, *The Arab Economies in a Changing World*, 2007, p. 76.

[35]For recent data on population and work force growth in these different categories of MENA states, see World Bank, *Middle East and North Africa Region, 2008 Economic Developments and Prospects: Regional Integration for Global Competitiveness*, 2009, pp. 99–100.

agriculture, while it represents only 14.7% of GDP.[36] These figures produce a dissonance between important policy considerations: food, water, employment and trade. The political sensitivity of the agricultural sector diverts most of the available water sources to agricultural uses, compounding the water scarcity problem discussed above. Yet MENA states are becoming increasingly aware that food "self-sufficiency" is a chimera, unattainable in the face of water constraints; indeed, most of the region's states are net-food importers.[37] While this condition should encourage MENA states to liberalize agricultural imports, unilaterally or in multilateral and regional frameworks, the large agricultural sector presents a formidable adjustment policy obstacle, as well as a political one. Indeed, as net-food importers, MENA states do not welcome the prospect of the reduction of agricultural production and export subsidies in food-exporting states, since this would inevitably raise world prices for foods that they import.[38] Overall, this presents a difficult environment for regional integration in agricultural trade.

The public sector in most MENA states is very strong, reflecting the state-led development models pursued since independence in the mid-twentieth century. As Richards and Waterbury state unequivocally, "these states monopolize resources; they control large investment budgets, strategic parts of the banking system, virtually all subsoil minerals, and the nation's basic infrastructure in roads, railroads, power and ports."[39] As a result, the proportion of government employees in the general work force is very high – twice the world average.[40] The implications for regional integration are that there exists a large, educated and somewhat entrenched sector of society – on which the maintenance of government depends – that is wary of economic liberalization in general and trade openness in particular, presenting a significant obstacle to integration.[41]

Not unrelated, and reflecting the region's low industrial manufacturing capacity, is the high proportion of the services economy in MENA countries' GDP, at times very high.[42] This feature constitutes both an opportunity for regional integration, and an obstacle to it, as it reduces the intensity of regular tariff-on-goods economics.

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[36]In 2000, the same ratio (employment/GDP) in Syria was 32%/24%; in Tunisia – 22.1%/12.1%; and in Algeria – 14.1%/9.6% (based on Eurostat, Euro-Mediterranean Statistics, 2000).

[37]Richards/Waterbury, *A Political Economy of the Middle East*, (3rd ed.) 2008, pp. 144–156.

[38]Noland/Pack, *The Arab Economies in a Changing World*, 2007, p. 138.

[39]Richards/Waterbury, *A Political Economy of the Middle East*, (3rd ed.) 2008, p. 179.

[40]Sutherland/Siegman/Hoekman/Messerlin, *Harnessing Trade for Development and Growth in the Middle East*, Report by the Council on Foreign Relations Study Group on Middle East Trade Options, 2002, p. 17, fn. 18, citing Handoussa, A Scenario for the New Role of the State in MENA, Background Notes for *Economic Trends in the MENA Region*, 2000.

[41]Noland/Pack, *The Arab Economies in a Changing World*, 2007, pp. 200–201.

[42]Tovias/Kalaycioglu/Dafni/Ruben/Herman, What Would Normalization of Economic Relations between Mashrek Countries, Turkey and Israel Imply? The World Economy 30 (2007) 4, pp. 665–666, put the service sector's GDP proportion in the Mashrek sub-region at 62%, with industry at 25% and agriculture at 13%.

Intra-regional and Extra-regional International Trade Patterns

For present purposes, the most important feature of MENA states' international trade patterns is that the proportion of intra-regional trade out of overall international trade is very low. In fact, of the world's regions, MENA has the lowest level of intra-regional trade in proportion to total merchandise trade, with the exception of South Asia.[43] For most countries in the region, the ratio "remains in the low single digits."[44]

The issue of low intra-regional trade constitutes a critical component of the debate on regional economic integration in MENA. If low intra-regional trade in MENA is the result of a lack of product complementarity, as is often contended,[45] regional liberalization agreements will not create much trade; conversely, if the low ratio of intra-regional trade is the result of trade barriers, agreements may encourage trade and economic integration. Intra-regional trade in MENA has been slow to grow, as opposed to other developing regions[46] in which RTAs have been effectively executed. This comparative perspective encourages proponents of MENA regional integration. However, economic research tends to suggest that while regional integration will produce economic gains, they will be modest.[47]

Moreover, an interesting feature of intra-regional trade in the MENA region, according to some research, is the relatively higher level of intra-sub-regional trade, i.e., among the Gulf states, or among Maghreb states. This suggests that economic integration should be encouraged in sub-sets of states, at least at earlier stages, rather than at the full regional level.[48]

[43]World Bank, *Middle East and North Africa Region, 2008 Economic Developments and Prospects: Regional Integration for Global Competitiveness*, 2009, p. 36. See also Miniesy/Nugent/Yousef, Intra-Regional Trade in the Middle East: Past Performance and Future Potential, in: Hakimian/Nuggent (eds.), *Trade Policy and Economic Integration in the Middle East and North Africa: Economic Boundaries in Flux,* 2004, p. 41, (pp. 45–46). Intra-regional trade in sub-Saharan Africa is also generally low; compare Foroutan/Pritchett, Intra-Sub-Saharan African Trade: Is It Too Little? Journal of African Economies 2 (1993) 1, p. 74; Yang/Gupta, Regional Trade Arrangements in Africa: Past Performance and the Way Forward, African Development Review 19 (2008) 3, p. 399.

[44]World Bank, *Middle East and North Africa Region, 2008 Economic Developments and Prospects: Regional Integration for Global Competitiveness*, 2009, pp. 36–38. Controlling for the dominance of extra-regional oil exports, if only non-oil intra-regional exports are compared to total non-oil exports, the ratio rises to about 25%.

[45]See, e.g., Fischer, Prospects for Regional Integration in the Middle East, in: de Melo/Panagariya, *New Dimensions in Regional Integration*, 1993, p. 423 (434 et seq.).

[46]Miniesy/Nugent/Yousef, Intra-Regional Trade in the Middle East: Past Performance and Future Potential, in: Hakimian/Nuggent (eds.), *Trade Policy and Economic Integration in the Middle East and North Africa: Economic Boundaries in Flux,* 2004, p. 41 (45–46).

[47]See footnote 3 *supra*; and De Rosa, Gravity Model Analysis, in: Hufbauer/Brunel, *Maghreb Regional and Global Integration: A Dream to be Fulfilled*, 2008, p. 45 (finding that a free trade area in the Maghreb would yield a gain of only $1 Billion, or 1% of base total trade).

[48]Bolbol/Fatheldin, Intra-Arab Exports and Direct Investment: An Empirical Analysis, Arab Monetary Fund Economic Paper No. 12 (2005), pp. 3–4.

MENA and Integration in the WTO System

Membership in the WTO

Participation in the multilateral trading system is a yardstick for describing and evaluating a region's economic integration in both economic and legal terms. This is especially true in a region such as MENA that has a relatively low level of regional integration.

Of the 18 states[49] included in the MENA region, 12 are WTO Members, but the degree of their experience in the system varies widely. Lebanon and Syria were original Contracting Parties under the GATT 1947, but withdrew in the early 1950s. Israel became a GATT Contracting Party in 1961, and Kuwait in 1963, whereas Egypt joined in 1970. Morocco joined in 1987 and Tunisia in 1990. The last pre-WTO memberships were of Bahrain (1993) and Djibouti (1994). Not surprisingly, most oil-abundant MENA states are relative latecomers to the system.[50] Since the establishment of the WTO in 1995, five MENA states have successfully completed the accession process: the UAE and Qatar in 1996; Jordan and Oman in 2000; and Saudi Arabia in 2005.[51] The accumulated experience and familiarity with WTO rules of these states is a positive asset in the regional integration process. Through reciprocity and tariff and policy bindings, the WTO can also serve as a forum for

[49]Under Article XII of the Agreement Establishing the WTO, accession to the WTO is open to "any State or separate customs territory possessing full autonomy in the conduct of its external commercial relations and of the other matters provided for in this Agreement." In principle, therefore, a non-State entity such as the Palestinian Authority, could become a WTO Member. However, given the current disconnect in the governance of the West Bank and Gazah, this remains a highly theoretical possibility, and even under the formal terms of the largely defunct agreements between Israel and the Palestinians, Palestinian accession was not possible; see Broude, WTO Accession: Current Issues in the Arab World, Journal of World Trade 32 (1998) 6, p. 147.

[50]"Under the mercantilist logic that dominates trade negotiations, there is little incentive for them to join the WTO – no country imposes tariffs on oil" (Noland/Pack, *The Arab Economies in a Changing World*, 2007, p. 212). Indeed, the motivation of Saudi Arabian accession, for example, had little to do with prying open foreign markets, and more with political and investment-related concerns (see Broude, WTO Accession: Current Issues in the Arab World, Journal of World Trade 32 (1998) 6, p. 147).

[51]An issue of continued interest is Saudi Arabia's enforcement (albeit sporadic) of the Arab boycott against Israel, despite assurances that it would be discontinued after accession. Saudi Arabia agreed not to invoke the Article XIII WTO Agreement non-application clause vis-à-vis Israel to the WTO and to stop boycott policies. However, various reports as well as statements by Saudi Arabian officials suggest that the boycott has not been terminated, with general reference to security exception justification. For analysis of the boycott see Broude, WTO Accession: Current Issues in the Arab World, Journal of World Trade 32 (1998) 6, p. 147; Kontorovich, The Arab League Boycott and WTO Accession: Can Foreign Policy Excuse Discriminatory Sanctions? Chicago Journal of International Law 4 (2003) 2, p. 283; Weiss, Congressional Research Service Report for Congress, *Arab League Boycott of Israel*, April 19, 2006.

promoting domestic reform and additional liberalization that will have positive effects on regional economic integration.[52]

Accessions in Process

Of the remaining states, Algeria, Iraq, Lebanon, Libya, and Yemen are all observers at the WTO, have applied for Membership and have active WTO accession Working Parties (Algeria applied to GATT in 1987 and to the WTO in 1995); Syria has not applied. As a region, MENA's membership in the WTO is therefore incomplete. The accession process, however, can itself serve as a catalyst for regional integration, as candidates for accession are required to make legislative and policy changes that they would not necessarily have made for the sake of a regional agreement. The Completion of accession can therefore be expected to have a positive effect on regional arrangements; it will also remove some of the legal awkwardness of RTAs between WTO Members and non-Members.[53]

Moreover, beyond formal membership in the WTO, what is the actual depth of MENA state participation in the WTO? We can gain a sense of this through a brief examination of WTO commitments in goods and services; assessments made in the WTO's Trade Policy Review Mechanism (TPRM); participation in WTO negotiations; and participation in WTO dispute settlement.

Liberalization of Trade in Goods

With respect to trade in goods, the simple average applied Most-Favored Nation tariff of the Gulf states members of the WTO is in the vicinity of 5%, less than half the world average. In contrast, Jordan, Tunisia, Morocco, and Egypt each exceed the world average tariff, Morocco and Tunisia with average tariffs of over 24%.[54] The high degree of protection in the latter states and the strong intra-regional variance suggests that liberalized regional trade might result in economically undesirable trade diversion, but this is open to debate as per the general debate

[52]Sutherland/Siegman/Hoekman/Messerlin, *Harnessing Trade for Development and Growth in the Middle East*, Report by the Council on Foreign Relations Study Group on Middle East Trade Options, 2002, p. 38.

[53]See Choi, Legal Problems of Making Regional Trade Agreements with Non-WTO Member States, Journal of International Economic Law 8 (2005) 8, p. 825.

[54]World Bank, *Middle East and North Africa Region, 2008 Economic Developments and Prospects: Regional Integration for Global Competitiveness*, 2009, p. 41. It is noteworthy that most of the high-tariff MENA countries are beneficiaries of Generalized System f Preference (GSP) programs in developed markets.

on product complementarity in the region. Bound tariffs can be much higher than applied tariffs, leaving significant room for flexibility and protection, if chosen. In addition, non-tariff barriers to trade in MENA are higher than in any other region in the world,[55] reflecting a highly bureaucratized domestic export/import environment.[56] These are indicators that integration of most MENA states into the world trading system is lacking.

Liberalization of Trade in Services

The number of specific services liberalization commitments made by MENA states under the General Agreement on Trade in Services (GATS) varies considerably from state to state, from very few (Bahrain[57] and Tunisia[58]), to substantial (Saudi Arabia[59] and Jordan[60]). However, on average relatively few commitments have been made. Furthermore, the existence of specific GATS commitments belies the reality of services trade with most MENA economies, which is heavily impacted by onerous government involvement, bureaucracy, and lack of infrastructure.[61] Thus, despite WTO membership, in both goods and services, MENA countries practice what has been termed "limited globalization" that is largely the result of domestic environments that are not conducive to business.[62]

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[55]World Bank, *Middle East and North Africa Region, 2008 Economic Developments and Prospects: Regional Integration for Global Competitiveness*, 2009, p. 42, based on Kee/Nicita/Olarreaga, Estimating Trade Restrictiveness Indices, World Bank Working Paper, January 2008, http://siteresources.worldbank.org/INTRES/Resources/OTRIpaper.pdf.

[56]For description and data, see Lawrence, *A US–Middle East Trade Agreement: A Circle of Opportunity?* 2006, pp. 44–47.

[57]WTO, *Kingdom of Bahrain – Schedule of Specific Commitments*, WTO Doc. GATS/SC/97, April 15, 1994; WTO, *Kingdom of Bahrain – Schedule of Specific Commitments – Supplement* – WTO Doc. GATS/SC/97/Suppl. 1, February 26, 1998.

[58]WTO, *Tunisia – Schedule of Specific Commitments*, WTO Doc. GATS/SC/87, April 15, 1994; WTO, *Tunisia – Schedule of Specific Commitments – Supplement*, WTO Doc. GATS/SC/87/Suppl. 1, April 11, 1997; WTO, *Tunisia – Schedule of Specific Commitments – Supplement 2*, WTO Doc. GATS/SC/87/Suppl. 2, February 26, 1998.

[59]WTO, *The Kingdom of Saudi Arabia – Schedule of Specific Commitments*, WTO Doc. GATS/SC/141, March 29, 2006.

[60]WTO, *The Hashemite Kingdom of Jordan – Schedule of Specific Commitments*, WTO Doc. GATS/SC/128, December 15, 2000.

[61]For a strong critique of inefficiencies in the MENA services market, see Sutherland/Siegman/Hoekman/Messerlin, *Harnessing Trade for Development and Growth in the Middle East*, Report by the Council on Foreign Relations Study Group on Middle East Trade Options, 2002, pp. 13–21.

[62]Noland/Pack, *The Arab Economies in a Changing World*, 2007, p. 105.

Trade Policy Reviews

Some of the WTO's Trade Policy Reports (TPRs) on MENA countries confirm this image of low integration, albeit in only mildly judgmental language. For example, Egypt's TPR from 2005, after noting the high average applied MFN rate, notes that "despite recent tariff reforms, Egypt's tariff system remains complex, with numerous exemptions, reductions, and concessions." It then describes the host of documentation and customs procedures for imports, noting a couple of efforts that have been made to enable speedier processing – implying that the general rule that processing can be slow.[63] Further criticism is found in the TPRs finding that Egypt's tariff structure "hides high levels of effective protection of almost all industries, except for those fabricating metal products."[64] Mention is made several times throughout the report of the high level of state involvement in the market. The TPR on Tunisia from 2005 similarly describes the domestic market as "highly protected," noting the high average applied MFN tariff, and the long time needed to clear customs, as well as significant restrictions on trade in services.[65] Having said this, however, TPRs are favorable in the case of states such as Jordan, that have taken significant steps towards integration through WTO commitments.[66]

MENA Participation in WTO Negotiations

The Agreement Establishing the WTO was signed in Morocco, and the current round of multilateral WTO negotiations was launched in Qatar. Beyond this geographical terminology, however, MENA states' involvement in multilateral trade talks has been modest, as a survey of negotiation submissions to the WTO reveals. MENA country submissions in the Doha Round are diverse; there is no overt regional grouping in the talks, and Member submissions tend to be focused on specific interests, in some cases as part of like-minded negotiation groups with Members from outside the region. Morocco was relatively engaged in agricultural talks during 2003 when it served as chair of the G-77 and the Africa Group, and additionally subscribed to a proposal supporting extension of additional protection

[63] See WTO, Trade Policy Review Body, *Trade Policy Review – Egypt – Report by the Secretariat – Revision*, WTO Doc. WT/TPR/S/150/Rev. 1, August 5, 2005, pp. 23–24.

[64] See WTO, Trade Policy Review Body, *Trade Policy Review – Egypt – Report by the Secretariat – Revision*, WTO Doc. WT/TPR/S/150/Rev. 1, August 5, 2005, p. 29.

[65] See WTO, Trade Policy Review Body, *Trade Policy Review – Tunisia – Report by the Secretariat – Revision*, WTO Doc. WT/TPR/S/150/Rev. 1, 31 October, 2005, pp. 24–25 and 89.

[66] But compare with the 2008 TPR on Jordan, which is generally favorable in its descriptions of Jordanian trade policy (WTO, Trade Policy Review Body, *Trade Policy Review – Jordan – Report by the Secretariat*, WTO Doc. WT/TPR/S/206, October 6, 2008).

to Geographical Indications beyond wines and spirits.[67] Tunisia and Egypt have been active in the NAMA-11 Group of Developing Countries with respect to non-agricultural market access. Egypt is also a member of the G-20 group relating to agriculture,[68] and has made independent submissions to the rules committee regarding amendments to the WTO Antidumping Agreement (ADA). Israel has also been active in discussions on amendments to the ADA, and in agriculture, together with extra-regional states with similar agricultural interests.

In 2004 the UAE proposed a specific sectoral agreement on primary aluminum, its second largest industry after oil, an initiative that it has pursued consistently ever since.[69] Qatar has made proposals relating to liberalization of certain energy-related goods as environmental products.[70] Jordan made a number of interesting submissions within the context of the reform of the WTO Dispute Settlement Understanding (DSU), including, *inter alia*, proposals on remand authority, unsolicited amicus curiae briefs and requests for interpretation from non-WTO tribunals.[71] Jordan has also participated in some submissions made by the group of Recently Acceded Members (RAMs), as has Oman, and in one case – Saudi Arabia. Saudi Arabia also made an early contribution to the debate on carbon taxation, in the Committee on Trade and Environment.[72] Overall, the picture that emerges is of disparate participation in negotiations, emphasizing the differences between MENA states rather than their similarities, with no particular regional identity or voice. With few exceptions, participation is neither broad nor deep, and ultimately very selective, making most MENA states passive participants, most of the time, in most Doha agenda areas.

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[67]See WTO, Trade Negotiations Committee, *Geographical Indications – The Significance of "Extension" in the TRIPS Agreement and Its Benefits for WTO Members – Addendum*, WTO Doc. TN/C/W/14/Add. 2, July 15, 2003.

[68]See http://www.g-20.mre.gov.br/members.asp; the G-20 of developing countries in WTO negotiations is not to be confused with the G-20 of major economies http://www.g20.org/G20/ in which Saudi Arabia is the only Arab member, leading to some tension with other Arab countries who question whether Saudi Arabia represents broader MENA country interests (see, e.g., World Bulletin, *Egypt Supports Saudi Presence in G-20 Minister*, November 26, 2008, http://www.worldbulletin.net/news_detail.php?id=32163).

[69]WTO, Negotiating Group on Market Access, *Market Access for Non-Agricultural Products – Proposal on a Sectoral Agreement on Materials – The Primary Aluminum Case – Communication from the UAE*, WTO Doc. TN/MA/W/37/Add. 1, May 28, 2004; and WTO, Negotiating Group on Market Access, *Market Access for Non-Agricultural Products – Communication from the UAE*, WTO Doc. TN/MA/W/37/Add. 2, April 21, 2005.

[70]Starting with WTO, Committee on Trade and Environment – Special Session, *Environmental Goods – Submission by the State of Qatar – Paragraph 31(iii)*, WTO Doc. TN/TE/W/14, October 9, 2002.

[71]See WTO, Dispute Settlement Body – Special Session, *Jordan's Contribution towards the Improvement and Clarification of the WTO Dispute Settlement Understanding – Communication from Jordan*, WTO Doc. TN/DS/W/43, January 28, 2003.

[72]WTO, Committee on Trade and Environment – Special Session, *Energy Taxation, Subsidies and Incentives in OECD Countries and their Economic and Trade Implications on Developing Countries, in particular Developing Oil Producing and Exporting Countries – Submission by Saudi Arabia*, WO Doc. WT/CTE/W/215, TN/TE/W/9, September 23, 2002.

MENA Participation in the WTO Dispute Settlement System

MENA states' participation in the WTO dispute settlement is very low, lower than the participation of other developing regions and closer to the participation pattern of LDCs. In fact, no MENA state has ever initiated dispute settlement proceedings in the WTO, and only one – Egypt – has been a respondent (in four cases, only one of which resulted in a Panel Report, which was unappealed).[73] Participation as third parties has also been very limited with both Israel and Egypt involved each in a handful of disputes.; in one case, Morocco submitted an amicus curiae brief to the Appellate Body.[74]

In sum, while formal global integration, as reflected by the number of MENA states joining the ranks of the WTO, has increased over the last decade, and can be expected to continue growing over the next few years, the real integration of most MENA states into the multilateral trading system is lacking in both economic and institutional respects, conforming with a pattern of limited globalization.

Bilateral Trade Agreements in the MENA Region

Inter-Arab Bilateral Agreements

In addition to the gradual increase in individual MENA states' participation in the WTO, the last decade has witnessed the development of a web of bilateral trade agreements between the Arab states of the region. This is a trend that has expanded in parallel to the sub-regional and regional initiatives discussed in the next section, though its complementarity with them is tenuous. The main drivers of the regional proliferation of bilateral trade agreements have been Egypt, Jordan, Tunisia, and to some extent Morocco (the same states that are parties to the Agadir Agreement), but virtually all MENA states have touched this circle. Thus, Jordan has agreements designated as Free Trade Agreements (FTAs), with Tunisia, Syria, Lebanon, Egypt,[75] the UAE, Bahrain and Kuwait, all signed since 1998, as well trade and cooperation agreements with Libya, Algeria and Yemen.[76] Egypt has similar

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[73]The disputes are: DS205 *Egypt – Import Prohibition on Canned Tuna with SoyBean Oil*, DS211 *Egypt – Definitive Antidumping Measures on Steel Rebar from Turkey* (settled by the Panel Report in WTO Doc. WT/DS211/R, August 8, 2002), DS305 *Egypt – Measures Affecting Imports of Textiles and Apparel Products*, and DS327 *Egypt – Antidumping Duties on Matches from Pakistan*.

[74]WTO, *European Communities – Trade Description of Sardines*, WTO Doc. WT/DS231/AB/R, adopted October 23, 2002.

[75]The translated text of the Egypt–Jordan FTA is available online at http://mba.tuck.dartmouth.edu/cib/trade_agreements_db/archive/Jordan-Egypt.pdf.

[76]See Hashemite Kingdom of Jordan, Ministry of Industry and Trade, http://www.mit.gov.jo/Default.aspx?tabid=739.

agreements, some designated as FTAs, with Lebanon, Syria, Morocco, Tunisia, Libya, Jordan and Iraq,[77] and Tunisia has agreements with Algeria, Egypt, Libya, Jordan, Morocco and Syria.[78]

This brisk rise of bilateral trade agreements in a region that had previously seen only low-key bilateral trade and economic cooperation agreements can be explained in a number of ways. First, there are the genuine goals of promoting intra-regional trade and cooperation towards exports of jointly produced goods. Second, FTAs are proliferating worldwide, and some MENA states simply do not wish to be left behind, whether they have adopted a genuine policy of liberalization or not. Third, the Arab world has a very charged history of failed pan-Arab economic and political union;[79] it is understandable that full regional integration is treated with apprehension and skepticism, and in this setting, bilateralism serves as a fallback for regionalism. Finally, bilateral FTAs in the region can be understood as a reaction to the increasing number of EU and US FTAs with partners in the region,[80] as an attempt to prevent the creation of a "hub-and-spokes" structure of trade.[81]

However, these bilateral FTAs have significant weaknesses from the perspective of regional integration. In essence, they are traditional reciprocal tariff reduction agreements with only partial product coverage employing both positive and negative lists. They should more properly be designated as preferential trade agreements, or as one analysis of typical agreements says, "[i]t appears that 'FTA' has been used as a generic word for a wide range of bilateral preferential trade arrangements, involving different schedules of liberalization and policy instruments. Virtually all the reviewed intra-Arab bilateral FTAs involve slow gradual trade liberalization, reflected in numerous lists for exceptions. . .."[82] Rules of Origin (RoO) in the bilateral FTAs are similar – generally 40% value-added – but the product coverage varies significantly between agreements, complicating customs processing if preferences are to be enjoyed. Furthermore, the agreements only cover trade and goods, not services; this is not uncommon in FTAs, but leaves the bilateral path to regional integration in MENA a generation behind. Agricultural trade, too,

[77]See Government of Egypt, Ministry of Trade and Industry, Trade Agreement Sector, http://www.tas.gov.eg/english.

[78]See Republic of Tunisia, Ministry of Trade and Handicrafts, http://www.commerce.gov.tn/coop_1.htm.

[79]Indeed, for better or for worse, "greater economic integration in the Arab world has consistently been a stated goal of public policy and a yardstick for evaluation of the achievements of Arab nationalism in the post-independence era" (Maamri, Free Trade Areas, Euro-Mediterranean Partnership and Prospects of South–South Integration in the Mediterranean, in: Prassello, *Sustainable Development and Adjustment in the Mediterranean Countries following the EU Enlargement*, 2006, p. 166 (175).

[80]See Sect. 6 *infra*.

[81]Zarrouk/Zallio, Integrating Free Trade Agreements, World Bank Working Paper, 2000, p. 19, http://www.worldbank.org/mdf/mdf3/papers/global/Zarrouk.pdf.

[82]Zarrouk/Zallio, Integrating Free Trade Agreements, World Bank Working Paper, 2000. p. 14.

is only minimally liberalized.[83] Finally, it might even be the case that the partial and gradual coverage of the FTAs "is seen as preventing rather than stimulating trade flows" within the region.[84]

Thus, as if to echo the global debate on the competition between multilateralism vs. regionalism, in the MENA region we see an unhealthy parallelism between regionalism and bilateralism. MENA intra-regional FTAs may not be planned as stand-ins for more serious regional integration, but as concurrent alternative paths they complicate the horizon of regional trade regulation, necessitate scarce resources to negotiate and maintain, and ultimately result in unintended economic distortions. Indeed, in the legal and regulatory senses, they appear to cause fragmentation rather than integration.

Arab–Israeli Bilateral Agreements

Bilateralism is also evident in Israel's respective trade agreements with Egypt and Jordan, but for different reasons.[85] These agreements are associated with particular political relationships with Israel on the basis of distinct political settlements and peace agreements, and so for the time being must remain on separate bilateral tracks. Furthermore, as demonstrated by the general failure of the Madrid multilateral track process and the subsequent Barcelona process,[86] for political reasons Israel could not be considered a potential partner to inter-Arab regional integration at least until peace is achieved with all Arab countries and the Palestinians. Even then, it might not be included directly as part of a regional scheme, given prevalent Arab unwillingness to include Israel in the region, sometimes on the basis of fears of Israeli hegemony.[87] Bilateralism is therefore the realistic path open to Israel in trade relations with its neighbors.

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[83]This assessment is based on the above working paper and on the summary of Egypt's FTAs available at Government of Egypt, Ministry of Trade and Industry, Trade Agreement Sector, http://www.tas.gov.eg/english.

[84]Zarrouk/Zallio, Integrating Free Trade Agreements, World Bank Working Paper, 2000, p. 19, http://www.worldbank.org/mdf/mdf3/papers/global/Zarrouk.pdf.

[85]One could also mention in this context the bilateral Israeli–Palestinian relationship under the relevant instrument of the Oslo accords (*Protocol on Economic Relations between the Government of the State of Israel and the P.L.O., representing the Palestinian People*, Paris, April 29, 1994); however, there is a significant gap between the framework of the agreement and the actual practice of Israeli–Palestinian economic relations, and current economic relations are too strongly linked to the political and military situation. On forward looking options, see Arnon/Bamya, *Economic Dimensions of a Two-State Agreement between Israel and Palestine*, 2007.

[86]Peters, Practices and their Failures: Arab–Israeli Relations and the Barcelona Process, UC Berkeley Institute of European Studies, paper 040402, 2004, http://repositories.cdlib.org/ies/040402/.

[87]For example, see Kaye, *Beyond the Handshake: Multilateral Cooperation in the Arab–Israeli Peace Process, 1991–1996*, 2001, Chap. 5, (pp. 129–130).

The Israel–Egypt agreement is little more than an agreement granting reciprocal MFN treatment.[88] Relations with Jordan have expanded, however, since the revision of the agreement's annexes in 2004 that brought the relations much closer to a full FTA. Under the revision, most trade between Israel and Jordan will be duty free by 2010, and in addition, provisions have been made to comply with Pan-Euro-Mediterranean RoO to allow for diagonal cumulation of origin in Jordanian–Israeli exports to the EU.[89]

In sum, with few exceptions, bilateralism appears to exert fragmenting effects within MENA, in both legal and economic senses, even as it is pursued in parallel with the sub-regional and regional programs discussed below.

MENA's Regional and Sub-regional Economic Integration

In discussing MENA's economic integration at the full regional level, it is obligatory to describe its history of failure. Given the introductory nature of this article, this section will indeed provide such an historical background. Then, it will focus on sub-regional integration initiatives, culminating with a discussion of the contemporary efforts at more advanced regional integration, the GAFTA and Agadir Agreement.

Historical Background

Historically, the Arab League, established in 1945 and today numbering 22 members,[90] has been the main forum for discussing inter-Arab cooperation (i.e., to the exclusion of Israel), including economic integration. Indeed, the regionalization of economic relations is well within the organization's mandate as set out in its constitutive treaty, the Pact of the Arab League States (the "Pact").[91] Under

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[88] *Agreement on Trade and Commerce between Israel and Egypt*, May 8, 1980, http://www.mfa.gov.il/MFA/Foreign%20Relations/Israels%20Foreign%20Relations%20since%201947/1979-1980/Annex%20IX%20-%20Agreement%20on%20trade%20and%20commerce%20between. Other efforts to encourage Israeli–Egyptian economic cooperation will be discussed in Sect. VI *infra*.

[89] See Israel, Ministry of Industry, Trade and Labor, http://www.israel-industry-trade.gov.il/NR/exeres/B9C3F9D4-1339-4757-B57A-859E3153042E.htm. For an economic analysis of free trade between Israel and Jordan (prior to the revision of the agreement) see Tovias/Al-Khouri, An Empirical Estimation of the Potential Economic Effects of a Bilateral Free Trade Area Agreement between Israel and Jordan in the Context of the Euro-Mediterranean Partnership, Israel Affairs 10 (2004) 3, p. 138.

[90] Arab League membership includes four states not included in this article's definition of MENA: Sudan, Somalia, Comoros and Mauritania.

[91] See *Pact of the League of Arab States*, March 22, 1945, available at http://avalon.law.yale.edu/20th_century/arableag.asp.

Article 2 of the Pact, the purpose of the Arab League is "to draw closer the relations between member States and co-ordinate their political activities with the aim of realizing a close collaboration between them...," including the purpose of a close co-operation in "economic and financial matters, including trade, customs, currency agriculture and industry."[92]

Several attempts at economic integration were made under the Arab League umbrella, but as the above survey of intra-Arab trade shows, it has not succeeded in satisfying an ambitious interpretation of its goals, which would ultimately include an Arab free trade area or common market. First of these was the 1950 Treaty for Joint Defence and Economic Cooperation, agreed upon more on the background of security concerns than economic ones, which included only two very vague clauses that ventured little more than the Pact itself.[93] This was followed by a 1953 Convention on the Facilitation of Trade Exchange and the Regulation of Transit Trade,[94] which included some custom-free commitments relating to specified livestock and agricultural produce (much of which were perishable goods and so unlikely to be traded widely within the region at the time) and limited preferences on specified industrial products.

In 1957, the Economic Council of the Arab League approved in principle the text of an Agreement on Arab Economic Unity (AAEU). The AAEU was signed only in 1962 and entered into force only in 1964, after ratification by Iraq.[95] The AAEU included ambitious language whereby complete economic union shall be established among Arab League members, on the basis of the freedom of movement of persons and capital,[96] but this goal was to be achieved gradually. The first step was the founding of the Council of Arab Economic Unity (CAEU) in 1964, an organization that is still active.[97] The CAEU has succeeded in promoting agreements on prevention of double taxation and other cooperative economic agreements between its members.

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[92]Article 2(a) of the Pact.

[93]See Articles 7–8 of the *Treaty for Joint Defence and Economic Cooperation between the States of the Arab League*, June 17, 1950, available at http://avalon.law.yale.edu/20th_century/arabjoin.asp.

[94]Convention on the Facilitation of Trade Exchange and the Regulation of Transit Trade, Resolution 590/19 of the Council of the Arab League, September 7, 1953. This convention was subsequently amended four times between 1954 and 1959. The English and French texts of the convention were published as 1955/53 and 1955/54 (respectively), *Agreements and Conventions Concluded Between Member States Within the Framework of the Arab League (League of Arab States Treaty Series)*; the English text of the convention with its amendments is available GATT, *Accession of the United Arab Republic – Memorandum on the Commercial Policy of the United Arab Republic – Addendum*, GATT Doc. L/1816/Add.3, October 18, 1962 http://www.wto.org/gatt_docs/English/SULPDF/90760427.pdf.

[95]See also Boutros-Ghali, *Recueil des Cours, Collected Courses of the Hague Academy of International Law*, 1972, p. 71.

[96]See Pollan, *Legal Framework for the Admission of FDI*, 2006, p. 174.

[97]See http://www.caeu.org.eg/English/Intro.

Under the Arab League and the CAEU, five states (Egypt, Iraq, Jordan, Kuwait and Syria) agreed in 1964 to establish an Arab Common Market (ACM). The ACM was supposed to have gradually removed quantitative restrictions and tariffs towards the achievement of a common market during the 1970s, but its effectiveness was riddled with autonomous exceptions and consecutive extensions of transitional periods.[98] Subsequent regional events essentially made the ACM a dormant agreement.

The Arab League ability to serve a unifying regional force was damaged by this disappointing outcome. The failure of these earlier attempts at regional economic integration has been attributed to a lack of economic incentives, but no less importantly, to political rivalries, the absence of leadership interest and political will and weak institutional frameworks.[99] As Boutros-Ghali wrote in his 1972 *Recueil des Cours*,[100] "Il apparaît ainsi que tout cet edifice conventionnel n'est qu'une façade dissimulant la crise que traverse la coopération arabe...."[101]

Sub-regional Economic Integration in MENA

Three sub-regional economic integration agreements developed through the 1980s following the relapse of the idea of an ACM encompassing the full membership of the Arab League.[102] These associations were created between countries which had either geographical proximity and/or economic similarity, and were strongly related

[98]For a detailed description of the ACM's early years, see Hershlag, *The Economic Structure of the Middle East*, 1975, pp. 193–194.

[99]For complementary analyses of the political and institutional roots of the Arab League's inability to promote Arab unity and economic integration, see Fawzy, The Economics and Politics of Arab Economic Integration, in: Galal/Hoekman (eds.), *Arab Economic Integration: Between Hope and Reality*, 2003, p. 13, 20 et seq.; Barnett/Solingen, Designed to Fail or Failure of Design? The Origins and Legacy of the Arab League, in: Acharya/Lain (eds.), *Crafting Cooperation: Regional International Institutions in Comparative Perspective*, 2007; a central issue is the structural (and partially deliberate) ineffectiveness of the organization: the Arab League has adopted thousands of resolutions (of which 80% were never implemented), and established bureaucracies and other trappings of an international organization, although it lacks any monitoring or sanctioning powers – an endeavour to "be seen but not heard," (*Ibid*., pp. 213–215).

[100]See Boutros-Ghali, *Recueil des Cours, Collected Courses of the Hague Academy of International Law*, 1972, p. 71.

[101]"It appears therefore that this whole edifice of conventions is nothing but a façade that hides the crisis that Arab cooperation is undergoing."

[102]Barnett/Solingen, Designed to Fail or Failure of Design? The Origins and Legacy of the Arab League, in: Acharya/Lain (eds.), *Crafting Cooperation: Regional International Institutions in Comparative Perspective*, 2007, p. 209. However, the seeds for the GAFTA as we know it today were in fact sown in 1981 with the signing of the Arab League's *Agreement to Facilitate and Develop Inter Arab Trade* (AFDIAT) in Tunis in 1981 (see *infra*). Almost two decades would pass before the AFDIAT was given concrete meaning, leaving a vacuum that allowed the emergence of sub-regionalism, which in turn may have had a negative impact on regionalism.

to shared security concerns. Like the bilateralism phenomenon discussed in the previous section, sub regional initiatives replicate the general multilateralism vs. regionalism dilemma in that they can be viewed either as "building blocks" or "stumbling blocks" to overall regional economic integration. However, while at certain points sub-regionalism may have robbed regionalism of its thunder, only one of these three sub-regional has had any lasting success, diminishing the proportions of the problem.[103]

The Cooperation Council for the Arab States of the Gulf

The Cooperation Council for the Arab States of the Gulf (GCC) is an organization of the Arab states of the Gulf established in Riyadh, in May 1981.[104] Its members are Saudi Arabia, the UAE, Bahrain, Qatar, Kuwait and Oman. The members enjoy similar political systems and economic concerns, all of them being kingdom states that have economies built on oil exports. The main impetus for the creation of the GCC was political rather than economic however, with the outbreak of Iran–Iraq in 1980.[105] Nevertheless, the GCC has proven to be a relative success in the level of economic integration it has reached since its establishment.

The objectives of the GCC include the coordination, integration and interconnection between its Member States so as to achieve unity between them; the deepening and strengthening of relations between their peoples in various fields; and the formulation of "similar regulations" in economic, educational and cultural fields.[106] The GCC Charter established an unremarkable intergovernmental institutional structure, in which all substantive decisions require unanimity, and disputes are referred to an ad hoc Commission that refers its recommendations or opinions to the GCC Supreme Council which may act as it deems appropriate.[107]

[103]Although the Agadir Agreement currently has only four members among MENA state's it is not a form of sub-regionalism in that its membership is open to "all Arabic nation members of the Arab League and the Greater Arab Free-Trade Zone and with Association Agreements or free trade agreements with Europe" (Article 29, Agadir Agreement).

[104]See Charter of the Cooperation Council for the Arab States of the Gulf, May 25, 1981, http://www.gcc-sg.org/eng/index.php?action=Sec-Show&ID=1 (the "GCC Charter").

[105]The GCC was "originally conceived of as a security organization – to counter perceived threats from Islamic Revolutionary Iran, Baathist Socialist Iraq, and the Soviet incursion into Afghanistan" (Al-Momani, Reacting to Global Forces: Economic and Political Integration of the Gulf Cooperation Council, Journal of the Gulf and Arabian Peninsula Studies 34 (2008) 128, p. 47). For an evaluation of the defense and security aspects of GCC cooperation, see Legrenzi, Did the GCC Make a Difference? Institutional Realities and (Un)Intended Consequences, in: Harders/Legrenzi (eds.), *Beyond Regionalism? Regional Cooperation, Regionalism and Regionalization in the Middle East*, 2008, p. 107 (109–111).

[106]Article 4 of the GCC Charter.

[107]Article 10 of the GCC Charter.

One of the first steps taken by GCC members was to approve the Unified Economic Agreement (UEA) which was ratified in late 1981.[108] The UEA set out to establish both a FTA and a Customs Union (CU).[109] The FTA, which broadly applies to all intra-GCC trade, was successfully established in 1983.[110] The CU component did not fare as well and remained defunct for 20 years.[111] Consequently, the GCC Member States decided in 2001 to establish a CU which was indeed launched on January 1, 2003, creating a common external tariff of 5% for all products from non-GCC countries (with certain products designated as duty free, and tobacco products subject to 100% duty). The CU Implementation Procedures[112] establish a "single-point-of-entry" principle, introduce Uniform Customs Legislation for all GCC Members, and consolidate national product bans and restrictions for all member countries.[113] It appears that the GCC CU has been successfully implemented, despite complications related to differential foreign trade obligations due to Bahrain's and Oman's FTAs with the USA.

As a further step, the GCC launched the GCC Common Market program on January 1 2008, aimed at liberalizing the intra-GCC movement of labor, services and capital. This is planned for implementation over the next few years. Efforts to achieve monetary union and a central monetary bank by 2010 have been set back by lack of interest on the part of some member countries.[114] Additionally, the GCC is currently engaged in FTA negotiations with the EU[115] and a number of other states outside the region. Another ongoing development is the admission of Yemen as a participant in some GCC programs, though not as a member. This potential enlargement of the GCC would be an interesting step, because Yemen, as a non-royalist, resource-poor, labor abundant LDC, is not cast in the mold of the original

[108]See The Unified Economic Agreement between the Countries of the Gulf Cooperation Council, November 11, 1981, http://mba.tuck.dartmouth.edu/cib/trade_agreements_db/archive/GCC.pdf.

[109]Articles 1–3 and 4, respectively.

[110]To qualify for GCC origin for the purposes of the GCC UEA, products must satisfy a double rule: 40% value-added in GCC Members; and 51% GCC citizens' ownership in the producer (Article 3(1) UAE).

[111]See Legrenzi, Did the GCC Make a Difference? Institutional Realities and (Un)Intended Consequences, in: Harders/Legrenzi (eds.), *Beyond Regionalism? Regional Cooperation, Regionalism and Regionalization in the Middle East*, 2008, p. 107 (116).

[112]Implementation Procedures for the Customs Union of the Cooperation Council for the Arab States of the Gulf (The GCC Customs Union), 2003, approved by the GCC Supreme Council in Qatar, December, 2002, http://www.gcc-sg.org/eng/index.php?action=Sec-Show&ID=93.

[113]On the latter, see Article 13 of the CU Implementation Procedures.

[114]Kawach, Oman Reaffirms that It Will not Join Currency Union, Emirates Business 24/7 news, July 08, 2008, http://www.business24-7.ae/articles/2008/7/pages/07082008_41b341e598aa44779bc8159663cd75b9.aspx.

[115]Negotiations at some level have in fact been conducted since 1988; current difficulties relate to the EU requirement of human rights conditionality and the abolition of export duties by the GCC (see AFP, GCC Suspends EU Free Trade Talks, December 24, 2008, http://www.arabianbusiness.com/541941-gcc-suspends-eu-free-trade-talks.

GCC Members. These are all issues of ongoing interest to be monitored in the next year and beyond.

The Arab Maghreb Union

The Maghreb's sub-regional attempt at economic integration, the Arab Maghreb Union (UMA) has not been remotely as successful as the GCC, primarily due to political tensions that evolved between its members. The idea of Maghreb integration hails at least as far back as the 1964 Conference of Economic Ministers of the Maghreb Countries in Tunis, which led to the creation of the Comité Permanent Consultatif du Maghreb (CPCM).[116] However, plans to launch a sub-regional CU did not make progress until 25 years later. The AMU was agreed upon in February 1989 between Algeria, Libya, Mauritania, Morocco and Tunisia.[117] The AMU Treaty roughly corresponded to the GCC charter but included more ambitious institutional provisions such as the establishment of a consultative assembly and a regional judicial authority.[118] Amongst the objectives of the Union is to work towards the free movement of persons, goods, services and capital, but the AMU Treaty itself did not include operative economic provisions.[119] Subsequent understandings were to establish a CU in 1995 and a common market in 2000. However, none of these were to materialize due to political tensions that emerged in the early 1990s on two separate fronts: between Algeria and Morocco over the Western Sahara; and between Libya and the other four AMU Members over Libya's involvement in the Lockerbie incident. Later years also saw tension between Libya and Mauritania over alleged Libyan involvement in an attempted coup in Mauritania in 2003.[120] Beginning 2007, however the union has been revived and meetings between member countries on various issues have been held, but its future as a vehicle of sub-regional economic integration remains unclear. The map of economic integration has changed significantly since 1989, and AMU Members have differing preferences with respect to integration with either/or African neighbors, other Arab states, the EU or the USA.[121]

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[116]See Benslimane, The Permanent Consultative Committee of the Maghreb, Journal of Modern African Studies 5 (1967) 1, p. 129.

[117]See Treaty Establishing the Arab Maghreb Union, Marrakech, February 17, 1989, http://www.maec.gov.ma/EN/UMA.htm (the "AMU Treaty").

[118]Articles 12 and 13 of the AMU Treaty, respectively.

[119]Article 2, Treaty Establishing The Arab Maghreb Union (February 17 1989, Marrakech).

[120]See Brunel, Maghreb Regional Integration, in: Hufbauer/Brunel (eds.), *Maghreb Regional and Global Integration: A Dream to be Fulfilled*, 2008, p. 7 (10).

[121]For an economic assessment of Maghreb sub-regional integration, see Brenton/Baroncelli/Malouche, Trade and Investment in the Maghreb, World Bank, Middle East and North Africa, Working Paper No. 44, June, 2006; and for a forward looking analysis, see Brunel/Hufbauer, Reviving Maghreb Integration: Recommendations, in: Hufbauer/Brunel (eds.), *Maghreb Regional and Global Integration: A Dream to be Fulfilled*, 2008, p. 163.

The Arab Cooperation Council

The Arab Cooperation Council (ACC) bears mention merely for the sake of completing the picture of sub-regional integration attempts, and for illustrating once more the strong (and often negative) linkage between regional politics and regional economic integration. The ACC was established in 1989 by Egypt, Jordan, Iraq and North Yemen,[122] largely as a response to rebuffs by the other sub-regional groupings. The ACC was extremely short lived, for all intents and purposes collapsing after the Iraqi invasion of Kuwait in 1990.[123]

Advances at the Regional Level: The GAFTA and the Agadir Agreement

Overview and the General Distinction between GAFTA and the Agadir Agreement

In recent years, MENA has witnessed two significant developments in economic integration at the regional level: the GAFTA and the Agadir Agreement. Both frameworks have the potential of overcoming the difficulties of the past, as well as making MENA's fragmented bilateral trade and sub-regional trade arrangements redundant. Indeed, it might seem odd that the same region would have two concurrent regional integration initiatives, when so little has been achieved in the past.

However, there are significant differences between them, and each structure serves different constituencies and different purposes. The GAFTA is an Arab League framework, and as such its explicit goals are intra-regional-looking, but at the same time it aims for inclusiveness of Arab League states beyond the MENA region. In contrast, the Agadir Agreement, while also formally open to accession of all Arab League Members that are GAFTA signatories, focuses more on the Euro-Mediterranean sphere, in that an additional accession requirement is the existence of a FTA with the EU (thus subtly limiting the range of potential members), and that its underlying aim is to promote cumulation of origin under Pan-European RoO[124] within the region for the sake of benefiting more fully from FTAs with the EU;[125]

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[122]See *Agreement on the Establishment of the Arab Cooperation Council*, February 16, 1989, UNTS No. 26558, Vol. 1530 (1989), p. 417.

[123]See Ryan, Jordan and the Rise and Fall of the Arab Cooperation Council, The Middle East Journal 52 (1998) 3, p. 386.

[124]Article 6.1 of the Agadir Agreement.

[125]On EU–MENA relations, see Momani, The EU, the Middle East and Regional Integration, World Economics 8 (2007) 1, p. 47.

these elements are what make the Agadir Agreement a potential MAFTA – "Mediterranean Arab Free Trade Area,"[126] – and justify its separate existence.

The GAFTA

In 1981, the members of the Arab League adopted an Agreement to Facilitate and Develop Inter-Arab Trade (AFDIAT). Taken on its own, the AFDIAT was not much of a departure from the prior legacy of the Arab League. Although it aimed at liberalization, perhaps even the establishment of a regional FTA, it was vague in its language and left open the selection of covered products to a set of malleable "principles."[127] It could well have been seen as yet another part of the Arab League's *façade dissimulant*.[128] Nevertheless, 16 years later it was to become the basis for what might yet be seen as a *relance Arabe*.

On February 19, 1997, the Social and Economic Council of the Arab League adopted a declaration on a Pan-Arab FTA establishing an "Executive Program" for the AFDIAT, which is in fact the text of the GAFTA.[129] The GAFTA required that "all Arab goods traded among the party-states shall be liberalized in accordance with the gradual liberalization principle which shall be applied as of January 1, 1998," allowing for "full liberalization" by July 21, 2007.[130] It established a principle of national treatment among states parties,[131] and a general prohibition on non-tariff barriers.[132] GAFTA members include 17 of the 22 Arab League countries,[133] of which Yemen and Sudan, as LDCs, have a longer period of liberalization (until 2010) and the Palestinian Authority has been exempted from tariff reductions "due to its geopolitical situation."[134] In 2002, the Arab League's

[126]Note, however, that GAFTA too has an EU context: the fact that in the mid-1990s eight Arab League Members had chosen to participate in the EU's Euro-Mediterranean Program (discussed briefly in the next section) served as a wake-up call for pan-Arab economic integration; see Zorob, Intraregional Economic Integration: The Cases of GAFTA and MAFTA, in: Harders/Legrenzi (eds.), *Beyond Regionalism? Regional Cooperation, Regionalism and Regionalization in the Middle East*, 2008, p. 169.

[127]Article IV AFDIAT.

[128]Fn. 99 *supra*.

[129]See fn. 6 *supra*.

[130]Article 2.1 of the GAFTA.

[131]Article 1.4 of the GAFTA.

[132]Article 3 of the GAFTA.

[133]Arab League member countries that are not members of GAFTA are Algeria, Djibouti, Somalia, Comoros Islands, and Mauritania.

[134]See Syria, Ministry of Agriculture and Agrarian Reform, National Agricultural Policy Center, working Paper No. 8, Implementation of the Great Arab Free Trade Area Agreement: The Case of Syria (undated), http://www.napcsyr.org/dwnld-files/working_papers/en/08_gafta_en.pdf. Indeed, the Palestinian Authority can hardly make effective tariff reduction commitments under present circumstances.

Economic and Social Council resolved to accelerate the gradual liberalization process, abolishing tariffs by January 1, 2005.[135]

Although difficult to assess, thus far it appears that the record of GAFTA tariff reductions is positive (if patchy in some recorded cases); its main weakness is in the realm of non-tariff barriers,[136] reflecting the general problem discussed in Sect. 3 *supra*. Its institutional aspects are certainly not robust, particularly not its dispute settlement procedures.[137] Moreover, trade in services and investment liberalization are not included in GAFTA, and will require further efforts, if the GAFTA is not to remain fighting the last war – especially given the strong role of services and oil-based capital in MENA economies, as previously noted. As far as regional economic integration is concerned, the GAFTA constitutes a few steps in the right direction, but many more will be needed.

The Agadir Free Trade Area Agreement

The Agadir Agreement (sometimes known as "MAFTA"), based on an earlier declaration of intent from 2001, was signed in Rabat in February, 2004, entering into force on January 1, 2006. It establishes a free trade area between the Arabic Mediterranean states of Egypt, Jordan, Morocco and Tunisia, and is open to accession of other Arab States that are parties to FTAs with the EU. The Agadir Agreement calls for full liberalization in trade in industrial goods (in which it technically departs from the GAFTA), with trade in agricultural goods to be liberalized according to the plan set in the GAFTA.[138] Trade in services between the Agadir countries is governed by the GATS.[139] The Agadir Agreement would not, therefore, seem to contribute much substance to regional integration as such, in relation to the GAFTA and WTO. However, in contrast with the GAFTA, the Agadir Agreement speaks the language of the WTO, albeit imperfectly, having been agreed between WTO conversant states.[140] More significantly, the main, unheralded purpose of the Agadir Agreement is to promote the adherence to Pan-Euro-Mediterranean RoO, to facilitate regional trade with the EU.[141]

[135]Resolution 1431/2002.

[136]See Lawrence, *A US–Middle East Trade Agreement: A Circle of Opportunity?* 2006, pp. 50–51.

[137]For a critique of the weakness of dispute settlement in the GAFTA see Hassanien, *Trading Spaces: Lessons from NAFTA for a Robust Investment Dispute Settlement Mechanism under Great Arab free Trade Agreement (GAFTA)*, 2007 ExpressO, http://works.bepress.com/mohamed_hassanien/1.

[138]Article 4 of the Agadir Agreement.

[139]Article 5 of the Agadir Agreement.

[140]See, e.g., Articles 5, 9, and 10 of the Agadir Agreement.

[141]See Article 6.1 of the Agadir Agreement.

Conclusions: The Challenge of Regional Coherence and Cohesion

If anything, this chapter has emphasized the diversity of the MENA region, and the diversity of problems it faces towards the goal of regional economic integration. This is not merely a diversity of economics, but a diversity of culture, and above all, of politics. Over time it has also become a diversity of institutions and legal frameworks. Indeed, this is a region divided at the multilateral (WTO), regional, sub-regional, bilateral and national levels. Above and beyond the fundamental economic questions of complementarity and the like, MENA is a fragmented region – one might easily talk of a "couscous bowl." As such the region faces the challenge of regional coherence and cohesion. This challenge may be broken down into the following components:

First, one source of incoherence is the WTO gap – the gap between states that are WTO members and those that are not. The former are learning a common language – in which they may still express their differences, but in a manner intelligible to their counterparts in the region and outside of it. In this context, for example, from both trade and policy perspectives, Syria should certainly be encouraged to apply for WTO Membership, and states should assist each other not only in accession but in compliance.

Second, the baffling bilateralism that has evolved over the last decade or so should be dissolved into a single regional framework, preferably an existing and functioning one, such as the GAFTA. Bilateralism provided some stimuli for integration, but ultimately it is static in the background of the larger goal of regional integration.

Third, the institutional framework of economic integration in the region should be significantly bolstered. A meaningful dispute settlement system in the GAFTA would signal that the commitments undertaken are meaningful. MENA states should learn that they can litigate their economic differences without political reverberations. Taking this a step further, MENA states would do well to expand the role of business and civil society in consideration and implementation of their policies.

Fourth, MENA integration must break free of the archaic goods paradigm, and think hard about how to integrate the region's strengths in the areas of services, investment, and even IP and competition. Government procurement, for example, seems like a prime area in which regional integration can reap early harvests.

Fifth, the parallel relationships with the EU and the USA should be harmonized. This is most technically clear in the area of RoOs, but the EU–US parallel involvement – it should not be viewed necessarily as rivalry – casts a longer shadow. There is no reason that MENA should not gain from its relationships with both powers at the same time; but this would require a concerted effort on the part of MENA states.[142]

Last, but not least, the region must positively resolve the part played by Israel, quite simply the elephant in the room. Arab states must take the lead on this, and integrate Israel into the region, rather than with it. The benefits would be far-reaching, in political and economic terms, to the region as a whole; but a strong vision and sturdy hands will be required for this to be achieved.

[142]Differential prospects for cumulation of RoOs is a central, though not exclusive, aspect of this relationship. Whereas the EU has adopted the Pan-Euro-Mediterranean RoO as a general policy aimed at promoting intra-regional efforts producing exports to the EU, the USA has followed a modest and selective path through the establishment of "Qualified Economic Zones" between Israel, on one hand, and Egypt and Jordan, on the other, limited in product coverage and scope of effect on preferences. The difference between US/QIZ policy and EU/RoO policy is an important one, but one that cannot be covered in the scope of this introduction.

North American Regional Economic Integration: Recent Trends and Developments

Jeffrey L. Dunoff

Introduction

Recent years have witnessed a series of initiatives to expand and enhance economic integration across North America.[1] This chapter reviews the most important of these integration efforts, including the Free Trade Agreement of the Americas; the North American Free Trade Agreement; the Dominican Republic – Central America – United States Free Trade Agreement; the Central American Common Market; the CARICOM Single Market; and efforts to create an Economic Union under the auspices of the Organization of Eastern Caribbean States. In each instance, I provide a brief overview of the agreement; describe recent political, economic and legal developments; and review dispute settlement activity. A brief conclusion follows.

Free Trade Agreement of the Americas

The Free Trade Agreement of the Americas (FTAA) represents an effort to unite the economies of the Americas into a single free trade area. This effort began at a Summit of the Americas in December 1994 in Miami, USA. At the Miami summit, the Heads of State and Government of the 34 democracies in the region agreed to launch negotiations over establishment of a free trade area. Participating states

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[*]I am grateful for superb research assistance from Harvard Law School students Matt Sullivan, Evgeniya Rubinina, and Davida Cannon.

[1]For current purposes, I follow convention, and include Central America and the Caribbean as part of North America.

C. Herrmann and J.P. Terhechte (eds.), *European Yearbook of International Economic Law 2010*, European Yearbook of International Economic Law,
DOI 10.1007/978-3-540-78883-6_13,

agreed to achieve substantial progress towards building the FTAA by 2000 and to complete negotiations by the end of 2005.

From 1994–1998, the parties engaged in extensive preparatory efforts. Twelve working groups were established and four ministerial meetings were held. Formal negotiations were launched in April 1998 at the Second Summit of the Americas, held in Santiago, Chile. Soon thereafter nine negotiating groups were established: nonagricultural goods, agriculture, services, intellectual property, subsidies and antidumping, government procurement, investment, competition, and dispute settlement. In addition, a consultative group on small economies was created, and committees on civil society and electronic commerce were formed. After several years of fitful negotiations, the negotiation process was suspended.[2]

The FTAA can be understood, in part, as a reaction to the patchwork of regional integration efforts discussed below. Specifically, a hemisphere-wide FTAA could serve to harmonize the various trade regimes that have been negotiated among regional trading partners. Moreover, an agreement integrating the economies of North and South America would cover the one gaping hole in the complex matrix of trade agreements currently found in the western hemisphere as it would link the major economies of the Americas. Finally, a hemisphere wide free trade area could be expected to spark hemispheric cooperation on a range of other political and socio-economic issues.[3]

The FTAA initiative reflected an ambitious and unprecedented effort to integrate a large number of economies of enormously different sizes and states of development. While progress was always halting at best, negotiations broke down following a November 2003 Ministerial. At the Ministerial, ministers “affirmed their commitment to a comprehensive and balanced FTAA” including “provisions in each of the FTAA negotiating areas.” At the same time, however, states were also authorized to remove specific issues or products from negotiations. In short, the ministerial text contemplated a type of variable geometry, with some states joining an “FTAA-lite” that excluded sensitive issues, supplemented by plurilateral accords among some FTAA parties that included additional commitments.

Some states understood this decision as authorization to seek to remove entire sectors from the negotiations. In particular, Brazil indicated an unwillingness to negotiate subjects that it found highly sensitive, such as investment and intellectual property. Brazil’s reluctance to negotiate on issues of concern to the United States in turn prompted the United States to refuse to make concessions on issues of great interest to Brazil, such as agriculture. As Schott summarizes:

> The [Ministerial] declaration complicated the task of crafting a balanced package of concessions that negotiators can sell to their respective legislatures. It took pressure off

[2]A more detailed discussion of FTAA negotiations can be found on the FTAA website at http://www.ftaa-alca.org. Additional analysis can be found in Gabriele Tondl’s report on regional integration in South America in this volume.

[3]See generally Schott, *Prospects for Free Trade in the Americas*, 2001; Schott, Does the FTAA Have a Future? Institute for International Economics (November 2005).

> the Brazilian negotiators by giving them an excuse for their minimalist position on so-called WTO-plus issues – i.e., those that go beyond the scope of existing WTO rights and obligations. For Brazil, the [Ministerial] decision seemed to condone an FTAA that simply removed traditional border barriers and did not require commitments on new issues like investment and competition policy. At the same time, it allowed US officials to defend inaction on US farm barriers because of lack of reciprocity from their Brazilian counterparts.[4]

Since the Miami Ministerial, little political or diplomatic energy has been invested in the FTAA process, and negotiations are no longer active. As of the end of 2008, there appeared to be little enthusiasm for reviving FTAA processes in any of the hemisphere's major trading nations, and little prospect for completing negotiations on the FTAA at any time in the near future.

North American Free Trade Agreement

Overview

Canada, the United States, and Mexico are party to the North American Free Trade Agreement (NAFTA). The agreement creates the world's largest free trade area, with the parties accounting for about one-third of the world's total GDP. Since the agreement entered into force on January 1, 1994, the three parties have systematically eliminated most tariff and non-tariff barriers to trade and investment among themselves. In addition to providing for the progressive phase-out of tariffs on goods, the treaty was one of the early regional agreements to address a broader set of economic and regulatory issues, and includes detailed provisions on foreign investment, trade in services (including banking, securities, insurance, and telecommunications), intellectual property, food safety standards, government procurement, and certain immigration law matters. Labor and environmental issues are addressed in supplemental or "side" agreements, namely the North American Agreement on Labor Cooperation and the North American Agreement on Environmental Cooperation.[5]

In addition to its substantive commitments, NAFTA establishes a Free Trade Commission, consisting of cabinet-level representatives of the three parties. The Commission is to meet annually to supervise NAFTA implementation, oversee the further elaboration of the agreement, resolve disputes arising out of the agreement, supervise work of NAFTA committees and working groups, and consider any other matters that may affect the operation of the agreement. The Commission is

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[4] Schott, Does the FTAA Have a Future? Institute for International Economics (November 2005).

[5] For an authoritative account of NAFTA politics from the start of negotiations through the implementation of treaty obligations, see Mayer, *Interpreting NAFTA: The Science and Art of Political Analysis*, 1998.

authorized to create committees, working groups, or expert groups and delegate responsibilities to them. The Commission is also explicitly empowered to seek advice and information from non-governmental organizations.

Recent Developments

On January 1, 2008, the last NAFTA tariffs and quotas – on sugar and a variety of other agricultural products – were officially eliminated after years of gradual reduction. However, despite much success in implementing the treaty's terms, NAFTA remains highly controversial. NAFTA supporters note that trade among the three countries experienced a threefold increase, growing from $297 billion in 1993 to $930 billion in 2007, and argue that the pact has produced both economic growth and increased employment opportunities.[6] Opponents challenge these economic claims as exaggerated and misleading, and criticize as insufficient developments regarding higher wages, labor standards, and environmental protections.[7]

Canada hosted the most recent meeting of the NAFTA Free Trade Commission in Vancouver, British Columbia in August 2007. At this meeting, Canadian Minister of International Trade David Emerson, Mexican Secretary of the Economy Eduardo Sojo Garza-Aldape and US Trade Representative Susan Schwab agreed to seek increased market efficiencies, economic growth, prosperity, and innovation in the three member states. In particular, they pledged to facilitate trade in a number of specific sectors, including swine, steel, consumer electronics, and chemicals.

The NAFTA states have also undertaken initiatives outside the formal NAFTA processes in areas related to economic integration. For example, since 2005, leaders of the three NAFTA countries have met under the auspices of the Security and Prosperity Partnership of North America (SPP), a parallel institution created to improve border security and economic cooperation. At an April 2008 summit, leaders from the three countries reaffirmed their commitment to "smart and secure borders" while pledging to increase competitiveness, strengthen energy security and environmental protection, protect consumer safety, and respond to emergencies.[8] Nevertheless, some officials and business actors fear a "border thickening" that began after the September 11 attacks will persist, imposing significant obstacles to commerce.

In addition to government activities, NAFTA has also sparked private sector initiatives designed to promote integration. For example, in 2007 the architecture professions of Canada, Mexico, and the United States signed a Mutual Recognition

[6]"NAFTA – Myth vs. Facts," USTR fact sheet, March 2008, available at http://www.ustr.gov/assets/Trade_Agreements/Regional/NAFTA/Fact_Sheets/asset_upload_file202_14592.pdf.

[7]See, e.g., Debunking USTR Claims in Defense of NAFTA: The Real NAFTA Score 2008, Public Citizen report, available at http://www.citizen.org/documents/NAFTA_USTR_Debunk_web.pdf.

[8]See Joint Statement of President Bush, President Calderon, Prime Minister Harper, available at http://www.whitehouse.gov/news/releases/2008/04/20080422-4.html.

Agreement designed to facilitate the recognition of credentials within the three NAFTA states. In addition, other professional bodies are in the process of negotiating standards and criteria for the licensing and certification of professional service providers.

NAFTA was an issue during the 2008 Presidential elections in the United States. The 2008 Democratic Party platform, adopted at the party's national convention in Denver in August 2008, called for negotiations to "amend" the treaty. During the campaign, Democratic candidate Barack Obama stated that he would ask Mexico and Canada to renegotiate the treaty, under threat of a US withdrawal from the agreement. After the election and before his inauguration, the President-elect appeared to backtrack from these comments. In November 2008, Mr. Obama named Rep. Rahm Emanuel as White House chief of staff. Mr. Emanuel served as point man for the Clinton White House in securing congressional approval of NAFTA in 1993. In addition, Mr. Obama nominated Gov. Bill Richardson, another strong NAFTA supporter, to serve in his cabinet as Secretary of Commerce.[9]

Dispute Settlement

NAFTA includes a number of provisions addressing dispute settlement. The principal dispute settlement mechanisms are found in NAFTA chapters 11, 19, and 20. Each of these provisions is outlined below, along with a brief description of developments during the past year.

NAFTA Chapter 11 provides a number of substantive protections for NAFTA investors in other NAFTA parties and creates an international arbitral mechanism for the settlement of disputes between NAFTA investors and host states. Alternatively, the investor may have recourse to the host state's domestic courts. Chapter 11 provides that final arbitral awards are enforceable in domestic courts. A relatively large number of chapter 11 disputes have been filed over the years.[10] Significant chapter 11 developments during the past year include the following:

Centurion Health Corp v. Canada – In July 2008, a US investor served Canada with notice of intent to file a chapter 11 claim arising out of Canada's alleged treatment of a proposed health care center.

Clayton/Bilcon v. Canada – In February 2008, US investors served Canada with notice of intent to file a chapter 11 claim arising out of governmental actions related

[9] In January 2009 Gov. Richardson withdrew his name from nomination in light of a federal investigation of one of his political donors.

[10] Documents related to chapter 11 claims filed against Canada can be found on the Foreign Affairs and International Trade website at http://www.international.gc.ca/trade-agreements-accords-commerciaux/disp-diff/gov.aspx?lang=en. Documents related to chapter 11 claims filed against the United States can be found on the State Department's website at http://www.state.gov/s/l/c3741.htm. Documents related to chapter 11 claims filed against Mexico can be found on the Ministry of the Economy's website at http://www.economia.gob.mx/?P=5500.

to the permitting of a basal quarry and marine terminal in Nova Scotia. In May 2008, the investor filed a notice of arbitration.

Bishop v. Canada – In October 2008, a US investor served Canada with notice of intent to file a chapter 11 claim arising out of Canada's allegedly wrongful changes to the fishing license lottery system.

Dow AgroSciences v. Canada – In August 2008, a US investor served Canada with notice of intent to file a chapter 11 claim for loses allegedly caused by Quebec's ban on the sale and certain uses of certain lawn pesticides.

Georgia Basin Holdings v. Canada – In February 2008, a US investor filed notice of intent to file a chapter 11 claim arising out of Canada's allegedly unlawful export controls on logs harvested in British Columbia.

Shiell v. Canada – In October 2008, US investors filed notice of intent to file a chapter 11 claim arising out of Canada's alleged violation of minimum standards of treatment.

Merill & Ring Forestry v. Canada – In September 2008, a number of labor unions sought leave to file amicus curiae briefs in this ongoing action involving Canadian forestry practices. As of the end of the year, this request was pending.

Gallo v. Canada – In June 2008, a US investor filed a statement of claim alleging breach of the minimum standard of treatment and expropriation. Canada filed a statement of defense in September 2008.

Greiner v. Canada – In September 2008, a US investor filed notice of intent to file a chapter 11 claim arising out of allegedly improper changes to the fishing license lottery system.

Apotex v. USA – In December 2008, a Canadian investor filed a notice of arbitration arising out certain federal court actions that allegedly prevented the investor from marketing certain medicines in the United States.

Cases Regarding the Border Closure due to BSE Concerns – In January 2008, an arbitral panel dismissed for lack of jurisdiction a claim by Canadian investors arising out of a US ban on certain Canadian-origin cattle and beef products.

Grand River Enterprises Six Nations v. USA – In July 2008, Canadian investors submitted their memorial on the merits. Complainants allege that a 1998 agreement between state attorneys general and tobacco firms as well as subsequent implementing legislation violate NAFTA provisions on national treatment, most-favored-nation treatment, and expropriation.

No chapter 11 investment disputes were initiated against Mexico in 2008, nor were any awards rendered in pending chapter 11 disputes against Mexico in 2008.

NAFTA Chapter 19 creates an alternative to domestic court judicial review of final determinations of antidumping and countervailing duty cases. In particular, chapter 19 provides for independent binational panel review of decisions by domestic investigating authorities. Chapter 19 panels review these decisions solely to determine, based on the administrative record, whether the relevant domestic investigating authority properly applied its national laws. Panels employ the same standard of review and the same general legal principles as would a domestic court in the state where the determination was made. Chapter 19 panels can either uphold the decision or remand it to the investigating authority, and panel decisions are binding upon the parties.

One chapter 19 panel report was issued in 2008. In that case, the panel upheld US agency determinations in a review of antidumping and countervailing duty orders regarding stainless steel sheet and strip in coils from Mexico. In addition to this case, three additional requests for panel review were filed in 2008. Mexico sought review of both the final injury determination and the injury determination by the USA regarding light walled rectangular pipe and tube, and Canada challenged the US final antidumping duty review regarding carbon and certain alloy settle wire rod. These disputes were pending as of December 31, 2008. In addition, two disputes filed during 2007 remained pending as of the end of 2008.

NAFTA Chapter 20 contains a general dispute settlement provision applicable to all disputes involving the interpretation or application of the NAFTA. Chapter 20 disputes begin with consultation among the disputing parties. If this is not successful, a disputing party may request a meeting of the NAFTA Free Trade Commission. If the Commission is unable to resolve the dispute, a disputing party may request the establishment of a five-member arbitral panel. A chapter 20 panel report contains findings of fact and a determination of whether the challenged measure is inconsistent with a party's NAFTA obligations or nullifies or impairs benefits that a complaining state could reasonably have expected under the agreement. NAFTA parties rarely invoke chapter 20 mechanisms and no chapter 20 disputes were filed and no chapter 20 reports were issued in 2008.

It is important to note that not all economic disputes involving these three states are addressed through NAFTA's institutional framework. Thus, for example, a number of disputes involving NAFTA parties are submitted to WTO dispute settlement. In December 2008, Mexico and Canada each sought WTO consultations with the United States over a US provision requiring country of origin labeling on certain agricultural products.[11] In October 2008, Mexico sought consultations with the United States over certain US measures affecting the importation and sale of Mexican tuna.[12] Also, during 2008, a panel of the WTO Appellate Body upheld a Mexican challenge to certain methodologies used by the United States to calculate antidumping orders,[13] and later in the year a WTO arbitrator determined how long the USA would have to implement the WTO decision.[14]

[11]Request for Consultations, WT/DS386/1, United States – Certain Country of Origin Labelling Requirements (December 22, 2008) (Mexican request for consultations); Request for Consultations, WT/DS384/1, United States – Certain Country of Origin Labelling (COOL) Requirements (December 4, 2008) (Canadian request for consultations).

[12]Request for Consultations, WT/DS381/1, United States – Measures Concerning the Importation, Marketing and Sale of Tuna and Tuna Products (October 28, 2008).

[13]WTO Appellate Body, WT/DS344/AB/R, United States – Final Anti-dumping Measures on Stainless Steel from Mexico (April 30, 2008).

[14]WTO Article 21.3(c) Arbitral Panel, WT/DS344/15, United States – Final Anti-Dumping Measures on Stainless Steel from Mexico (Oct. 31, 2008) (arbitration under article 21.3(c) of the DSU).

Other disputes involving NAFTA states are addressed through various bilateral and domestic channels. Important developments occurred in two long-standing disputes during 2008. The first of these disputes involves a decades-long battle over the export of Canadian softwood lumber products to the USA.[15] This dispute was apparently resolved by the US–Canada Softwood Lumber Agreement (SLA), signed on October 12, 2006. However, several disputes over implementation have arisen. In March 2007, the United States requested formal consultations to address concerns about Canada's implementation of certain export measures, including surge mechanisms and quota volumes. After consultations failed, in August 2007 the United States initiated international arbitration proceedings. In March 2008, the arbitral tribunal determined that Canada had violated the SLA by failing to adjust quotas in 2007 with respect to Eastern provinces, but that no such adjustment was required regarding Western provinces.[16] A subsequent stage of arbitral proceedings is addressing whether a remedy should be imposed for the violation.

In January 2008, the United States filed a second arbitral claim, alleging that Ontario and Quebec were providing producers grants, loans, loan guarantees, and tax credits and other benefits in violation of the SLA's anti-circumvention provisions. Also, in January 2008 Canada announced a proposal to create a $1 billion Community Development Trust that would include aid to its forestry industry. In response, the United States sought assurances that the plan was SLA-compliant.

Another long-standing dispute involves the use of Mexican trucks in the United States. Under NAFTA, cross-border trucking was to be liberalized by December 1995. However, thereafter Mexico complained that the USA had improperly blocked Mexican trucks from operating in the USA, and in February 2001 a chapter 20 panel found in favor of Mexico. Nevertheless, a series of US regulations have had the effect of largely excluding Mexican trucks from operating in the USA. Eventually, the USA initiated a "pilot" program permitting 100 Mexican trucks to operate in the USA. In August 2008, the US Department of Transportation announced plans to extend the initiative for another two years. In September, the House of Representatives voted to suspend the pilot program by a vote of 395–18.[17] The Senate, however, took no immediate action on the bill.

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[15]For an introduction to and analysis of this dispute, see Dunoff, The Many Dimensions of Softwood Lumber, available at http://ssrn.com/abstract=1013609.

[16]See USTR Disappointed with Tribunal's Mixed Decision on Softwood Lumber, USTR press release, Mar. 4, 2008, available at http://www.ustr.gov/assets/Document_Library/Press_Releases/2008/March/asset_upload_file97_14550.pdf.

[17]See H.R. 6630 (110th Congress 2008); see also Snider, Transportation: House Votes to End Mexican Truck Program as Administration Threatens to Veto Measure, BNA Int'l Trade Rep. 25 (2008), p. 1350.

The Dominican Republic – Central America – United States Free Trade Agreement

Overview

On August 5, 2004, the Dominican Republic – Central America – United States Free Trade Agreement (CAFTA-DR) was signed by the five Central American states of Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua; the Dominican Republic; and the United States of America. The agreement entered into force for the United States and El Salvador, Guatemala, Honduras, and Nicaragua in 2006, and for the Dominican Republic in 2007. Costa Rica approved the treaty through a national referendum in October 2007, and, in November 2008, adopted implementing legislation and regulations. As a result, the agreement will enter into force for Costa Rica as of January 1, 2009.

The agreement is designed to create new economic opportunities by eliminating tariffs, opening markets, promoting transparency, and facilitating investment among the signatory countries. Duties on most consumer and industrial goods will be eliminated, with remaining duties on consumer and industrial goods to be phased-out within 10 years. Duty-free treatment for certain agricultural goods will be phased in over time, with the exception of sugar, where liberalization is being provided through a slowly expanding tariff-rate quota.

CAFTA-DR parties also commit to provide, subject to very few exceptions, substantial market access across a broad range of services sectors, including financial services, telecommunications, express delivery, computer and related services, distribution services, professional services, advertising, audiovisual services, construction and engineering services, and energy services. The agreement provides for heightened standards for the protection and enforcement of a broad range of intellectual property rights. Separate chapters address foreign investment, government procurement, and telecommunications.

The agreement also includes labor and environment obligations. In particular, each Party commits not to fail to effectively enforce its domestic labor and environment laws, through a sustained or recurring course of action or inaction, in a manner affecting trade between the Parties. Moreover, each Party must ensure that its domestic law provides access to fair, equitable, and transparent proceedings for the enforcement of labor and environment laws. Parties recognize the importance of cooperation to help ensure the capacity of the Central American Parties and the Dominican Republic to meet their labor and environment obligations under the agreement. The labor chapter establishes a cabinet-level Labor Affairs Council to oversee implementation of the agreement's labor provisions and to provide a forum for consultation and cooperation on labor matters. The environmental chapter establishes a cabinet-level Environmental Affairs Council to oversee implementation of the treaty's environmental provisions. In a parallel agreement, the CAFTA-DR Environmental Cooperation Agreement, the Parties established a framework for environmental cooperation.

The treaty creates a Free Trade Commission, consisting of the Parties' trade ministers, to supervise the implementation and overall operation of the agreement. The Commission will meet annually and make decisions by consensus. The Commission will assist in the resolution of any disputes that may arise under the agreement. It may issue interpretations of the agreement and agree to accelerate duty elimination on particular products and adjust the agreement's product-specific rules of origin. The treaty also establishes a Committee on Trade Capacity Building, comprised of representatives of each Party. The overall objective of the Committee is to assist the Central American Parties and the Dominican Republic to implement the agreement and adjust to liberalized trade.

Recent Developments

Parties to the agreement extended Costa Rica's deadline to implement the agreement by three months, until January 1, 2009, after an initial extension proved insufficient. As noted above, Costa Rica adopted the necessary implementing legislation and the agreement entered into force for Costa Rica on January 1, 2009.

In November 2008, officials from the CAFTA-DR states held the first meeting of the Labor Affairs Council in San Salvador, El Salvador. The council reaffirmed the importance of each party effectively enforcing its labor laws and respecting the ILO Declaration on Fundamental Principles and Rights at Work. In addition, the labor practices of CAFTA-DR parties has been subject of some controversy in the United States. Following receipt of formal complaint from US and Guatemalan unions, in July 2008 the US Department of Labor agreed to investigate Guatemalan enforcement of its labor laws.[18]

In 2007, the CAFTA-DR Parties agreed to amend several textiles-related provisions of the treaty, including, in particular, changing the rules of origin to require the use of US or regional pocket bag fabric in originating apparel. In July 2008, the USA implemented these provisions.

Dispute Settlement

Chapter Twenty sets out detailed procedures for the resolution of disputes between the Parties over compliance with the agreement. Parties are to engage in consultations; if these prove unsuccessful, any consulting Party may refer the matter to the Free Trade Commission, which will attempt to resolve the dispute. If the Commission cannot resolve the dispute, any consulting Party may refer the matter to a panel

[18]Brevetti, Regional Agreements: DOL Initiates Investigation of CAFTA-DR Complaint by AFL-CIO, Guatemala Unions, BNA Int'l Trade Rep. 25 (2008), p. 1105.

comprising independent experts that the Parties select. If the disputing Parties cannot resolve the dispute after they receive the panel report, they will seek to agree on acceptable trade compensation. If they cannot agree on compensation, or if the complaining Party believes the defending Party has failed to implement an agreed resolution, the complaining Party may suspend trade benefits equivalent in effect to those it considers were impaired as a result of the disputed measure. If the defending Party considers that the proposed level of suspension is "manifestly excessive," or believes that it has modified the disputed measure to make it conform to the agreement, it may request the panel to reconvene and decide the matter. The complaining Party may suspend trade benefits up to the level that the panel sets. Similar compliance procedures apply to disputes over a Party's conformity with the treaty's labor and environmental law enforcement provisions.

Chapter 10 of the treaty permits investors from a party to submit to binding international arbitration a claim for damages against another party. In addition, an annex to chapter 10 calls on the parties, within three months of the date of entry into force, to initiate negotiations to develop an appellate body to review arbitral awards.

Central America Common Market

Overview

The Central American Common Market (CACM) comprises Costa Rica, Guatemala, El Salvador, Honduras, and Nicaragua. Its foundations were laid by the General Treaty on the Central American Economic Integration signed on December 13, 1960, between Guatemala, El Salvador, Honduras, and Nicaragua, which provides for creation of a free trade regime among the parties.[19] The process of regional economic integration was suspended in the 1970s with the suspension of the Organization of Central American States (ODECA), and was reinvigorated twenty years later under the auspices of the Central American Integration System. Pursuant to the Protocol of Tegucigalpa to the ODECA Charter (signed on December 13, 1991) and the Protocol to the General Treaty on Central American Economic Integration (signed on October 29, 1993), the CACM became part of the Economic Integration Subsystem of the Central American Integration System, and acquired an institutional framework in the shape of the Secretariat for Central American Economic Integration (SIECA).

[19] General Treaty on the Central American Economic Integration, Dec. 13, 1960, http://www.sice.oas.org/trade/camertoc.asp.

Recent Developments

Negotiations on the conclusion of an Association Agreement between Central American States (CACM members plus Panama) and the EU were officially launched in June 2007; trade issues are one of the areas covered by the Association Agreement. Four negotiation rounds have been held, including two rounds in 2008. Recent negotiations have focused upon customs union issues, non-tariff barriers to trade, and sanitary and phytosanitary issues.

Negotiations are also underway between CACM States and CARICOM regarding the conclusion of a trade agreement.

Dispute Settlement

The CACM has a dispute resolution mechanism aimed at the settlement of trade disputes regarding the application or interpretation of legal instruments governing the process of economic integration in Central America. The mechanism involves mandatory consultations; intervention by the Council of Ministers; and binding arbitration. If a party does not comply with an award, the other party has the right to suspend benefits proportionate to the damage suffered.

Only states can file claims with the dispute resolution mechanism. Since it came into existence in 2003, fifteen cases have been submitted to the mechanism. Ten of these cases were resolved at the consultation stage. Two were resolved with the intervention of the Council of Ministers. One dispute is in arbitration. The two most recent cases are in the consultation stage and in the process of being settled.[20]

CARICOM Single Market and Economy

Overview

The CARICOM Single Market and Economy (CSME) currently comprises 12 member states: Antigua and Barbuda, Barbados, Belize, Dominica, Grenada, Guyana, Jamaica, Saint Kitts and Nevis, St Lucia, St Vincent and the Grenadines, Suriname, Trinidad and Tobago.

The CSME was initially conceived in 1973, when the Commonwealth Caribbean leaders decided to transform the Caribbean Free Trade Association (CARIFTA)

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[20]Information on disputes submitted to the CACM can be found on the Integrated Database of Trade Disputes for Latin America and the Caribbean at http://idatd.eclac.cl/controversias/mcca.htm?perform=buscar.

into a Common Market and established the Caribbean Community, of which the Common Market would be an integral part. Although a free-trade area had been established earlier, CARIFTA did not provide for the free movement of labor and capital, or the coordination of agricultural, industrial, and foreign policies. The Treaty was further revised between 1989 and 2003 to provide for, i.e., trade in goods from free zones and free circulation of goods. The CSM Treaty was ratified by the twelve state members in 2006.

The CSME involves, among its other elements, free movement of goods and services – through measures such as eliminating all barriers to intra-regional movement and harmonizing standards to ensure acceptability of goods and services traded; a common external tariff; free circulation of goods imported from extra regional sources; and a common trade policy.

Recent Developments

Throughout 2008, with the assistance of the CARICOM Secretariat, Haiti revised and developed legislative frameworks to enable it to join CSME. It is expected that Haiti will participate in the free trade in goods in 2009.

During 2008 member states devoted significant energies to developing a Protocol on Contingent Rights, which will clarify the rights of Community nationals as they move through member states to give effect to free trade in services and the right of establishment. Major outstanding issues included the right of access to primary education for children of CARICOM nationals. The parties hope to complete a draft Protocol by the end of 2009.

In July 2008, the 29th Meeting of the Conference of the CARICOM Heads of Government was held. The meeting celebrated the 35th anniversary of the signing of the Treaty of Chaguaramas. In addition, the conference witnessed the launch of the CARICOM Development Fund.

In March 2008, the CARICOM Council for Trade and Economic Development approved the suspension of the common external tariff on three categories of items in an effort to provide relief from the rising costs of commodities. The commodities affected included baby formula, juices for infant use, and certain agricultural goods such as milk, chicken, lamb, onions, beans, and potatoes.

The CARICOM Competition Commission was inaugurated in January 2008, in Paramaribo, Suriname.

Dispute Settlement

The 2001 Revised Treaty of Chaguaramas Establishing the Caribbean Community Including the CARICOM Single Market and Economy provides that the Caribbean Court of Justice (CCJ) shall have jurisdiction to hear claims arising out of the implementation of the CSME. Interestingly, in addition to claims by states parties against other states, it is also possible for private parties – individuals and companies – of the contracting states to appear as parties, with special leave by the CCJ, when such persons have been prejudiced in respect of the enjoyment of the right or benefit conferred on them directly by the CSM Treaty, provided that the state party entitled to espouse the claim has omitted or declined to do so, or has agreed that the private party could bring a claim instead of it.[21] The Court can also hear referrals from national courts and tribunals concerning the questions of interpretation and application of the Treaty.[22] The Treaty further allows the states parties to have recourse to other means of dispute resolution on a voluntary basis, such as good offices, conciliation, mediation, and arbitration.[23]

The CCJ also serves as an appellate court for civil and criminal cases arising out of the courts of some of the CARICOM member states and has heard several cases in this capacity; however, it does not appear to have heard any trade disputes arising out of the CSM Treaty yet.

Organization of Eastern Caribbean States

Overview

The Organization of Eastern Caribbean States (OECS) was established on June 18, 1981 by the Treaty of Basseterre. It currently consists of nine states: Antigua and Barbuda, the Commonwealth of Dominica, Grenada, Montserrat, St. Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines. Anguilla and British Virgin Islands are associate members. The arrangement is intended to contribute to the sustainable development of member states by facilitating integration into the global economy and bilateral and multilateral cooperation. The OECS Authority, which is the organization's main policy-making body, consists of the Heads of Government of OECS members. It makes decisions by consensus. The Eastern Caribbean Central Bank ensures harmonization of monetary policy.

In July 2001, at the 34th meeting of the Authority, the OECS Heads of Government endorsed proposals to deepen the integration process with the long-term goal of creating an economic union. Member states are in the process of negotiating an OECS Economic Union Treaty. A draft of the treaty, which is available at http://www.oecs.org, provides for two new organs – a Regional Assembly, consisting of

[21] The 2001 Revised Treaty of Chaguaramas Establishing the Caribbean Community Including the CARICOM Single Market and Economy, Art. 222.

[22] The 2001 Revised Treaty of Chaguaramas Establishing the Caribbean Community Including the CARICOM Single Market and Economy, Art. 214.

[23] The 2001 Revised Treaty of Chaguaramas Establishing the Caribbean Community Including the CARICOM Single Market and Economy, Art. 188–210.

members of national parliaments, and a Commission, which represents an expanded treaty Secretariat. After the treaty is completed, it will go before national parliaments in member states for ratification.

Recent Developments

In November 2008, the OECS Heads of Government met in Montserrat. The meeting focused on the on-going efforts to establish an Economic Union. In addition, the Heads discussed an OECS perspective in ongoing CARICOM/Canada negotiations over a Trade and Development Agreement, with a special emphasis in the areas of services, development, and special and differential treatment for small island states. A May 2008 meeting also focused on ongoing efforts to promote Economic Union.

Trinidad and Tobago is engaged in ongoing discussions about joining the proposed Economic Union. In August 2008 it signed a Declaration with three OECS members – Grenada, St. Lucia and St. Vincent and the Grenadines – to pursue an Economic Union by 2011 and deeper political integration by 2013. The OECS Heads of Government endorsed the effort to integrate Trinidad and Tobago at a September 2008 summit.

During 2008, several member states launched public consultations over Economic Union. In April, Dominica became the first state to engage in a public dialog with its citizens on this issue. Other states to launch public consultations during the year included Montserrat, and St. Vincent and the Grenadines.

Conclusion

States in North America, Central America, and the Caribbean have engaged in numerous efforts at regional integration. Although many of the treaties formalizing these efforts have common features, the various initiatives face very different political and economic challenges. The most ambitious effort, the FTAA, has run aground. The largest existing free trade area, NAFTA, has proved to be politically contentious. Several of the efforts among smaller economies, including under the auspices of CARICOM and the OECS, are still in their formative stages.

Integration in Latin America

Gabriele Tondl and Timo Bass

Recent Economic Developments in LA

In the 1950, 1960s and 1970s, LA countries practised an economic regime characterized by market intervention and import substitution policies. Countries wished to shelter the development of their own industries and to limit foreign influence. They enjoyed a relatively stable economic growth that reached on average 5% during that period. However, the situation changed completely in the 1980s.

In view of the excess liquidity in international capital markets after the first oil price shock, LA countries borrowed heavily on international markets. This brought them into a severe debt crisis in the early 1980s, when interest rates substantially increased. Many LA countries slipped into serious recession and stagnation in the 1980s, which went into their economic history as the "lost decade." Consequently, one after the other had to reconsider its economic model, starting to foster market-orientation and to integrate into the world economy.

The 1990s became the decade of reforms in LA. Reforms were designed in line with the Washington Consensus, a set of guidelines which the international institutions had proposed for LA. They focused on deregulation, privatization, reduction of government deficits, macroeconomic stabilization and liberalization of trade, and direct investment.[1] Consequently, the region became ready for free-trade negotiations with third countries and within the region, and started to search actively to attract international investments. Growth resumed in the 1990s, reaching on average 3.3%, but this was weaker than expected and certainly below the growth in

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[1]Chile started economic reforms already in the late 1970s, earlier and more ambitiously than the rest of the region. Thus it experienced a better economic performance, and did not suffer a recession in the 1980s but grew at 7.3% in the period 1985–1997 (Corbo et al. 2005).

C. Herrmann and J.P. Terhechte (eds.), *European Yearbook of International Economic Law 2010*, European Yearbook of International Economic Law,
DOI 10.1007/978-3-540-78883-6_14,

other dynamic emerging markets. Moreover, the region was not immune to crisis. Mexico went into a deep financial crisis in 1994/1995 caused by increasing public debt financing and declining oil prices, which led to a substantial currency devaluation and economic decline. LA was also heavily affected by the Asian crisis in 1998, and suffered in that period a substantial decline in growth, a tightening of financial markets, with consequent pressures on currencies and devaluations. Most dramatic was the devaluation of the Brazilian Real in 1999. Only Chile managed to remain almost unaffected by the Asian crisis.[2]

In the course of economic crises and successive attacks on currencies, countries such as Mexico and Brazil moved from a semi-fixed exchange rate system to floating exchange rates.[3] Argentina originally had adopted a currency board in 1991 with the aim of controlling hyperinflation. However, the fixed exchange rate brought the economy under stress when its mighty neighbour economy Brazil devalued its currency and world market prices for Argentina's exports declined. The country entered into a severe recession. International investors raised the risk score of the country, inducing massive capital flight. At the height of this financial crisis Argentina had to declare debt default and unfreeze the fixed link with the dollar in early 2002. A massive devaluation of its currency followed.

Despite the profound pro-market reforms in LA in the 1990s, growth performance was disappointing. Moreover, poverty and inequality had not been reduced.

LA constitutes a big, growing market, with 559 million inhabitants in 2005. There are important differences in economic development between LA countries. Argentina, Chile and Mexico lead in per capita income (see Table 1), while countries like Peru and Venezuela reach just half of that income level.

According to ECLAC (Economic Commission for Latin America and the Caribbean), LA reached an annual growth of 4.9% in 2007. Growth was higher in South America (5.5%) than in Central America and Mexico (3.6%). Table 1 shows that among the main LA economies, Argentina, Venezuela, Colombia and Chile were heading in growth in the recent period, whereas the growth rate of Brazil and Mexico was slightly below 3% (see Table 1). Macroeconomic stability has also improved in many LA economies. The major economies, Brazil, Mexico, and Chile as well as Colombia and Peru, have flexible exchange rate systems and inflation target monetary policies that helped to reduce their inflation rates. Argentina was able to stabilize its currency in 2003.[4] Real interest rates have dropped and inflation fell below 10%, except for Venezuela (see Table 1). Gross fixed capital formation was fairly stable in the region (see Table 1). However, it declined substantially in

[2]Singh/Belaisch/Collyns/De Masi/Krieger/Meredith/Rennhack, Stabilization and Reform in Latin America: A Macroeconomic Perspective on the Experience since the Early 1990s, IMF Occasional Paper no. 238, 2005; Corbo/Hernández/Parro (2005), Institutions, economic policies and growth: Lessons from the Chilean experience, Central Bank of Chile Working Papers no. 317, 2005.

[3]ECLAC — Economic Commission for Latin America and the Caribbean (1999), Economic Survey of Latin America and the Caribbean 1998–1999, Santiago, Chile.

[4]ECLAC — Economic Commission for Latin America and the Caribbean (2006), Economic Survey of Latin America and the Caribbean 2005–2006, Santiago, Chile.

Table 1 Basic economic indicators for the major LA economies

	Population (million)		GDP in billion current US $	
	2005	1998	2005	1998
Argentina	38.7	36.0	183.1	299.0
Brazil	186.4	166.0	882.5	788.0
Chile	16.3	14.8	118.9	73.1
Colombia	44.9	40.8	122.9	98.5
Mexico	103.1	95.3	767.7	421.0
Peru	27.9	2.5.2	79.4	56.6
Venezuela	26.6	23.4	144.8	91.3
	Period average		Period average	
	2003–2005	1998–2002	2003–2005	1998–2002
	GDP p.c. in PPP (constant 2000 internat. $)		*Real GDP growth %*	
Argentina	11,778.3	11,766.0	9.0	−3.1
Brazil	7,346.4	7,126.5	2.6	1.7
Chile	10,183.1	9,148.9	5.5	2.5
Colombia	6,285.3	5,989.1	4.6	0.5
Mexico	9,351.3	8,929.6	2.8	3.2
Peru	5,144.8	4,712.6	5.2	1.7
Venezuela	5,376.6	5,722.5	6.5	−1.5
	Gross fixed capital formation (% of GDP)		*External debt (% of exports)*	
Argentina	18.6	16.1	402.4	497.6
Brazil	17.6	20.0	209.6	383.0
Chile	21.2	22.1	121.8	165.7
Colombia	17.8	14.8	180.6	211.5
Mexico	19.3	20.5	84.2	101.6
Peru	18.2	20.3	210.0	351.2
Venezuela	17.4	23.9	103.2	152.9
	Inflation rate		*Real interest rate*	
Argentina	9.2	4.7	1.0	16.2
Brazil	9.4	6.1	44.5	57.5
Chile	2.3	3.7	0.1	9.8
Colombia	6.0	10.6	7.6	13.0
Mexico	4.4	10.7	0.9	5.8
Peru	2.5	3.3	10.3	21.0
Venezuela	22.9	22.1	−8.8	8.1
	Labour force participation rate		*Poverty rate*	
Argentina	71.2	68.2	20.2	12.3
Brazil	72.4	71.9	21.4	22.7
Chile	58.7	59.6	5.6	9.6
Colombia	74.9	72.8	17.8	21.7
Mexico	62.2	62.9	11.6	23.7
Peru	72.1	70.0	30.6	34.9
Venezuela	72.5	67.8	40.1	29.2
	Exports in % GDP		*Trade balance (% of GDP)*	
Argentina	24.9	14.1	7.8	2.3
Brazil	17.1	11.4	4.2	−0.9
Chile	39.7	31.0	7.1	1.0
Colombia	21.5	18.9	0.0	−1.0
Mexico	29.1	29.4	−1.8	−2.0

(*continued*)

Table 1 (continued)

	Exports in % GDP		*Trade balance (% of GDP)*	
	2003–2005	1998–2002	2003–2005	1998–2002
Peru	21.2	15.2	2.9	−2.7
Venezuela	37.0	25.3	17.6	5.8
	FDI inflows (% of GDP)			
Argentina	2.2	3.5		
Brazil	2.3	4.6		
Chile	6.4	6.8		
Colombia	4.6	2.6		
Mexico	2.5	3.2		
Peru	2.7	2.8		
Venezuela	2.2	3.3		

Source: Own calculations based on World Development Indicators 2007

Venezuela and increased significantly in Colombia. LA countries adopted more prudent fiscal policies during the recent economic cycle, and therefore were able to accelerate the reduction of their external debt (see Table 1).[5]

After the recent economic upswing, practically all major countries in LA showed an increase in labour force participation and a decline in poverty (see Table 1).

Finally, one has to note that LA countries have become highly open economies, with rapidly growing export rates reaching about 20% in Colombia and Peru and almost 40% in Chile (see Table 1). It is noteworthy that trade balances also turned into surplus in recent years. In particular, oil and mineral exporters like Venezuela and Chile benefited from high world market prices. Since the second half of the 1990s, foreign direct investment has risen steeply, with a short drop in 2003 but an immediate gain thereafter. Annual inflows amounted to 2.2–6% in the major economies (see Table 1), Chile also leading in this area.

In the next section we shall discuss the present status of LA trade and integration agreements, both within the region and with its major trade partners, the USA and the EU.

Integration in LA

Overview on LA Integration and Trade Agreements

Within LA, plans for integration and free trade areas have been repeatedly launched since the 1960s. The wish to strengthen its own political identity, to define its own

[5]ECLAC — Economic Commission for Latin America and the Caribbean (2006), Economic Survey of Latin America and the Caribbean 2005–2006, Santiago, Chile; ECLAC — Economic Commission for Latin America and the Caribbean (2007), Economic Survey of Latin America and the Caribbean 2006–2007, Santiago, Chile.

strategy independently of the political ambitions of its mighty Northern neighbour, the USA, and international institutions has been the major motivation for such plans in LA.

The first initiative for a Latin American free trade area goes back to the LAFTA (Latin American Free Trade Association) of 1961, an agreement foreseeing the creation of a free trade zone between South American countries and Mexico originally by 1972, then by 1980. In 1981 ALADI (Asociación Latinoamericana de Integración, Latin American Integration Association) succeeded LAFTA. ALADI aims at the creation of a free trade area, but also considers the possibility of subregional free trade agreements (FTA) under its umbrella.

Under ALADI several such subregional free trade agreements were concluded: the Andean Community (CAN), MERCOSUR (Mercado Común del Sur) and the Grupo de los Tres (Colombia, Mexico, Venezuela) (see Fig. 1).

The five Central American countries Costa Rica, El Salvador, Guatemala, Honduras and Nicaragua created the CACM (Central American Common Market) already in 1963, establishing a free trade area.[6] Due to the political turmoil in the region and the war between El Salvador and Honduras, the organization was ailing in the 1970s and 1980s, but has seen a revival since 1991.[7] CACM has established free trade in goods except for sugar cane, coffee, alcoholic beverages and petroleum products.[8] Each of its members has maintained bilateral free trade agreements with Mexico since the period 1995–2001.[9]

The Andean Community (CAN, Comunidad Andina) was established in 1997 between Colombia, Peru, Venezuela, Ecuador and Bolivia to create a customs union. Venezuela left the Andean Community in 2006, claiming that it could not pursue its goals with that community and moreover it did not agree with the free trade arrangements that Peru and Colombia planned with the USA. These affairs will be discussed in detail below.

The Grupo de los Tres was established between Colombia, Mexico and Venezuela in 1995 to establish free trade. However, this free trade agreement broke up due to the withdrawal of Venezuela in 2006, which intended to become a member of Mercosur.

Mercosur entered into force between Argentina, Brazil, Uruguay and Paraguay in 1991. It is a customs union and aims at creating a common market following the model of European integration. In Mercosur, the rapidly industrializing Brazil intended to get free market access for its industrial products in Argentina, while Argentina wished to eliminate trade barriers for its agricultural products in Brazil.

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[6] Hummer, Integration in Lateinamerika und in der Karibik. Aktueller Stand und zukünftige Entwicklungen, Verfassung und Recht in Übersee (2005) 1, pp. 6 et seq.

[7] Hummer, Integration in Lateinamerika und in der Karibik. Aktueller Stand und zukünftige Entwicklungen, Verfassung und Recht in Übersee (2005) 1, pp. 6 et seq.

[8] SIECA — Secretaria de Integracion Economica Central Americana (2007), State of the Current Central American Economic Situation, Guatemala.

[9] SIECA — Secretaria de Integracion Economica Central Americana (2007), State of the Current Central American Economic Situation, Guatemala.

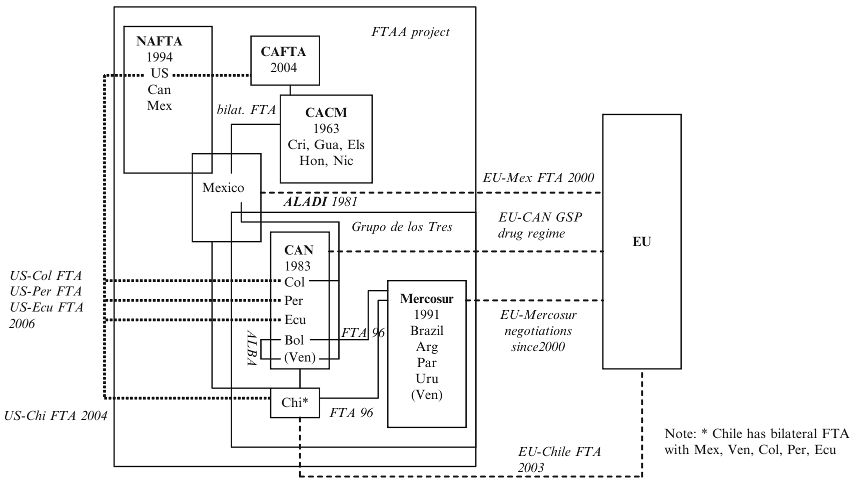

Fig. 1 Intra-LA Free Trade Agreements and trade relations with EU and USA

Mercosur has undergone several crises since its creation which have impeded the elimination of trade barriers and even more the creation of a common market. In the late 1990s Brazilian manufacture exports became increasingly competitive, above all due to the devaluation of the real. In response, Argentina re-imposed tariffs on Brazil. A recent clash between Argentina and Uruguay with regard to the building of a pulp paper mill along the border has again impeded the integration process of Mercosur. Chile and Bolivia have been associated members of Mercosur since 1996 and covered by free trade regimes. Colombia, Ecuador and Peru are further associated members. Venezuela signed an accession protocol to Mercosur in 2007, and was expected to become member in 2008. But the official joining of Venezuela is still awaited because Brazil and Paraguay have not approved Venezuela's bid for full membership yet. It is the aim of Mercosur to create a South American continent-wide free trade area.

Chile, originally a member of the predecessor of the Andean Community, maintains the above- mentioned association agreement with Mercosur but also a number of bilateral free trade agreements with other LA countries: with Venezuela (1993), Colombia (1993), Ecuador (1994), Peru (1998) and Mexico (1998).[10]

There are several initiatives between LA states to promote intra-LA political and economic integration. In 1994, 27 Central and South American states proclaimed with the Declaration of Quito the creation of a free trade area comprising all LA, the LAFTZ (Latin American Free Trade Zone).[11]

[10]Hummer, Integration in Lateinamerika und in der Karibik. Aktueller Stand und zukünftige Entwicklungen, Verfassung und Recht in Übersee (2005) 1, pp. 6 et seq.

[11]Hummer, Integration in Lateinamerika und in der Karibik. Aktueller Stand und zukünftige Entwicklungen, Verfassung und Recht in Übersee (2005) 1, pp. 6 et seq.

There are also several projects to promote integration within South America. In 2004, the South American States proclaimed the CSN (Comunidad Sudamericana de Naciones), aiming to create a political, social and economic integration area between South American states.

Also in 2004, Venezuela launched ALBA, the Boliviarian Alternative for Latin America that wishes to establish an integration area characterized by strong social policies, heavy state intervention and renationalization among LA, opposed to the projected FTAA launched by the USA (see Fig. 1). A major element of this initiative is the integration of Latin American oil markets under the leadership of the region's most important oil producer Venezuela, which wishes to diversify away from its primary export destination for oil, the USA. To date, Cuba and Bolivia have joined Venezuela under this initiative. The principles of this integration project, which are centred on state intervention and state ownership, stand in sharp contrast to the other integration concepts for LA which are based on economic deregulation and liberalization. The initiative of Venezuela is likely to separate again the subcontinent, and delay intra-LA integration.

LA has entered and negotiated trade agreements with the USA and the EU (see Fig. 1). Mexico, Peru and Chile are also involved in the APEC (Asia-Pacific Economic Cooperation) which includes the USA, Australia, New Zealand, China and Japan among others, and aims to achieve a free trade area by 2010.

Recent Developments in the Andean Community: An Emerging Political Divide in South America

As mentioned above, today's Andean Community (CAN, Comunidad Andina) was established in 1997. Before the official founding in 1997, the Andean Community was called the Andean Pact, which was created in 1969 by Bolivia, Chile, Columbia, Ecuador and Peru with the signing of the Cartagena Agreement. Four years later, in 1973, Venezuela joined the trade bloc.[12] Nevertheless, due to discrepancies in the political attitudes, Chile left the Andean Pact. These discrepancies also nearly led to a standstill of the diplomatic relations between the members. However, in the 1990s it came to a revitalization of this LA integration project in the course of the Trujillo Protocol, where the members approved once more their willingness to create a common market.[13] In contrast to the Andean Pact,

[12]CAN, Comunidad Andina, Secretaria General, Brief History, http://www.comunidadandina.org/INGLES/quienes/brief.htm (last visited 19/03/2009).

[13]Schirm, Kooperation in den Amerikas: NAFTA, Mercosur und die Dynamik regionaler Zusammenarbeit, 1997.

they introduced a concrete institutional integration mechanism, the Sistema de Integracion Andina (SAI), which emphasizes political and social tasks.[14]

The official aims of CAN are:[15]

– The promotion of the member countries' balanced and harmonious development under equitable conditions through integration and economic and social cooperation
– The support of the economic growth and the labour market
– The simplification of their participation in the integration process to achieve the formation of a common market
– The strengthening of the international competitiveness to reduce the Member Countries' external vulnerability
– The abolishment of the regional disparities by reinforcing subregional solidarity
– The achievement of continuous improvement of the living standards throughout CAN

At the beginning of this century, all members were facing political and economic difficulties due to the overall sluggish economic situation throughout the world. These difficulties led to a decreasing trade volume within the community because national interests became more important. A separation into two ideological parties followed. On the one hand, Columbia and Peru, which were interested in economic and trade issues to solve the problem of decreasing trade volumes and, on the other hand, the remaining members Bolivia, Ecuador and Venezuela, who wished to focus more on the political and social issues within CAN.[16]

In June 2003, the Andean Council of Presidents expressed their interest to reanimate the Andean Integration Project in Quirama, and the members agreed on a common external tariff which was to enter into force by 1 January 2004. Due to resistance of several economic sectors, the coming into effect of the common external tariff was postponed. However, during subsequent years the scope of the integration process of CAN was expanded. The members had elaborated a new integration strategy that introduced several legal provisions to facilitate trade within the community and measures to promote economic development. This strategy of political integration, which led to a positive impulse for the integration project and to a remarkable increase in trade within CAN, was approved at the Council of Presidents in July 2005.[17]

[14]Köpke, Implikationen der Handelsvereinbarungen der EU mit Zentralamerika und den Andenländern, 2006, Forschungs- und Dokumentationszentrum Chile-Lateinamerika, available at http://fdcl-berlin.de/?id=761.

[15]CAN, Comunidad Andina, Secretaria General, About us: http://www.comunidadandina.org/INGLES/who.htm (last visited 19/03/2009).

[16]European Commission (2007), Andengemeinschaft — Regionales Strategiepapier 2007–2013, http://ec.europa.eu/external_relations/andean/rsp/07_13_de.pdf (last visited 19/03/2009).

[17]European Commission (2007), Andengemeinschaft — Regionales Strategiepapier 2007–2013, http://ec.europa.eu/external_relations/andean/rsp/07_13_de.pdf (last visited 19/03/2009).

With the withdrawal of Venezuela in 2006, CAN was confronted with the biggest crisis in its history. Owing to Columbia's and Peru's continuing efforts to achieve FTAs with the United States, Venezuela's President Chavez decided to withdraw from CAN. The withdrawal of Bolivia and the possible dissolution of CAN were both prevented by an extraordinary Council of Presidents. At this meeting, the remaining members emphasized their commitment to CAN.

Nevertheless CAN is still facing a big crisis, which is caused by the above-mentioned ideological differences in trade policies. Meanwhile, the presidents of Columbia and Peru signed FTAs with the United States and still make efforts to obtain an FTA with the EU, whereas the presidents of Bolivia and Ecuador distance themselves from the United States and the EU (Polo Democratico).

These fundamental differences became evident at the Andean Council of Presidents in Tarija in June 2007. Nevertheless, the members accomplished an agreement. This compromise was verified in Decision 667 of the treaties and legislation of the Andean Community, which determined the general framework for the negotiations of the Association Agreement between the Andean Community and the European Union. It says that:

> the Andean Community recognizes the existence of different levels of development and economic approaches among the Member Countries, which shall be taken into account in the joint negotiation of an Association Agreement between the Andean Community and the European Union, and of the right to express differences and to negotiate different levels of coverage and depth, as the case may be, of the subjects and commitments of that Agreement.

Moreover the decision indicates that "The existing asymmetries between the Andean Community and the European Union and within the Andean Community shall be recognized and reflected in the commitments assumed by the Parties, while ensuring Special and Differentiated Treatment for Bolivia and Ecuador". This means that Columbia and Peru allow Bolivia and Ecuador to exclude themselves from negotiations such as investments, intellectual property, etc., to give national interest priority.[18]

Therefore, the Decision 667 provided the foundation for the negotiations about a free trade agreement with the EU, which began in September 2007. Nevertheless, the negotiations about an Association Agreement with the EU, which includes political dialogue, cooperation and trade, is still stagnating due to the mentioned differences in foreign policy between the members of CAN. Against the background of these difficulties, the EU announced in 2008 that it will start separate bilateral free trade negotiations with the member countries of CAN.[19]

[18]CAN, Comunidad Andina, Secretaria General, About us: http://www.comunidadandina.org/INGLES/who.htm (last visited 19/03/2009).

[19]Neuber, Brüssel setzt den Spaltkeil an — EU will einzeln mit den Andenstaaten über Freihandel verhandeln, 2008, AG Friedensforschung an der UNI Kassel, available at http://www.uni-kassel.de/fb5/frieden/regionen/Lateinamerika/anden.html (last visited 19/03/2009).

Alongside these political problems, all member countries of CAN have recently shown a positive development of their convincing economic indicators such as GDP, investment, unemployment, foreign debt, inflation, etc. Nevertheless, all CAN members still belong to the group of South America's poorer countries. They still have high unemployment rates and widespread underemployment. Moreover, they are confronted with the problem of unequal distribution of income, which has led to a distinctive gap between the rich and the poor.

Trade Agreements with Major Extra-LA Partners

Free Trade Agreements LA–USA

The USA has always been interested to assure its political hegemony in LA and to improve political stability in the region, above all in its backyard Central America and the Caribbean Basin. Consequently, these countries show a strong presence of US investors and have mainly exported to the US markets, even before the agreement of free trade areas.

In 1993, the USA launched an initiative for a regular summit of the 34 states of the Americas (Summit of the Americas). The aim of these summits is cooperation in the fields of democratization, human rights, social policies, environmental protection, the fight against terrorism, drugs and corruption, and trade liberalization.

Since 1994, Mexico has been part of NAFTA (North American Free Trade Agreement), which has resulted in a strong engagement of US investors in outsourcing in Mexico and an extremely high proportion of Mexico's exports being to the USA (over 80%). The NAFTA agreement relates exclusively to trade liberalization. However, cooperation in environment policy and development in labour standards has been agreed in two separate agreements.

In 2004, the USA and the other Central American countries signed the free trade zone CAFTA (Central American Free Trade Agreement).[20] Both agreements guarantee the dominance of the USA as major trading partner.

The USA launched an initiative for the FTAA (Free Trade Area of the Americas) in 2003 which should comprise 34 countries from the Americas; however, many LA countries show reluctance to enter into such arrangements. Many LA countries, above all Brazil, Argentina and Venezuela, fear that the USA would dominate such an agreement and that they should foster intra-LA integration. Consequently, progress of the FTAA repeatedly was weakened. The summit of the American States in Argentina in 2005 was accompanied by heavy protests against the FTAA.

Consequently, the USA attempted to enter into bilateral trade negotiations with several priority LA countries. Shortly after the EU–Chile trade agreement, the USA

[20]Hummer, Integration in Lateinamerika und in der Karibik. Aktueller Stand und zukünftige Entwicklungen, Verfassung und Recht in Übersee (2005) 1, pp. 6 et seq.

signed a free trade agreement with Chile in 2004. For the USA, Chile is an important market for machinery and transport equipment, but also for some agricultural products. The agreement foresees unrestricted market entry for manufactured and agricultural goods and all kind of services, investment and government procurement.[21]

The USA started also free trade negotiations with Peru, Colombia and Ecuador in 2004, with a wish to secure stability and better prosperity in the region. Free trade agreements were signed with Peru and Colombia in 2006. These two agreements are still pending implementation. They foresee a gradual elimination of access barriers for industrial products (10 years) and agricultural products (15 years) in the case of Peru and an immediate access in the case of Colombia, access to the service sector and free access and protection of investors.[22] The US agreements require the parties to enforce national environmental and labour regulations and compliance with fundamental ILO labour rights. Critics stress that the FTA would yield more satisfactory results for the USA than for the LA countries. For example, in the case of Mexico the NAFTA agreement was blamed for causing a sharp rise in corn prices, harming the consumers. Others argued that too little capacity and competence was devoted to negotiations by the LA governments, and that the agreements would mainly benefit the exporting sector without improving employment and reducing inequality.

The USA favours the inclusion of Latin America in a common free trade area, i.e. the establishment of the FTAA, and watches the creation of intra-LA agreements with reservation, since that would weaken its political influence in the region and strengthen intra-LA political relations.

Free Trade Agreements EU–LA

The European Union member countries, particularly its member countries Spain and Portugal, have long historical and cultural ties with LA. Therefore, the EU has increasingly searched to institutionalize political and economic dialogue with the region since the 1990s. The increasing economic influence of the USA in LA and the conclusion of US free trade arrangements with single countries and groups of countries, such as the NAFTA, have been observed by the EU with much attention. Being aware that it would risk losing its role in the region as the USA moves on to establish FTAs, the EU has also searched to intensify political and economic relations with the region.

[21]Office of the United States Trade Representative, Free Trade with Chile, http://www.ustr.gov/Document_Library/Fact_Sheets (last visited 16/01/2008).

[22]Office of the US Trade Representative, Colombia Free Trade Agreement, http://www.ustr.gov/Trade_Agreements/Bilateral/Colombia_FTA/Section_Index.html (last visited 16/01/2008); Office of the US Trade Representative Peru Trade Promotion Agreement, http://www.ustr.gov/Trade_Agreements/Bilateral/Peru_TPA/Section_Index.html (last visited 16/01/2008).

On the economic level, LA constitutes a large and growing market for the EU, offering high market potential to export its high technology products and services and a market that lends itself also to increase presence through foreign direct investment, more and more in the privatized service sector. Despite that fact, trade with LA accounted for only 0.5% of total EU trade in 2005.[23]

LA countries expect to reduce the predominance of trade relations with the USA when entering into free trade agreements with the EU. Diversification of trade destinations and FDI ownership is an important goal for LA. Given the trade deficit with the EU in the 1990s, LA has become increasingly concerned to gain market access for its agricultural products in the still highly protected EU markets. Trade with the EU accounts for around 15% of LA trade.[24]

An institutionalized political dialogue between the EU and the Latin American and Caribbean countries has been taking place every other year since the Rio summit in 1999. At a lower level, the EU maintains a special dialogue with Mercosur, the Andean Community, Central America, Mexico and Chile.[25]

Cooperation programmes of the EU cover the regions as a whole, its subregions and countries. These programmes encompass the fields of social support and enforcement of labour regulations, promotion of regional cooperation and integration in LA, reinforcement of human rights, democracy, good governance and prevention of conflict, cooperation in the field of higher education (ALFA programme), and environmental protection. The EU wishes to enforce an advance in political rights and stability in LA; therefore, the agreements foresee that a violation of the commitments of LA in this area would lead to the suspension of the trade agreements.

The cooperation agreements have been in force with the Andean Community since 1993, the Central American republics since 1999, Mercosur since 1999 (in addition, bilateral cooperation with individual Mercosur countries has been in operation since 1991–1995), and Mexico since 2000. With Chile, an association agreement was enacted in 2003 which includes also trade agreements.

At bilateral level, one can name the EU–Brazil cooperation agreement established in 1992 as an example. It covers higher education issues, and foresees scholarships under the Erasmus Mundi programme and the establishment of

[23]UN Comtrade, Commodity Trade Database, United Nations.

[24]UN Comtrade, Commodity Trade Database, United Nations.

[25]European Commission, DG External Trade (2004), Bilateral Trade Relations Central America, http://ec.europa.eu/trade/issues/bilateral/regions/central_america/index_en.htm, (last visited 02/02/2008); European Commission, DG External Trade, Bilateral Trade Relations Latin America and the Caribbean, http://ec.europa.eu/trade/issues/bilateral/regions/lac/index_en.htm (last visited 02/02/2008); European Commission, DG External Trade, Bilateral Trade Relations Andean Community, http://ec.europa.eu/trade/issues/bilateral/regions/andean/index_en.htm (last visited 02/02/2008).

European Studies Centres, social programmes and environmental support to fight deforestation.[26]

Mercosur countries constitute the major trade relation of the EU with LA. For Mercosur countries, the EU is their principal market for agricultural exports, while the EU sells manufactured goods on Mercosur markets. The EU–Mercosur FTA was intended to go beyond the WTO and be considered as a single undertaking. The EU has a strong interest to gain unrestricted market access for manufactured products and in the service sector, while Mercosur countries wish to have free access for agricultural products. Both parties still face important restrictions under the current WTO regime. Since the conflicting interests of the two parties in the WTO negotiations of the Doha Round — Mercosur requests a larger cut in agricultural subsidies then the EU is willing to accept, while the EU demands substantial cuts in tariffs for industrial products and access in services — the negotiations for an EU–Mercosur FTA have come to a standstill. Moreover, the bargaining power of Mercosur has been repeatedly weakened by political tensions between its member states. The accession of Venezuela to Mercosur in 2008 brings a new member with a distinctly different political ideology into the group, and will once again threaten the political decision-making power of Mercosur. The planned agreement of the EU with Mercosur aims at achieving an opening of public procurement, agreements on wines and phytosanitary measures, and regulations on investment, as well as a dispute settlement mechanism.

Given the standstill of the EU–Mercosur negotiations, the EU has sought to enter into bilateral negotiations within the group. Its most important trading partner in Mercosur is Brazil, where it exports machinery and transport equipment. In these sectors, relatively high tariffs are still in effect. In addition, the EU is a principal investor in telecommunications, energy, financial services, automotive and agri-food industries. In contrast, the EU imports mainly primary products from Brazil.[27]

For the Andean Community (Colombia, Peru, Ecuador, Bolivia, and Venezuela until its exit in 2006) the EU is the second important trading partner after the USA and most important FDI source. Countries of the Andean Community presently trade with the EU under the Generalized System of Preferences (GSP); in addition those combating drug production have duty-free access to EU markets in products covered by the GSP and a number of sensitive and even agricultural products. The applicability of the GSP is subject to the implementation of the main international conventions on human, social and environmental regulations. In 2003, plans for a free trade agreement between the EU and CAN were launched. Negotiations started in 2007. Given the apparent internal difference in CAN that led to a stagnation

[26]European Commission, DG External Relations, Brazil, Country Strategy Paper 2007–2013, http://ec.europa.eu/external_relations/brazil/csp/index.htm (last visited 02/02/2008).

[27]European Commission, DG External Trade, Bilateral Trade Relations Brazil, http://ec.europa.eu/trade/issues/bilateral/countries/brazil/index_en.htm (last visited 16/01/2008).

of the negotiations (see above), the EU started bilateral negotiations with CAN members.[28]

In contrast to these planned trade agreements, the EU maintains two important bilateral trade agreements with Mexico and Chile.

The EU–Mexico association agreement includes three pillars; political dialogue, cooperation and trade. It entered into force in 2000. Considering the predominance of the USA as a principal trading partner, the EU is subordinate for Mexico. No more than 4% of its exports go to the EU, and 10% of its imports originate from the EU. In contrast to the trade product structure with other LA countries, EU–Mexican trade comprises in both directions mainly machinery, transport equipment and chemical products. The EU has become an important investor in Mexico, holding 23% of all foreign-owned companies in 2003, mainly in the service sector and car production. The EU–Mexico FTA — the first transatlantic agreement of the EU — covers liberalization of trade in manufactured goods, agricultural products (by 2010) and services, and investment.[29] All these areas are highly important for the EU, which wishes to participate in the large Mexican market and to benefit from the NAFTA agreement by investing in Mexico.

The association agreement with Chile was implemented in 2003. It covers trade in manufactured and agricultural goods, services, government procurement and investment, going well beyond the WTO commitments. It includes sections on technical regulations and phytosanitary measures. However, the association agreement comprises not only this trade agreement but also agreements on political dialogue and cooperation. The latter includes specific initiatives of the EU to promote education and social support in Chile. The EU imports mining and agricultural products from Chile, and exports mainly consumer goods and machinery there.[30]

Trade of the EU with the CACM is covered by the GSP and the drug regime. While trade with the EU accounts for around 10% of trade for the Central American countries, it is negligible for the EU.

The Effect of LA Free Trade Agreements on Its Trade Structure

For historical reasons and promoted by the recent free trade agreements described above, Latin America has developed important trade relations with the USA, but also more and more within the subcontinent and with the EU.

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[28]European Commission, DG External Trade, Bilateral Trade Relations Andean Community, http://ec.europa.eu/trade/issues/bilateral/regions/andean/index_en.htm (last visited 02/02/2008).

[29]European Commission, DG External Trade, Bilateral Trade Relations Mexico, http://ec.europa.eu/trade/issues/bilateral/countries/mexico/index_en.htm (last visited 17/01/2008).

[30]European Commission — DG External Trade, Bilateral Trade Relations Chile, http://ec.europa.eu/trade/issues/bilateral/countries/chile/index_en.htm (last visited 02/02/2008).

Given their natural abundances, LA countries have a high share of agricultural and mineral products in their exports: Argentina is a major exporter of beef and soybean, Brazil of coffee, meat and sugar cane, Chile exports fruits, wine and fish such as salmon, the Central American countries export pineapples, bananas and coffee. These agricultural products dominate in their exports to the USA and the EU. Mexico and Venezuela are major oil producers and Chile is the world's major copper producer. Oil producers possess also a key product for developing intra-LA trade.

However, some Latin American countries have developed a diversified economic structure and export also more advanced manufactured goods: for example, Brazil exports motor vehicles and pharmaceuticals, Mexico exports machinery and components, to a large extent products of its maquilladora industries, and Costa Rica produces electronic circuits.[31] These manufactured goods lend themselves to the development of export relations with third countries but also within LA.

The USA is the most important export partner for Central America, the Andean Community and Venezuela, from where 30–50% of exports go to the USA (see Table 2). In the case of Mexico, exports to the USA reach an extreme share of more than 80%. Venezuela and Ecuador are also very focused in their exports to the US market, with around 50% of their exports. For almost all countries in this group, exporting to the USA has grown in importance, a development favoured by the free trade arrangements of NAFTA and CAFTA. A remarkable exception is Bolivia, which substantially reduced its exports to the USA and also to the EU in favour of intra-LA trade.

In Central America the EU closely follows the USA as export partner, but has lost to some extent. However, intra-LA trade relations have developed well, and have become even most important for countries such as Guatemala and El Salvador (see Table 2).[32] Exports to South America are negligible, but CACM receives 5–6% of its imports from Mercosur and CAN.[33] Developments in the export structure of Central America are closely linked with the strengthening of CACM after 1991, bilateral FTA with Mexico and CAFTA.

In the Andean Community, the EU is a much less important export partner than the USA and has also lost in importance. These developments will be influenced by the implementation of bilateral trade agreements with the USA and further trade agreements with the EU which are planned as mentioned above. The only country in CAN which exports equally to the USA, the EU and LA is Peru. As already mentioned, the reorientation of Bolivia's export towards its intra-LA trading partners is most noteworthy. With Venezuela one observes a decline of intra-LA exports, which is due to an export decline to Colombia after Venezuela left CAN

[31] SIECA — Secretaria de Integracion Economica Central Americana, State of the Current Central American Economic Situation, Guatemala.

[32] SIECA – Secretaria de Integracion Economica Central Americana, State of the Current Central American Economic Situation, Guatemala.

[33] Office of the US Trade Representative, Peru Trade Promotion Agreement, http://www.ustr.gov/Trade_Agreements/Bilateral/Peru_TPA/Section_Index.html (last visited 16/01/2008).

Table 2 Latin America's export partners

	Year	Export partners (% of total exports)		
		USA	EU	Intra-LA
Central America, Mexico				
Mexico	1995	83.4	4.2	4.5
	2006	84.8	4.3	4.3
Honduras	1995	42.6	36.4	6.4
	2006	32.5	25.9	31.1
Nicaragua	1995	41.9	32.4	20.1
	2006	46.0	21.6	21.1
Costa Rica	1995	40.1	30.7	16.3
	2006	42.4	17.8	11.5
Guatemala	1995	31.3	15.7	36.4
	2006	31.4	7.7	40.7
El Salvador	1995	17.5	30.9	44.9
	2006	28.2	11.9	43.0
Andean Community				
Ecuador	1995	43.2	17.9	18.6
	2006	53.7	11.5	24.5
Colombia	1995	35.6	24.1	25.6
	2006	40.8	15.4	26.7
Bolivia	1995	31.5	18.8	40.2
	2006	10.0	6.0	66.4
Peru	1995	18.7	27.7	18.3
	2006	21.9	23.0	21.7
Venezuela (left CAN in 2006)	1995	50.8	8.5	22.7
	2006	48.8	8.0	6.6
Mercosur				
Brazil	1995	18.8	27.9	22.1
	2006	17.6	21.5	23.6
Argentina	1995	8.6	21.4	46.3
	2006	8.8	17.0	41.1
Paraguay	1995	4.8	19.4	64.9
	2006	3.5	5.9	59.2
Uruguay	1995	6.0	20.6	53.3
	2006	13.8	16.9	35.2
Chile (Mercosur associate)	1995	12.6	26.1	19.5
	2006	15.5	26.5	16.4

Source: Own calculations based on UN Comtrade

in 2006. In turn, Venezuela's exports to the Netherland Antilles, Cuba (the two are not included in the group LA) and China increased.

For the rest of South America, namely for Mercosur and Chile, the EU is a more important export partner than the USA.

Argentina, Paraguay and Uruguay have a very high share of intra-LA exports, which relates to their membership in Mercosur. Recent small declines in intra-LA trade are related to some re-implementation of trade barriers in Mercosur. Bolivia's high intra-LA trade can also be explained by its association with Mercosur since 1996.

In LA, trade relations are generally fairly concentrated on one single trading partner, e.g. the USA in Central America, Mercosur with Argentina. However, the most advanced LA economies Chile and Brazil have managed to diversify their export destinations. They focus on EU trade, but are almost equally engaged in intra-LA trade and trade with the USA.

For the European Union, trade with LA plays still a subordinate role, accounting for just 0.46% of its exports. As mentioned above, LA would offer a high market potential for the EU, having reached a stable growth performance and a relatively high level of development in some countries. It should therefore be considered as a more attractive market than it is at present.

In contrast, LA has become much more important as an export partner for the USA. In 1990, the USA exported 11% of its goods to LA; in 2005 this share had climbed to 19%. It should be noted that it is not only the US neighbour Mexico which accounts for this high share, but other LA countries as well (in 1990, 7% of US exports went to Mexico, in 2005 13%.[34]). Although trade between LA and the USA is favoured by their closer geographical location, there is good reason to suppose that the EU has too much neglected a potential market in LA.

In summary, as shown in Prüfer and Tondl,[35] increasing trade openness has had a positive effect on LA growth performance. Trading has acted as an important channel for an increase in productivity, either because exporters are forced to improve their competitiveness on markets or because imported products introduce new technologies in the countries.

Conclusions

In the 1990s, LA countries became open economies. They actively searched liberalization of trade and opened to foreign direct investment.

LA countries concluded a number of free trade agreements with their main external trading partners, the USA and the EU. Given the large market potential in LA, both world trading powers competed in negotiating trade agreements with LA. However, LA was also very active in paving the way to intra-LA integration, aiming to reduce the predominance of the USA in trade relations. Mercosur, the Andean Community and CACM are free trade areas which are well-established and which have impressively fostered intra-LA trade. In a number of LA countries, such as Argentina and Bolivia, intra-LA trade has now become most important. Other major LA economies like Brazil and Chile have managed well to diversify their export markets.

The implementation of FTA has also promoted FDI flows into LA. Thus Mexico and Central America received important FDI from US companies, which aimed to

[34] UN Comtrade, Commodity Trade Database, United Nations.

[35] Prüfer/Tondl, The FDI-growth nexus in Latin America: The role of source countries and local conditions, forthcoming.

benefit from lower labour costs in their host economy and the easy trading of components within NAFTA or CAFTA. The motives of EU companies are different. For them, access to large markets is the main reason for investing in LA. EU–LA trade agreements have also facilitated that investment.

In summary, one can conclude that becoming more open economies has benefited the economic performance of LA countries.

The ASEAN Economic Community Under the ASEAN Charter; Its External Economic Relations and Dispute Settlement Mechanisms

Chien-Huei Wu

Introduction: ASEAN+3 After the Asian Financial Crisis

Ten years after the outbreak of the Asian financial crisis in 1997/1998, 2008 experienced another financial turmoil. This time, those Asian countries that were seriously struck by the Asian financial crisis are opting for a regional approach. They are not turning to the International Monetary Fund (the IMF), and are trying to deal with this financial crisis by themselves. As most Asian countries sought assistance from the IMF during the Asian financial crisis in 1997–1998, the change in their attitude in this financial crisis is worthy of investigation. The Asian financial crisis highlighted the crucial role of regional integration, and thus offered the stimulus for economic integration in this region. Firstly, the Association of Southeast Asian Nations ("ASEAN") brought forward their programme of an ASEAN Free Trade Area (AFTA) from 2008 to 2002. Secondly, ASEAN+3 (ASEAN plus China, Japan and the Republic of Korea, hereinafter "Korea") process was institutionalised in Malaysia in December 1997, with the aim of reacting against the financial crisis and ensuring their capacity to maintain financial stability. The experiences during the Asian financial crisis drove Asian countries to safeguard themselves against the next financial turmoil, and strengthened their determination for further economic integration.[1] The coming into being of ASEAN+3 can be deemed as a response to the Asian financial crisis.

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[1] The link between Asian regionalism and the Asian financial crisis has been noted in a huge amount of literature. As observed, the trend towards regionalism in East Asia stemmed directly from the Asian financial crisis. Several factors contribute to this trend: (1) the contagion relationships and policy externalities across the ASEAN countries and the Asian Newly Industrialised Economies, (2) major disappointment with the US inaction with regard to the crisis, (3) the lack of progress of the Asian Pacific Economic Cooperation (the APEC) in achieving close trade and financial cooperation, (4) Japan's offer to create an Asian Monetary Fund and China's decision not

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Up to now, there have been several significant events in relation to the regional economic integration in ASEAN and its East Asian Dialogue Partners. Firstly, the ASEAN Charter entered into effect on 15 December 2008. The ASEAN Charter envisages the establishment of three communities (or three pillars) under the framework of ASEAN: the ASEAN Economic Community (the AEC); the ASEAN Political-Security Community; and the ASEAN Socio-Cultural Community.[2] The 2004 Protocol on Enhanced Dispute Settlement Mechanism is a vehicle to enhance the establishment of the ASEAN Economic Community. Externally, negotiations for free trade agreements based on the framework agreement between ASEAN and its East Asian Dialogue Partners have been fruitful. By 2008, ASEAN had signed agreements on trade in goods with China, Japan and Korea. In addition, agreements on trade in services have been signed between ASEAN and China and Korea. A dispute settlement mechanism modelling the 1994 ASEAN Protocol on Dispute Settlement Mechanism, arbitral tribunals in essence, is included in the free trade agreements between ASEAN and China, Japan, and Korea. From an institutional perspective, the ASEAN Charter, the ASEAN Protocol on Enhanced Dispute Settlement Mechanism and the dispute settlement mechanism provided in the free trade agreements between ASEAN and its East Asian dialogue partners provide a good foundation for a deeper integration in the ASEAN+3 process.

This paper aims to examine the progress of regional integration of ASEAN+3 with special focus on its legal infrastructure. With this aim, I will firstly examine the legal architecture of the AEC under the ASEAN Charter. I will then review the progress of economic integration in ASEAN+3, including initiatives within ASEAN and free trade agreements between ASEAN and its East Asian

to depreciate its currency, and (5) the success of the "New Miyazawa Plan" in contrast to the inappropriateness of policies promulgated by the IMF during the crisis. The credibility given by these factors prompted East Asian countries to go for the regional approach. [Plummer/Jones, Introduction International Economic Integration and Asia: An Overview, in: Plummer/Jones (eds.) *International Economic Integration and Asia*, 2006, p. 1(3).] The same view is also shared by Rajan, who emphasises Asian motivation for monetary and financial regionalism and cooperation. He points out three main elements: (1) the body blow of the Asian financial crisis and the inadequate response of extra-regional players, (2) the under-representation of Asia in the IMF quota distribution and its lack of voice therein, and (3) external developments in regionalism, in particular the example of the European Union. [Rajan, Monetary and Financial Cooperation in Asia, in: Nagesh et al. (eds.), *Asia's New Regionalism and Global Role: Agenda for the East Asia Summit*, 2008, p. 185.

[2]The ASEAN Charter, Article 9, available at http://www.aseansec.org/. The concept of the ASEAN Economic Community (the AEC) was firstly proposed in the 2002 ASEAN Summit, based on the ASEAN Vision 2020 which foresees a more economically integrated ASEAN. See Tongzon, Role of AFTA in an ASEAN Economic Community, in: Hew (ed.) *Roadmap to an ASEAN Economic Community*, 2005, p. 1 (2). The ASEAN Vision 2020 envisions the creation of "a stable, prosperous and highly competitive ASEAN Economic Region in which there is a free flow of goods, services and investments, a freer flow of capital, equitable economic development and reduced poverty and socio-economic disparities". It should be noted, at this point that the free movement of workers is not included. Even in its later stage for formation of the AEC, the scope is limited to skilled workers only.

counterparts. I will cover both economic/trade integration and financial/monetary cooperation.[3] Finally, I will analyse dispute settlement mechanisms provided within ASEAN and by those agreements signed by ASEAN and China, Japan and Korea. This paper ends with a short conclusion summarising major arguments.

The ASEAN Charter and the AEC

As it only entered into force on 15 December 2008, it is far too early to tell whether the ASEAN Charter will remain a decorative instrument or transform itself into an effective or even a constitutional instrument. Nevertheless, it points to the roadmap for prospective regional integration therein.[4] The first point to note is that ASEAN is conferred legal personality that may enhance its competence and capacity in agenda-setting for future integration.[5] This may also indirectly contribute to the institution-building of the ASEAN Secretariat in supporting its integration process. In addition, as noted above, the Charter outlines three pillars for future integration of ASEAN, of which the AEC is the main theme of this paper. Article 9 briefly regulates the designation of each of the three pillars of the ASEAN Communities. As provided, the AEC is to be governed by the AEC Council, which meets at least

[3]Cooperation is normally considered as a term distinguished from integration. One of the major differences between cooperation and integration is that integration would demand a certain level of harmonisation. While this paper does not intend to measure the degree of economic/trade and monetary/financial integration or cooperation, it chooses to use the term "cooperation" to described the monetary and financial initiatives as adopted by ASEAN+3, since these initiatives are loose in form.

[4]From a chronological point of view, it is illogical to examine the legal architecture of regional integration in ASEAN by analysing the ASEAN Charter, since the developments of regional integration therein date from before the entry into force of this Charter. Nonetheless, as clarified by Article 52(1) of the Charter, for the purpose of legal continuity, all treaties, conventions, agreements, concords, declarations, protocols and other ASEAN instruments which have been in effect prior to the entry into force of the Charter shall continue to be valid. In addition, as made clear in Annex 1, the existing ASEAN Economic Ministers Meeting (the AEM), the ASEAN Free Trade Area (AFTA) Council, and the ASEAN Investment (AIA) Council are part of the ASEAN sectoral ministerial bodies, under the pillar of the ASEAN Economic Community. Furthermore, as dictated by Article 52(2) of the Charter, in the case of inconsistency of rights and obligations of ASEAN Member States between the existing instruments and the Charter, the Charter shall prevail. It is thus feasible to examine, in the first place, the legal framework for regional integration of the ASEAN through its Charter, and then come to sectoral elements.COMMENT TO AUTHOR: AIA elsewhere is shown as abbreviation for 'ASEAN Investment Area' – please review.

[5]ASEAN Charter, Article 3. In terms of the institutional reforms, it is argued that the ASEAN Secretariat should play the main role in coordinating and facilitating the implementation of the ASEAN agreements and plans. The ASEAN Secretariat should also be given the power to caution the member states in a timely manner. On the other hand, in the case of a trade dispute, this has to be resolved through a jurisdiction process; a legalised/judicialised dispute settlement mechanism is needed. See Akrasanee/Arunanondchai, Institutional Reform to Achieve ASEAN Economic Integration, in Hew (ed.), *Roadmap to an ASEAN Economic Community*, 2005, p. 63 (66–70).

twice a year. The Council should be chaired by the appropriate minister from the member state holding the ASEAN Chairmanship. The major duties of the AEC Council are set out as follows:

- Ensure the implementation of the relevant decisions of the ASEAN Summit.
- Coordinate the work of the different sectors under its purview, and on issues which cut across the other Community Councils.
- Submit reports and recommendations to the ASEAN Summit on matters under its purview[6].

Of these three elements, ensuring the implementation deserves most attention, as the implementation and compliance mechanism of ASEAN remains weak. It is mainly left to diplomatic negotiation, regardless of the designation of an enhanced dispute settlement mechanism.[7] In respect of the principles guiding the action of ASEAN and its member states in regional economic integration, the most relevant one is its adherence to multilateral trade rules, and its vision of ASEAN as a rule-based regime for effective implementation of economic commitments and for progressive reduction toward elimination of all barriers. The to here spirit of the ASEAN regional economic integration process is market-driven.[8] By virtue of Annex 1 to the Charter, the existing legal instruments and institutions, such as AFTA and the AEM, would be incorporated into the AEC.

However, the picture of the AEC remains unclear. As argued, AFTA, the ASEAN Framework Agreement on Trade in Services (AFTS) and the Framework Agreement on the ASEAN Investment Area (AIA), along with other relevant legal instruments and action plans, have provided a solid foundation for the AEC.[9] Nevertheless, whether one can be so optimistic remains to be seen. Furthermore, the concept of the AEC needs to be supplemented by concrete contents. The High-Level Task Force on ASEAN Economic Integration recommends that the AEC be the end-goal of economic integration, as outlined in the ASEAN Vision 2020. The AEC should be characterised as "a single market and production base, with free flows of goods, services, investment and skilled labour, and freer flow of capital by 2020".[10] For the realisation of the AEC, strengthening existing initiatives and building new initiatives should be approached on a progressive basis, with clear timelines.[11]

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[6]ASEAN Charter, Article 9(4).

[7]Infra, text to n. 88 ff.

[8]ASEAN Charter, Article 2(2)(n).

[9]Soesatro, ASEAN Economic Community: Concept, Costs, and Benefits, in: Hew (ed.) *Roadmap to an ASEAN Economic Community*, 2005, p. 13 (24–25).

[10]ASEAN, "Recommendations of the High-Level Task Force on ASEAN Economic Integration", available at http://www.aseansec.org/hltf.htm.

[11]Ibid. At the 12th ASEAN Summit, member states agreed to accelerate the establishment of the AEC by 2015. CEBA Declaration on Acceleration of the Establishment of the ASEAN Economic Community by 2015, (Ceba, Philippines, 13 January 2007), available at http://www.aseansec.org/19260.htm (last accessed 20/12/2008).

While it is true that the ultimate goal for the AEC is inspired by the experiences of the European integration, whether the AEC should head for a customs union or even a common market is subject to dispute. With regard to the ultimate form of the AEC, two approaches are respectively advanced by the Institute of Southeast Asian Studies (ISEAS, Singapore) and the ASEAN Institutes of Strategic and International Studies (ASEAN-ISIS): FTA plus, common market minus.[12] The ISEAS argues that the end objective of the AEC should not be a customs union like the European Economic Community (the EEC) in the 1960s and 1970s. Given the different degrees of openness and stages of economic development among the ASEAN countries, it would be extremely difficult, and thus unrealistic, to achieve an AEC modelled on the EEC. The IEAS thus proposed an FTA plus approach that would cover a zero-tariff ASEAN free trade agreement as well as some elements of a common market, such as free movement of capital and skilled labour.[13] By contrast, the ASEAN-ISIS suggested the AEC be a fully integrated market, a common market. Nevertheless, it allows member states to reserve deeper integration for a later stage than the set timeline. It is argued that this ‘common market minus’ approach can be more liberalising than the ‘FTA plus’ approach. Regulatory and policy harmonisation is desirable in certain aspects, while major efforts should be devoted to the free flows of trade and investments within ASEAN.[14] It finally opts for the latter approach.

At the 13th ASEAN Summit on 12 November 2007, a clearer picture of the AEC was drawn with the adoption of the ASEAN Economic Community Blueprint (the *Blueprint*).[15] This firstly directs ASEAN to “act in accordance with the principles of an open, outward-looking, inclusive, and market-driven economy consistent with multilateral rules, as well as adherence to rule-based systems for effective compliance and implementation of economic commitments”.[16] Four elements are identified in this blueprint: a single market and production base, a highly competitive economic region, a region of equitable economic development, and a region fully integrated into the world economy. At this moment, I will focus on the first element.

Section A of the *Blueprint* articulates the formation of the AEC as a single market and production base, comprising five core elements: free flow of goods; free flow of services; free flow of investment; freer flow of capital; and free flow of skilled labour. To begin with, it is helpful to recall that the AEC, being a single

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[12]Hew et al., ISEAS Concept Paper on the ASEAN Economic Community, in: Hew (ed.) *Roadmap to an ASEAN Economic Community*, 2005, p. 293 (293–308); ASEAN-ISIS, *Toward an ASEAN Economic Community: A Track-Two Report to ASEAN Policy-Makers*, 2003.

[13]Hew/Soesastro, Realizing the ASEAN economic community by 2020: ISEAS and ASEAN-ISIS approaches, ASEAN Economic Bulletin 23 (2003) 3, p. 292 (293–294).

[14]Hew/Soesastro, Realizing the ASEAN economic community by 2020: ISEAS and ASEAN-ISIS approaches, ASEAN Economic Bulletin 23 (2003) 3, p. 292 (294–295).

[15]ASEAN, *ASEAN Economic Blueprint*, 2008. Available at http://www.aseansec.org/5187-10.pdf (last accessed 20/12/2008).

[16]The *Blueprint*, para. 5.

market and production base, is to be realised with "new mechanism and measures to strengthen the implementation of its existing economic initiatives".[17] Therefore, the formation of the AEC is mainly based on the initiatives created under AFTA, AFTS and AIA. It is also worthwhile noting the development gap between the original ASEAN members, ASEAN-6 (Brunei Darussalam, Indonesia, Malaysia, Philippines, Singapore, and Thailand) and the new member states (Cambodia, Myanmar, Laos, and Viet Nam, or CMLV) which mainly leads to the "ASEAN minus X" approach.[18] Finally, one should also be aware that, up to now, Lao PDR has not yet completed its WTO accession process, and the WTO laws and disciplines may not be applicable.

In respect of the free flow of goods, the main focus is the non-tariff barriers, since the reduction of tariffs has mainly been carried out through initiatives under the AFTA. With the aim of full elimination of non-tariff barriers, the *Blueprint* attaches great importance to the transparency issue.[19] Another key element deals with standards and technical barriers to trade. The *Blueprint* instructs members to act in accordance with the requirements of the WTO agreement on Technical Barriers to Trade. Two strategies are included in this regard. On the one hand, the aim is to "harmonise standards, technical regulations and conformity assessment procedures through their alignment with international practices";[20] on the other hand, sectoral Mutual Recognition Arrangements (MRAs) on Conformity Assessment should also be developed and implemented in those areas identified in the ASEAN Framework Agreement on Mutual Recognition Arrangements.[21] A set of clearly-defined rules of origin and initiatives on trade facilitation and customs integration are aimed at enhancing the free flow of goods.[22]

With regard to the free flow of services, three points should be noted. Firstly, the AEC adopts the "ASEAN minus X" formula. Namely, liberalisation of trade in services may commence in those member states ready to proceed, and can be joined by others later.[23] The *Blueprint* also sets out four priority services sectors (air transport, e-ASEAN, healthcare, and tourism) which are to be liberalised by 2010, and a fifth sector, logistics services, by 2013.[24] The *Blueprint* does not intend to harmonise regulatory regimes, including qualification requirements, on trade in services, but chooses the mutual recognition approach. This is understandable, since the harmonisation approach in services trade would be

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[17]The *Blueprint*, para. 6.

[18]This development gap also brings about the element of "equitable economic development" (section C) in the *Blueprint*.

[19]The *Blueprint*, para. 14.

[20]The *Blueprint*, para. 19(i).

[21]The *Blueprint*, para. 19(ii).

[22]The *Blueprint*, paras. 15–17.

[23]The *Blueprint*, paras. 21(ix), 22.

[24]The *Blueprint*, para. 21(iii).

much more complicated than that in goods trade. Finally, the *Blueprint* pinpoints financial services, and restates its "ASEAN minus X" formula. Nevertheless, the *Blueprint* emphasises the "pre-agreed flexibilities" and endorses the importance of "orderly financial sector development" and "financial and socio-economic stability".[25]

The free flow of investment is a means through which ASEAN may attract foreign direct investment (FDI) as well as intra-ASEAN investment. This is to be implemented on the basis of the AIA and the ASEAN Agreement on the Promotion and Protection of Investment of 1987 (also referred to as the ASEAN Investment Guarantee Agreement). The liberalisation of investment focuses on the extension, with limited exceptions, of non-discriminatory treatment, including National Treatment and Most-Favoured-Nation Treatment to investors in ASEAN.[26] The free movement of capital then focuses on strengthening ASEAN capital market development and integration, where both the harmonisation approach and the mutual recognition approach are to be employed.[27] It also aims to enhance mobility by removing or relaxing restrictions, to facilitate both payments and transfer for current account transactions and capital flows to support foreign direct investment.[28] It can thus be seen that the free flow of capital is aimed at meeting the need of transactions deriving from trade in goods and services as well as the need for capital flows for investment. Lastly, free movement of natural persons is limited to skilled labour.[29]

In general, the AEC focuses on goods and services trade. Even in respect of services trade, the liberalisation is limited to priority sectors. The objective and purpose of free flow of investment, capital and skilled labour is mainly supportive of the free flow of trade in goods and services. Another obstacle to the implementation of the AEC is the weak capacity of the ASEAN Secretariat which will be exacerbated by the growing demand of "public goods" deriving from deeper integration, particularly in relation to harmonisation and mutual recognition arrangements. In order to harmonise regulatory regimes, to coordinate policies and/or to establish mutual recognition arrangements on qualification and standards, a stronger ASEAN Secretariat is indispensable. The conferral of legal personality to ASEAN by the ASEAN Charter is a step forward towards meeting this need. However, it is clear that the member states do not intend to establish a supranational organisation in the EC sense. The ASEAN way may persist due to their great attachment to national sovereignty and long-standing non-intervention policy.

[25]The *Blueprint*, para. 22.

[26]The *Blueprint*, para. 30.

[27]The *Blueprint*, para. 31.

[28]The *Blueprint*, para. 32.

[29]The *Blueprint*, para. 33.

External Economic Relations of ASEAN/AEC: ASEAN+3

Another force driving regional integration in ASEAN is the economic rise of China (and India). One of the aims of a single market and production base is to enhance the competitiveness of ASEAN both in trade activities and in attracting foreign direct investment. Namely, ASEAN centrality has to be ensured and maintained. Economic regionalism in East Asia has exhibited an interesting characteristic. Both China and Japan, and even Korea, are much stronger economic powers than ASEAN, individually or collectively. Nonetheless, due to historical and political resentment, East Asian countries have not been able to designate an institutional framework, even in very loose form, to enhance economic integration therein. By contrast, ASEAN has an institutional framework, albeit weak in its capacity, to coordinate integration within ASEAN and to extend its economic regionalism to East Asian countries,[30] India[31] and its Closer Economic Relations partners, namely, Australia and New Zealand.[32] Up to now, ASEAN has successfully put itself at the centre of (East) Asian economic regionalism. In this section, I will briefly elaborate the external relations of ASEAN as set out by the ASEAN Charter and outlined in the *Blueprint*. Based on these, I will explore major developments of the external aspects of ASEAN economic integration, confining the analysis to free trade agreements between ASEAN and its East Asian counterparts, namely China, Japan, and Korea.

Chapter XII of the ASEAN Charter regulates the external relations of ASEAN. It is directed to act as the primary driving force in initiating regional arrangements

[30]For an analysis of the strength of ASEAN in institutional coordination in contrast to the weakness of the cooperative framework in East Asian counterparts, see Yoshimatsu, *The Political Economy of Regionalism in East Asia: Integrative Explanation for Dynamics and Challenges*, 2008, chaps. 2 & 4.

[31]India has traditionally taken a lukewarm attitude toward ASEAN. India became a full dialogue partner of ASEAN in 1995 and subsequently participated in the Asian Regional Forum. The first ASEAN–India Summit was commenced at Phnom Penh, Cambodia on 5 November 2002. Later on, India acceded to the Agreement on Amity and Cooperation of Southeast Asia in Bali, Indonesia on 8 October 2003, and, at the same time signed a Framework Agreement on Comprehensive Economic Cooperation with ASEAN. Available at http://www.aseansec.org/4971.htm (last accessed 20/12/2008).

[32]The formulation of Australia and New Zealand as dialogue partners of ASEAN dated back to the 1970s. The first ASEAN–Australia and ASEAN–New Zealand Summits were held on 7 August 1977 and 8 August 1977 respectively. Since the 1990s, the ASEAN and the Australia–New Zealand Closer Economic Relations (CER) Agreement has established inter-regional dialogue through ASEAN Economic Ministers–Closer Economic Relations (AEM–CER) Consultations. In 2002, the ASEAN Free Trade Area (AFTA)–Closer Economic Relations (CER) Closer Economic Partnership (CEP) was established, with the aim of deepening the economic integration between the ASEAN countries and Australia and New Zealand. On 30 November 2004, in Laos, leaders from ASEAN, Australia and New Zealand agreed to launch the negotiations for a free trade agreement. The final deal of the ASEAN–Australia–New Zealand Free Trade Agreement was concluded in Singapore 28 August 2008. http://www.dfat.gov.au/trade/fta/asean/ (last accessed 13/12/2008).

and to maintain its centrality in regional cooperation and community building.[33] As prescribed, member states, through the ASEAN Summit and the ASEAN Foreign Ministers Meeting, should coordinate and endeavour to develop common positions and pursue joint actions and thus ensure consistency and coherence of ASEAN external relations.[34] The Charter also provides the legal basis for ASEAN to confer on an external party the formal status of Dialogue Partner, Sectoral Dialogue Partner, Development Partner, Special Observer, and Guest or any other status established henceforth,[35] which reflects the conventional practices of ASEAN.

The *Blueprint* also provides some guidance in formulating a coherent approach towards external economic relations. The *Blueprint* firstly reiterates the importance of making ASEAN a stronger and more dynamic segment of global supply chains and of ensuring that the internal market is an attractive destination for foreign direct investment. The *Blueprint* thus points to the external dimension of the AEC by situating itself in the global division of labour and competition with other trading partners.[36] Similarly, the *Blueprint* attaches great significance to the "ASEAN centrality" in its external economic relations in negotiating free trade agreements and comprehensive economic partnership (CEP) agreements. With this aim, external FTA or CEP commitments should be reviewed in light of those made with the objective of internal integration.[37] ASEAN should also achieve common approaches and/or positions in external economic relations and in regional/multilateral fora for a thorough, enhanced coordination.[38]

Economic and Trade Integration Within the ASEAN+3

Legal Personality of ASEAN

In examining the external economic relations of ASEAN in relation to China, Japan and Korea, a good starting point is the legal personality of ASEAN as conferred by the ASEAN Charter. Since its inception, ASEAN has been deliberately designed as a loosely-shaped intergovernmental organisation. An illustrative example is the

[33] ASEAN Charter, Article 41(3).

[34] ASEAN Charter, Article 41(4)–(6).

[35] ASEAN Charter, Article 44(1).

[36] The *Blueprint*, para. 64.

[37] The *Blueprint*, para. 65(i).

[38] The *Blueprint*, para. 65(ii). It should also be noted that, with the signing of the ASEAN–China Framework Agreement, Agreement on Trade in Goods, and Agreement on Trade in Services, the deadline for tariff elimination within AFTA was rearranged in order to match the ASEAN–China FTA deadline. This is regarded as the first domino effect triggered by the ASEAN–China FTA. Baldwin, The East Asia Noodle Bowl Syndrome, in: Hiratsuka/Kimura (eds.), *East Asia's Economic Integration: Progress and Benefit*, 2008, p. 45 (62).

establishment of the ASEAN Secretariat by the Agreement on the Establishment of ASEAN Secretariat, ten years after the ASEAN Declaration (Bangkok Declaration). The founding fathers of ASEAN have never envisaged a "transfer of sovereign power" in the EU/EC form. This remains unchanged even after the entry into force of the ASEAN Charter, by virtue of which ASEAN acquires its legal personality. The collective-decision-making nature of ASEAN reflects on its external agreements with its dialogue partners.

The Framework Agreement on Comprehensive Economic Co-operation between ASEAN and the People's Republic of China (the ASEAN–China Framework Agreement)[39] is an interesting example, with respect both to ASEAN and to China. In respect of ASEAN, the contracting parties may be referred as "ASEAN" or "ASEAN Member States" collectively, or "ASEAN Member State" individually. While the title of the ASEAN–China Framework Agreement suggests an agreement singed between ASEAN on the one hand, and China on the other, a closer look at the agreement proves that not to be true. In addition, the Early Harvest Programme as embodied in Article 6 of this Framework Agreement was bilaterally negotiated between China and individual ASEAN Member States.[40] Even with a legal personality, ASEAN, as an international organisation, may also never have the competence and/or mandate to sign any economic cooperation agreements with other countries. With respect to China, China only negotiated on behalf of its own customs territory, excluding its two special administrative regions which are at the same time full WTO members carrying the title of "Hong Kong, China" and "Macau, China".[41]

Patterns of Negotiation

Surprised or threatened by the progress made by the ASEAN–China Framework Agreement, Japan changed its lukewarm attitude toward an ASEAN–Japan FTA

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[39]Framework Agreement on Comprehensive Economic Co-operation between ASEAN and the People's Republic of China (Phnom Penh, Cambodia, 4 November 2002), available at http://www.aseansec.org/13197.htm (last accessed 15/12.2008).

[40]Greenwald, Note: The ASEAN–China Free Trade Agreement (ACFTA): A Legal Response to China's Economic Rise, Duke Journal of Comparative and International Law 16 (2006) 1, p. 193 (197).

[41]For a closer discussion on the legal and economic integration between China and Hong Kong, China and Macau, China, see Wu, One Country, Two Systems, and Three Memberships: Legal and Economic Integration between China and its Two SARs, Global Jurist (Advances) 7 (2007) 3, Article 7, available at http://www.bepress.com/gj/vol7/iss3/art7. Some Chinese lawyers tend to include Taiwan as part of China and refer to this as "One China, Four Memberships". See for example Zeng, WTO Rules and China–ASEAN FTA Agreement, in: Wong et al. (eds.), *China–ASEAN Relations: Economic and Legal Dimensions*, 2006, p. 93 (95–98). The author obviously does not share this view. Nevertheless, he correctly points to the complexities of the contracting parties to this ASEAN–China Framework Agreement.

and launched negotiations on a comprehensive economic partnership with ASEAN at the ASEAN–Japan Summit in Phnom Penh, Cambodia on 5 November 2002, the same venue where the ASEAN–China Framework was signed. One year later, the Framework for Comprehensive Economic Partnership between ASEAN and Japan[42] was signed in Bali, Indonesia. This development prompted Korea to jump into the FTA game.[43] At the ASEAN–Korea Summit in 2004, ASEAN and Korea agreed to initiate their negotiations on a comprehensive economic cooperation partnership. The ASEAN–Korea Framework Agreement on Comprehensive Economic Partnership was signed in 2005.[44]

Some patterns can be registered from the free trade agreement negotiations between ASEAN and China, Japan and Korea. Firstly, they adopted the same approach: from a framework agreement to specific issues. They initiated their free trade agreement negotiations through a joint declaration during the ASEAN-X Summit where other Eastern Asian counterparts were present. A potential domino effect may arise between these three countries.[45] After the joint declaration, a Framework Agreement that points to directions of future negotiations was signed. This would normally cover trade in goods, trade in services, and investments. It may also touch upon other areas of economic cooperation, such as trade facilitation and development of mutual recognition arrangements. In some cases, a clear and definitive timeline was set in the framework agreement.[46]

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[42] Framework for Comprehensive Economic Partnership between the Association of Southeast Asian Nations and Japan (Bali, Indonesia, 8 October 2003), available at http://www.aseansec.org/15275.htm (last accessed 15/12/2008).

[43] For Korean response to the ASEAN–China Framework Agreement, see Chung, China–ASEAN FTA and Korean FTA Policies, in: Wong et al. (eds.), *China–ASEAN Relations: Economic and Legal Dimensions*, 2006, p. 293 (293–308). See also Choi, Legal Analysis of Korea–ASEAN Regional Trade Integration, Journal of World Trade 41 (2007) 3, p. 581 (582–583).

[44] Framework Agreement on Comprehensive Economic Cooperation among the Governments of the Member Countries of the Association of Southeast Asian Nations and the Republic of Korea (Kuala Lumpur, Malaysia, 13 December 2005), available at http://www.aseansec.org/18064.htm (last accessed 15/12/2008).

[45] As observed by Baldwin, China's proposal for a free trade agreement with the ASEAN set off the alarm bell all around the region, especially to Japan and Korea. This in turn brought about the ASEAN–Japan, and ASEAN–Korea free trade agreements. A Japan–Korea free trade agreement may also be an option to respond the tariff discrimination produced by the ASEAN–China free trade agreement. According to Baldwin, the AFTA, ASEAN–China, ASEAN–Japan, and ASEAN–Korea free trade agreements constitute the four pillars of East Asian regionalism. Baldwin, The East Asia Noodle Bowl Syndrome, in: Hiratsuka/Kimura (eds.), *East Asia's Economic Integration: Progress and Benefit*, 2008, p. 45 (63–64).

[46] See for example the ASEAN–China Framework Agreement, Article 11. It is mandated that the Parties shall establish form dispute settlement procedures and mechanism within 1 year after the date of entry into force of the Framework Agreement. The Agreement on Dispute Settlement Mechanism of the Framework Agreement on Comprehensive Economic Co-operation between the Association of Southeast Asian Nations and the People's Republic of China (Vientiane, Lao PDR, 29 November 2004), available at http://www.aseansec.org/166366.htm (last accessed 15/12/2008).

In addition, the agreements categorise the sectors of trade in goods into the normal track and the sensitive track,[47] which in turn covers the sensitive list and the highly sensitive list. The timeframe for tariff reduction and elimination varies in accordance with these two tracks. Parties may enlist products into the normal track or sensitive track of their own accord, i.e., voluntarily, while a maximum ceiling is set for the sensitive track. Following the pattern of the Early Harvest Programme, the list of the products on the normal track and sensitive track was bilaterally negotiated between individual ASEAN member states and China or other East Asian countries. This is mainly derived from the different levels of development among ASEAN countries that prevent them from coordinating coherently and from establishing a common stance.

Further, in response to the signing of the ASEAN–China Framework Agreement in 2002, the Declaration of ASEAN Concord II (Bali Concord II)[48] in 2003 dictates the intra-AFTA tariffs to be zero and points to the direction for the AEC as a single market. This practice mirrors what the *Blueprint* says about the "ASEAN Centrality". Namely, the AEC should review the commitments made under the FTA or CEP in the light of those made for the objective of internal integration. While the AFTA was almost accomplished by 2002, at least in respect of tariff reduction, a free circulation of Chinese (Japanese/Korean) goods within ASEAN is still not possible even after the signing of the ASEAN–China Framework Agreement and Agreement on Trade in Goods. As explained by the Parties, since ASEAN is not a customs union, Chinese goods cannot circulate freely within ASEAN without incurring additional tariffs at internal borders.[49]

ASEAN Non-WTO Member State

It should also be noted again that, as of 20 December 2008, Lao PDR is not yet a member to the WTO. When some of the framework agreements were signed, even Viet Nam and Cambodia had not accomplished their accession process. It is subject to dispute how a WTO member enters into an FTA with a non-WTO member. Whether this agreement is subject to the control of the WTO disciplines may also be controversial. When commenting the WTO-consistency of the ASEAN–Korea Agreement, Choi writes that Article XXIV of the GATT 1994 and Article V of the GATS regulate differently with regard to the formation of a free trade agreement area or customs union between a WTO member and a non-WTO member. The legal text of Article XXIV:5 reads "the provisions of this Agreement shall not prevent, as between the territories of contracting parties, the formation of a customs union or of a free-trade area or the adoption of an interim agreement necessary for

[47]The ASEAN–China Framework Agreement, Article 3(4).

[48]Declaration of ASEAN Concord II (Bali Concord II, Bali, Indonesia, 7 October 2003), available at http://www.aseansec.org/19096.htm (last accessed 13/20/2008).

[49]WTO Document, WT/COMTD/51/Add.6 (16 October 2007), No 8.

the formation of a customs union or of a free-trade area". The phrase "as between the territories of contracting parties" does not envisage a free-trade area or customs union between a WTO member and a non-WTO member. By contrast, Article V:1 of the GATS provides that "[T]his Agreement shall not prevent any of its Members from being a party to or entering into an agreement liberalising trade in services between or among the parties to such an agreement". The wording of the GATS is slightly different. "An agreement liberalising trade in services between or among the parties to such an agreement" does not exclude the possibility for a WTO member to enter into an agreement with a party that is not a WTO member. Choi thus argues that in order to legitimatise the ASEAN–Korea free trade area, it is essential to acquire approval "by a two-thirds majority" from the WTO members in accordance with Article XXIV:10 of the GATT 1994.[50]

In addition, as clarified by the Parties in their notification to the WTO, China and ASEAN member states invoke the Decision of 28 November 1979 under GATT on Differential and More Favourable Treatment, Reciprocity and Fuller Participation of Developing Countries (the Enabling Clause)[51] as the legal basis of the ASEAN–China Framework Agreement.[52] The differential and more favourable treatment refers mainly to the Early Harvest Programme, where China has made a highly concessionary tariff reduction while ASEAN member states offer almost nothing. The Enabling Clause provides a legal basis for preferential and more favourable treatment accorded to developing countries, regardless of the Most-Favoured-Nation obligation of Art. I GATT. Within the Committee of Trade and Development, the EC raised its concerns on the transparency issue of the ASEAN–China Framework Agreement and reserved its rights for prompt consultations under paragraph 4(b) of the Enabling Clause.[53] Finally, in view of the fact that some ASEAN members had not accomplished their WTO accession process when the framework agreements were signed, the framework agreements then prescribe the conferral of Most-Favoured-Nation Treatment consistent with WTO rules and disciplines to all the non-WTO ASEAN member states.[54]

China's Market Economy Status

Another point to note is that, given China's non-Market Economy status in the WTO, China maintains the policy and insists on the recognition of its Market

[50]Choi, Legal Analysis of Korea–ASEAN Regional Trade Integration, Journal of World Trade, Vol. 41 (2007) 3 p. 581, (pp. 593–594).

[51]Decision of 28 November 1979 (L/4903).

[52]WTO Document, WT/COMTD/N/20 (21 December 2004) 1.

[53]WTO Document, WT/COMTD/51/Add.2 (8 February 2006) 1.

[54]See, for example, ASEAN–China Framework Agreement, Article 9; ASEAN–Japan Framework Agreement, Article 7; ASEAN–Korea Framework Agreement, Article 2.4.

Economy Status when negotiating free trade agreements with its trading partners.[55] This approach has its roots in China's Closer Economic Partnership Arrangement (the "CEPA") with its two special administrative regions, Hong Kong and Macau. The inclusion of the non-application of Section 15, 16 of China's Accession Protocol and paragraph 242 of its Working Party Report in the CEPA helps China to negotiate with its trading partners by following the same pattern, and consequently reduces the impacts of these "WTO-plus" obligations. This approach has proved itself very successful. According to the Trade Policy Review Report conducted in 2006, China has included the recognition of its market economy status into every regional and bilateral free trade agreement, or economic partnership agreement.[56]

Consistent with these conventional practices, Article 14 of the ASEAN–China Agreement on Trade in Goods of the Framework Agreement provides that all ASEAN member states recognise China to be a market economy. Section 15 and 16 of China's Accession Protocol to the WTO and paragraph 242 of its Working Party Report are not applicable to trade relations between each of the ASEAN member states and China.[57] The recognition of China as a market economy is actually of little economic importance; nonetheless, from a political point of view, this recognition is of great symbolic significance.

Selected Issues in Relation to Trade in Goods, Trade in Services[58]

In this subsection, I would like to explore some selected issues covered in the agreements on trade in goods, trade in services, and investment under the Framework Agreements signed between ASEAN and China, Japan, and Korea. Clearly, it is not possible and not feasible to cover all areas; nevertheless, it may be beneficial to identify some pertinent issues. Firstly, it is useful to clarify the timeframe for the

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[55] See Secretariat's Trade Policy Report on People's Republic of China, WT/TPR/S/161 (28 February 2006), para. 46. In addition to the ASEAN–China Agreement on Trade in Goods, the Chile–China FTA, the China–Pakistan Preferential Trade Agreement, the China–Australia Trade and Economic Framework Agreement (aim to establish an FTA), the China–New Zealand Trade and Economic Cooperation Framework (aiming to establish an FTA), and the China and the Southern African Customs Union (SACU) Joint Declaration (with the aim to establishing a FTA), as well as their accompanying talks and negotiations, have recognised China as a market economy. In addition, before commencing the negotiation of an FTA, Iceland and Switzerland have also recognised China as a market economy.

[56] Trade Policy Review Report, Secretariat Report, WT/TPR/S/161 (28 February 2006), para. 46.

[57] Agreement on Trade in Goods of the Framework Agreement on Comprehensive Economic Cooperation between the Association of Southeast Asian Nations and People's Republic of China (the ASEAN–China Agreement on Trade in Goods, Vientiane, Lao PDR, 29 November 2004, available at http://www.aseansec.org/16646.htm (last accessed 20/12/2008).

[58] While the issue of investments has been briefly referred in the framework agreements, no single agreement governing this issue has yet been signed by the ASEAN and China, Korea, or Japan.

accomplishment of free-trade areas as envisaged by the parties. As a pattern, timelines for ASEAN-6 and the East Asian countries differ from CMLV. Further, the schedules apply mainly to trade in goods under the normal track. The sensitive track has a longer period to phase in. In addition, in terms of the content and coverage of the agreement on trade in goods, the agreements signed between ASEAN and China and Korea resemble each other. In contrast, the Agreement on Comprehensive Economic Partnership among Member States of the Association of Southeast Asian Nations (the AJACEP)[59] is a comprehensive agreement with much wider coverage and detailed regulation. The ASEAN–China FTA prescribes different schedules for ASEAN-6 and CMLV. The implementation of tariff elimination under the normal track of the ASEAN–China FTA for ASEAN-6 and China should be carried out by 2010. The implementing period for CMLV is intended to be from 2005 to 2015. In respect of the ASEAN–Japan free-trade area, it is expected to be accomplished by 2012, whereas CMLV have five additional implementation periods. Regarding the ASEAN–Korea free trade area, the liberalisation of the trade in goods falling within the scope of the normal track should be finalised by 2010 for ASEAN-6 and Korea and by 2018 for CMLV.

Another point with regard to trade in goods is the incorporation of the WTO rules into the agreements signed by the ASEAN and the East Asian Countries. For example, Article III and X of the GATT are, *mutatis mutandis*, incorporated into and form an integral part of the ASEAN–Korea agreement on trade in goods.[60] In Article 7, parties reaffirm their commitments to abide by the WTO disciplines on non-tariff barriers, technical barriers to trade, sanitary phytosanitary measures, subsidies and countervailing measures, anti-dumping measures and intellectual property rights. On the one hand, these references to WTO rules may indicate the parties' great commitment to the WTO disciplines. On the other hand, the avoidance of producing additional rules can effectively reduce the potential difficulties and costs in interpreting and implementing the agreements. These WTO rules are also of practical value since the Lao PDR has not yet finalised its WTO accession. That being said, the ASEAN–China and ASEAN–Korea agreements on trade in goods have included a much wider scope of general exceptions.[61] The negotiators also spent lots of effort on drafting the rules of safeguard

[59]The Agreement on Comprehensive Economic Partnership Agreement among Japan and the Member States of the Association of Southeast Asian Nations (the AJACEP, Hanoi, Vietnam, 2 April 2008), available at http://www.mofa.go.jp/policy/economy/fta/asean.html (last accessed 26/12/2008).

[60]ASEAN–Korea Agreement on Trade in Goods under the Framework Agreement on Comprehensive Economic Cooperation among the Governments of the Member Countries of the Association of Southeast Asian Nations and the Republic of Korea (the ASEAN–Korea Agreement on Trade in Goods, Kuala Lumpur, Malaysia, 27 August 2006), available at http://www.aseansec.org/akfta.htm (last accessed 27/12/2008), Article 2, 3.

[61]ASEAN–Korea Agreement on Trade in Goods, Article 11; ASEAN–China Agreement on Trade in Goods, Article 12.

measures under these agreements, due to the fear of the surge of imports after the liberalisation.

With regard to trade in services, ASEAN has so far signed agreements with China and Korea. In respect of their market access, a party is obligated to accord "services and services suppliers of any other party treatment no less favourable than that provided under the terms, limitations, and conditions agreed and specified in the Schedule".[62] It then further prohibits the parties from limiting the activities of services suppliers by setting the following restrictions: the number of service suppliers, the total value of service transactions, the total number of service operations or the total quantity of service output, the total number of natural persons, the type of legal entity, or the participation of foreign capital.[63] The agreement then lays down its discipline on National Treatment. In those sectors where parties agree to liberalise based on the terms and conditions agreed, a party should not accord treatment to services or servicers suppliers less favourable than that it accords to its own like services and services suppliers.[64] The agreement then further clarifies that, whether formally identical or different, a treatment is considered to be less favourable if it modifies the conditions of competition in favour of domestic services or services suppliers.[65] Similar provisions are also included in the ASEAN–Korea Agreement on Trade in Services.[66]

Another important feature of the ASEAN–China and ASEAN–Korea agreements on Trade in Services relates to increasing participation of CMLV. Special commitments should be negotiated with the aim of strengthening their domestic services capacity, efficiency and competitiveness; improving their access to distribution channels and information networks, and liberalising sectors and modes of supply of export interests. Additional flexibility should be offered to these new member countries of ASEAN in the process of the liberalisation in trade in services.[67] This again points to the development gap and the need for special arrangements between ASEAN-6 and CMLV.

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[62] Agreement on Trade in Services of the Framework Agreement on Comprehensive Economic Co-operation between the Association of Southeast Asian Nations and the People's Republic of China, (the "ASEAN–China Agreement on Trade in Services", Cebu, the Philippines, 14 January 2007), available at http://www.fta.gov.sg/acfta/asean-china_tis_(main agreement).pdf (last accessed 27/12/2008), Article 18.1.

[63] ASEAN–China Agreement on Trade in Services, Article 18.2.

[64] ASEAN–China Agreement on Trade in Services, Article 29.1.

[65] ASEAN–China Agreement on Trade in Services, Article 29.3.

[66] Agreement on Trade in Services under the Framework Agreement on Comprehensive Economic Cooperation among the Governments of the Member Countries of the Association of Southeast Asian Nations and the Republic of Korea (the "ASEAN–Korea Agreement on Trade in Services", Singapore, 21 November 2007), available at http://www.aseansec.org/21111.pdf (last accessed 27/12/2008), Article 19, 20.

[67] ASEAN–China Agreement on Trade in Services, Article 17; ASEAN–Korea Agreement on Trade in Services, Article 18.

Financial and Monetary Cooperation Within ASEAN+3

The Chiang Mai Initiative

In the aftermath of the Asian Financial Crisis, the leaders of ASEAN+3 met in Manila and released a Joint Statement on East Asian Cooperation. They agreed to "strengthen policy dialogue, coordination and collaboration on financial, monetary and fiscal issues of common interests"[68] They focused on reforming the international financial architecture, but at the same time, enhancing the self-help and support mechanisms in East Asia through the framework of ASEAN+3. One year later, the financial ministers of ASEAN+3 gathered in Chiang Mai, Thailand and agreed to establish a regional financial arrangement in order to strengthen their self-help and support mechanisms. The "Chiang Mai Initiative" (CMI) was launched. It covers an expanded ASEAN Swap Arrangement[69] that would include all ASEAN member states and a network of bilateral swap and repurpose arrangements among ASEAN member states and China, Japan and Korea.[70]

The CMI is aimed to supplement the assistance provided by the IMF. The conditionality prescribed by the IMF is linked to the CMI, except for the 10% of automatic disbursement, later raised to 20% in 2005. The total size of the swap arrangement has greatly grown. As noted in the Joint Ministerial Statement in 2006, the size reached 75 billion US dollars.[71] Further, it is proposed to multilateralise the CMI. In the same statement, a task force was established to study possible options toward a regional liquidity support arrangement (CMI Multilateralisation, or

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[68]ASEAN, Joint Statement on East Asia Cooperation (Manila, Philippines, 28 November 1999), available at http://www.aseansec.org/5469.htm (last accessed 19/12/2008), para. 6(a).

[69]The ASEAN Swap Arrangement dated back to the 1977 Memorandum of Understanding on the ASEAN SWAP Arrangements. A swap transaction (ASEAN domestic currency against US dollars) can be requested for a period of two or three months, subject to one renewal, up to the amount of USD 100 million. Memorandum of Understanding on the ASEAN SWAP Arrangements (Kuala Lumpur, 5 August 1977), available at http://www.aseansec.org/6297.htm (last accessed 19/12/2008), Article 4, 7, and 9.

[70]ASEAN, Joint Ministerial Statement of the ASEAN+3 Finance Ministers Meeting (Chiang Mai, Thailand, 6 May 2000), available at http://www.aseansec.org/1026.htm (last accessed 19/12/2008), para. 6. In addition to bilateral swap arrangements (BSA), the Chiang Mai Initiative also calls for use of the ASEAN+3 framework to facilitate the exchange of consistent and timely data and information on capital flows, the establishment of a regional financing arrangement of supplement the existing international facilities, and enhancement of the ability to provide sufficient and timely financial support to ensure East Asian financial stability (Joint Ministerial Statement, para. 4, 6, 7). According to Rana, these objectives have been successfully achieved. Rana, Monetary and Financial Cooperation in East Asia: The Chiang Mai Initiative and Beyond, ERD Working Paper (2002) No. 6, Asian Development Bank, available at http://www.pecc.org/finance/forum2002/fmc-pradumna.pdf (last accessed 20/12/2008), 8–11.

[71]ASEAN, The Joint Ministerial Statement of the 9th ASEAN+3 Finance Ministers' Meeting (Hyderabad, India, 4 May 2006), available at http://www.aseansec.org/18390.htm (last accessed 23/12/2008), para. 5(iii).

post-CMI).This would transform the bilateral nature of the CMI into a multilateral self-managed reserve pooling arrangement governed by one single contractual agreement. It was agreed in 2008 that the total size of the multilateralised CMI would be at least 80 billion US dollars and the proportion of the amount of the contribution between ASEAN and East Asian counterparts would be "20:80".[72] It is also reiterated, in paragraph 6, that the two core objectives of the CMI are to "to address short-term liquidity difficulties in the region and to supplement the existing international financial arrangements". With the threat of imminent financial turmoil, the ministers agreed to expedite the CMI Multilateralisation in the first half of 2009.[73] Against this ongoing financial tsunami, Bank Indonesia is reported to have approached the ASEAN Swap Arrangement to swap its local currency into US dollars in order to strengthen and protect its national foreign exchange reserves.[74]

In terms of the progress that the CMI has so far made, the growth of the total size of the swap arrangements is undoubtedly a great success. At the same time, its transformation from bilateral swap arrangements into a single multilateral swap agreement is of equal, if not more, importance. Regardless of the current size of almost 80 billion US dollars, the amount a single country can borrow without the IMF conditionality is actually still insignificant compared to its financial need to ensure the liquidity. As argued, if the leaders of ASEAN+3 want to turn the CMI into something meaningful, two things have to be done: to enlarge the size of the swap based on a single, multilateral agreement, and to establish an institutionalised organisation. This organisation will be in charge of the coordination of financial issues, such as surveillance, crisis prevention and resolution, harmonisation of codes and regulatory standards, exchange rate and/or monetary policies.[75] Sussangkarn thus calls for the establishment of the Asian Monetary Fund of which this CMI Multilateralisation can be a cornerstone.

In spite of the progress of the CMI, some crucial issues need to be sorted out. A clearly defining rule of the swap activation process and an institutionalised decision-making mechanism would be beneficial to the future development of the CMI. In addition, the surveillance mechanism should also be strengthened in order to avoid the "moral hazard". Most importantly, the prospective Asian Monetary Fund has to define its relation with the IMF. As the ASEAN+3 financial ministers have kept reiterating, the CMI or prospective Asian Monetary Fund is to complement the role of the IMF. The conventional practices of the CMI still closely link to

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[72]ASEAN, The Joint Ministerial Statement of the 11th ASEAN+3 Ministers' Meeting (Madrid, Spain, 4 May 2008), available at http://www.aseansec.org/21502.htm (last accessed 23/12/2008), para. 8.

[73]ASEAN, Joint Ministerial Statement of the ASEAN+3 Finance Ministers (Dubai, 8 October 2008), available at http://www.aseansec.org/21987.htm (last accessed 23/12/2008), para. 4.

[74]TEMPO Interactive Jakarta, Indonesia to Propose Foreign Exchange Loan (10 October 2008) http://www.tempointeractive.com/hg/ekbis/2008/10/10/brk,20081010-139463,uk.html (last accessed 23/12/ 2008).

[75]Sussangkarn/Vichyanond, Directions of East Asian Regional Financial Cooperation, Asian Economic Papers 5 (2006) 3, p. 25 (31).

the IMF conditionality. These practices are reasonable, since expertise, especially on surveillance, within the CMI is far from sufficient. However, this does not exclude the possibility that the CMI or perspective Asian Monetary Fund develops its own surveillance mechanism or conditionality and thus loosens its link with the IMF. These issues are to be settled in line with the CMI Multilateralisation process, and thus can pave the way to the Asian Monetary Fund.

Asian Bond Market Initiative

Prior to the Asian financial crisis, Asian economies, in meeting their debt financing needs, referred mostly to bank lending, which is generally considered illiquid. The price for bank lending, namely, the interest rate, does not vary much in correspondence to changing market circumstances. Consequently, the adjustment has to take place in the form of rises and falls in the quantity of bank lending, which subsequently brings about the sharp booms and busts in bank flows. A sudden reversal in bank flows is believed to be one of the major factors of the Asian financial crisis.[76] Due to the underdevelopment of Asian bond markets, when the Asian economies gradually recovered their strength and accumulated surging foreign reserves, their foreign reserves are normally directed into foreign bond markets, especially the US bond market. In case of need for debt financing, they turn to, mostly, foreign currency denominated short-term bank lending. This undermines the efficiency of their foreign reserves and poses foreign exchange risk to their debt financing. In order to remedy this defect, two major initiatives have been taken: the Asian Bond Fund established by the Executives' Meeting of East Asia–Pacific Central Banks; and the Asian Bond Market Initiative (ABMI) launched under the framework of ASEAN+3. As this paper deals with economic regionalism in ASEAN+3, I will focus on the ABMI here.

The ABMI was endorsed by the financial ministers of ASEAN+3 in 2003. As noted in the Chairman's press release on the ABMI, the ABMI aims to "develop efficient and liquid bond markets in Asia, which would enable better utilisation of Asian savings for Asian investments. The ABMI would also contribute to the mitigation of currency and maturity mismatches in financing".[77] The ABMI is deemed as a key step forward in the financial cooperation of ASEAN+3. Two major tasks were set out: to facilitate the access to market through a wider variety of issuers, and to enhance market infrastructure to foster bond markets in Asia.[78] It was recognised by ASEAN+3 countries that the major role of public sectors is to improve market infrastructure, and that the participation of private sectors is

[76]Rajan/Rongala, *Asia in the Global Economy*, 2008, p. 249.

[77]ASEAN, Chairman's Press Release on the Asian Bond Market Initiative, available at http://www.aseansec. org/15030.htm (last accessed 26/12/2008).

[78]Chairman's Press Release on the Asian Bond Market Initiative.

indispensable for the success of the ABMI. Six voluntary working groups were established to study on the following: (1) creating new securitised debt instruments, (2) credit guarantee mechanisms, (3) foreign exchange transactions and settlement issues, (4) issuance of bonds denominated in local currency by Multilateral Development Banks (MDBs), foreign government agencies and Asian multinational corporations, (5) local and regional rating agencies, and (6) technical assistance coordination.

In 2008, the New ABMI Roadmap[79] was approved by the ASEAN+3 financial ministers. The New ABMI Roadmap aims to enhance the access of issuers and investors to an Asian regional bond market through voluntary efforts of individual countries, in particular the issuing of local-currency denominated bonds, and concerted efforts of ASEAN+3 as a group. The new ABMI Roadmap attaches great importance to the development of local-currency denominated bond market. In this context, it outlines a "reference of self-assessment" for benchmark, through which peer pressure would encourage member countries to implement local bond market reform.[80] Besides, the New ABMI Roadmap further institutionalises the ABMI. A Steering Committee was formed in order to ensure the effectiveness and efficiency of the ABMI. Four task forces were established, with the objective of (1) promoting the issuance of local currency-denominated bonds, (2) facilitating the demand for local currency-denominated bonds, (3) improving the regulatory framework, and (4) improving the related infrastructure for the bond markets. The Steering Committee will have to oversee and provide guidance to these task forces and report to the ASEAN+3 Finance Deputies' Meeting (AFDM+3), which will in turn report to the ASEAN+3 Finance Ministers' Meeting (AFMM+3). In addition, the Steering Committee is also in charge of the review and revision of the ABMI Roadmap.[81]

The Dispute Settlement Mechanism Within ASEAN and ASEAN+3

In this section, I will examine the dispute settlement mechanisms provided within ASEAN and by those agreements signed between ASEAN and China, Japan and Korea. In respect of ASEAN, I will touch upon the ASEAN protocol on Dispute Settlement Mechanism and the ASEAN Protocol on Enhanced Dispute Settlement Mechanism. In addition, the dispute settlement mechanisms as provided by the agreements between ASEAN and China, Japan and Korea would also be examined. At this point, it suffices to point out that the ASEAN–China Protocol on Dispute

[79] ASEAN, the New ABMI Roadmap, available at http://www.asianbondsonline.adb.org/documents/080731_ABMI_Roadmap_Publication_Final.pdf (last accessed 28/12/2008).

[80] The New ABMI Roadmap, para. 5.

[81] The New ABMI Roadmap, para. 6.

Settlement Mechanism under the Framework Agreement is the first dispute settlement mechanism going beyond amicable negotiation that China has agreed with its trading partners. Consequently, the ASEAN–China Protocol on Dispute Settlement Mechanism is of great significance not only to ASEAN but also to China.

ASEAN Protocol on Dispute Settlement Mechanism

Prior to 1996, disputes arising from the implementation of relevant ASEAN agreements were resolved in the ASEAN way, namely, consensual decision-making through amicable consultation and negotiation.[82] A small step toward the legalisation of the dispute settlement mechanism in ASEAN was the Protocol on the Dispute Settlement Mechanism (the ASEAN DSM)[83], which to a substantial extent mirrors the dispute settlement mechanism in the GATT era. The ASEAN DSM can be roughly separated into four phases: consultations, panel proceedings, appeal review, and implementations. I will briefly comment on the panel phase under the ASEAN DSM.

If a mutually satisfactory agreement can not be reached through consultations, the complaining member state can refer to the Senior Economic Officials Meeting (the SEOM) for the establishment of a panel to hear the case. The function of the panel is to "make an objective assessment of the dispute before it, including an examination of the facts of the case and the applicability and conformity with the sections of the Agreement and any covered agreement, and make such other findings as will assist the SEOM in making rulings provided for under the Agreement or any covered agreements".[84] It should be noted that Article 4.3 of this Protocol confers on the SEOM a discretionary power to "deal with the dispute to achieve an amicable settlement without appointing a panel". Because of this provision, no panel had ever been established under this Protocol.[85] It is also worth noting that the ASEAN DSM does not have the exclusive jurisdiction for intra-ASEAN trade disputes. That is, an ASEAN member state may refer to other fora for the settlement of disputes involving other member states.[86] Due to the ineffectiveness of the ASEAN DSM, member states, regardless of the limited

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[82]For a descriptive introduction of this ASEAN way, Greenwald, The ASEAN–China Free Trade Agreement (ACFTA): A Legal Response to China's Economic Rise, Duke Journal of Comparative and International Law 16 (2006) 1, p. 193 (202–204).

[83]ASEAN Protocol on Dispute Settlement Mechanism (20 November 1996, Manila), available at http://www.aseansec.org/7813.htm (last accessed 18/12/2008).

[84]ASEAN Protocol on Dispute Settlement Mechanism, Article 5.1.

[85]For an excellent analysis of this Protocol and pre-existent dispute settlement mechanisms with the ASEAN prior to this Protocol, see Sereno, Dispute Settlement in ASEAN Economic Agreements, in: Sereno/Santiago (eds.) *The ASEAN: Thirty Years and Beyond*, 1997, p. 385 (385–420).

[86]ASEAN Protocol on Dispute Settlement Mechanism, Article 1.3.

number,[87] referred to the WTO Dispute Settlement Mechanism (the WTO DSM) for the settlement of trade disputes between them.

Nevertheless, in order to sustain the AEC, a strengthened dispute settlement mechanism is indispensable. According to the Declaration of ASEAN Concord II (Bali Concord II) in 2003 where the AEC had already been envisaged, "ASEAN shall implement the recommendations of the High Level Task Force on ASEAN Economic Integration"[88] as its first step towards the realisation of the AEC. These recommendations included an enhanced dispute settlement mechanism that led to the signature of the ASEAN Protocol on Enhanced Dispute Settlement Mechanism (the ASEAN EDSM).[89] This ASEAN EDSM then resembles the WTO DSM, a development occurring earlier than Sereno predicted.[90]

ASEAN Protocol on Enhanced Dispute Settlement Mechanism

Some designations of this ASEAN EDSM have gone beyond the ASEAN Way. International trade lawyers can easily recall the main features of the WTO DSM: the compulsory jurisdiction, a permanent Appellate Body, and the quasi-automatic adoption of the panel and Appellate Body reports. These elements are included in the ASEAN EDSM. As provided, "a panel shall be established by the SEOM, unless the SEOM decide by consensus not to establish a panel".[91] An Appellate Body is to be established within the ASEAN Economic Ministers (the AEM), comprising seven persons.[92] The SEOM shall adopt the panel report unless a party to the dispute notifies the SEOM its decision to appeal or the SEOM decides by consensus

[87]These cases include: Malaysia – Prohibition of Imports of Polyethylene and Polypropylene (complaint by Singapore) WT/DS/1; Thailand – Customs and Fiscal Measures on Cigarettes from the Philippines (complaint by the Philippines) WT/DS/371. These two cases are interesting examples. The former is the very first case of the WTO DSM, but ended in Singapore's withdrawal of its request for the establishment of the panel. The latter came into the WTO after the ASEAN Protocol on Enhanced Dispute Settlement Mechanism entered into force. This may suggest that the ASEAN Enhanced Dispute Settlement Mechanism is still not as effective as it is intended to be.

[88]Declaration of ASEAN Concord II (Bali Concord II, Bali, Indonesia, 7 October 2003), available at http://www.aseansec.org/19096.htm.

[89]ASEAN Protocol on Enhanced Dispute Settlement Mechanism (Vientiane, Lao PDR, 23 November 2004), available at http://www.aseansec.org/16754.htm (last accessed 27/12/2008).

[90]Sereno argues that the member states of were not fully aware of the legal consequences of the Protocol of Dispute Settlement Mechanism and might not be well prepared for a legally enforceable agreements and commitments under this dispute settlement mechanism. She then notes that it might take another thirty years to establish a WTO-type dispute settlement mechanism. Sereno, Dispute Settlement in ASEAN Economic Agreements, in: Sereno/Santiago (eds.) *The ASEAN: Thirty Years and Beyond*, 1997, p. 385 (419).

[91]ASEAN Protocol on Enhanced Dispute Settlement Mechanism, Article 5.1.

[92]ASEAN Protocol on Enhanced Dispute Settlement Mechanism, Article 12.1.

not to adopt the panel report.[93] The Appellate Body report shall also be adopted by the SEOM unless a decision not to adopt the Appellate Body report is reached by consensus.

The ASEAN EDSM can also be separated into the aforementioned four phases. Three types of complaints are provided in the protocol: any benefit accruing to member states directly or indirectly under the Agreement or any covered agreement being nullified or impaired, the attainment of any objective of the Agreement or any covered agreement being impeded as a result of the failure of any member state's obligation under the Agreement or any covered to here agreement, and the existence of any other situation.[94] Before examining these four phases, it is desirable to clarify the scope and coverage of this protocol. The disputes subject to the consultation and dispute settlement procedure provided in this protocol are listed as an Appendix to the protocol. Nevertheless, the protocol is also applicable to future ASEAN economic agreements. Thus, the agreements which are covered, as provided in the protocol, include the agreements listed in the Appendix and all future ASEAN economic agreements. The protocol also makes clear that the protocol does not prejudice the rights of member states to seek recourse to other fora. As noted above, even with the entry into force of the ASEAN Protocol on Enhanced Dispute Settlement Mechanism, the Philippines referred to the WTO DSM for the Customs and Fiscal Measures on Cigarettes adopted by Thailand. The ASEAN EDSM is still not an effective forum for ASEAN to resolving their trade disputes. Further, regardless of the effort to legalise the ASEAN EDSM, the ASEAN EDSM also emphasises the desirability of amicable settlement of disputes between member states. Article 3.1 of the protocol instructs the member states to resolve amicably the differences in relation to interpretation or application of the Agreement[95] or any other covered agreement.[96] In addition, parties to a dispute may also agree to good offices, conciliation or mediation at any stage of the proceedings.[97]

The procedures of the dispute settlement mechanism as provided in the ASEAN EDSM begin with the consultations. Any request for consultation should be in writing, providing the identification of the measures at issue and the legal basis for the complaint.[98] If the consultations can not reach a mutually satisfactory agreement, the complaining member state can refer the matter to the SEOM, and request the establishment of a panel. The function of the panel is to "to make an objective assessment of the dispute before it, (including an examination of the facts of the case and the applicability of and conformity with the sections of the Agreement or

[93] ASEAN Protocol on Enhanced Dispute Settlement Mechanism, Article 9.1.

[94] ASEAN Protocol on Enhanced Dispute Settlement Mechanism, Article 3.2.

[95] The Agreement referred to here is the ASEAN Framework Agreement on Enhancing Economic Cooperation signed in Singapore in 1992, as amended by the Protocol to Amend the ASEAN Framework Agreement on Enhancing Economic Cooperation signed in Bangkok singed in 1995.

[96] ASEAN Protocol on Enhanced Dispute Settlement Mechanism, Article 3.1.

[97] ASEAN Protocol on Enhanced Dispute Settlement Mechanism, Article 4.1.

[98] ASEAN Protocol on Enhanced Dispute Settlement Mechanism, Article 3.3.

any covered agreements) and its findings and recommendations in relation to the case".[99] This provision is identical to that of the ASEAN DSM. Any party to the dispute that considers legal interpretations of the panel inconsistent with the Agreement or any other covered agreement may appeal the issues of law to the Appellate Body.[100] The findings and recommendations of the panel and Appellate Body report cannot add to or diminish the rights and obligations provided in the covered agreements.[101] In respect of implementation and surveillance, the protocol stresses the preference for prompt compliance. If compliance is temporarily not possible, compensation, on a voluntary basis, or suspension of concessions or obligations can be authorised. Nevertheless, both compensation and suspension of concessions or other obligations are only temporary measures available.[102]

Dispute Settlement Mechanism Provided in ASEAN+3 Agreements

Under the framework agreements signed by ASEAN and China, Japan and Korea, ASEAN signed a protocol on a dispute settlement mechanism bilaterally with China and with Korea.[103] In respect of Japan, the ASEAN–Japan Agreement on the Comprehensive Economic Partnership Agreement, in Chapter 9, regulates the settlement of disputes. The dispute settlement mechanisms provided for in these agreements take the form of arbitral tribunals, whose decisions are final and binding on the parties to the dispute.[104] To a substantial degree, the dispute settlement mechanisms provided in these three agreements are similar.

The first point to be clarified is the relationship between these dispute settlement mechanisms and the WTO DSM, namely, the competition of jurisdiction or choice of forum issue. All three dispute settlement mechanisms provide for a similar solution. That is, they do not prejudice parties' rights under the WTO Agreement to seek recourse to the WTO DSM or any other forum in accordance with any other

[99] ASEAN Protocol on Enhanced Dispute Settlement Mechanism, Article 7.

[100] ASEAN Protocol on Enhanced Dispute Settlement Mechanism, Article 12.6.

[101] ASEAN Protocol on Enhanced Dispute Settlement Mechanism, Article 14.2.

[102] ASEAN Protocol on Enhanced Dispute Settlement Mechanism, Article 16.1.

[103] Agreement on Dispute Settlement Mechanism of the Framework Agreement on Comprehensive Economic Co-operation between the Association of Southeast Asian Nations and the People's Republic of China (the "ASEAN–China DSM", Vientiane, Lao PDR, 29 November 2004), available at http://www.aseansec.org/16636.htm (last accessed 27/12/2008). Agreement on Dispute Settlement Mechanism under the Framework Agreement on Comprehensive Economic Cooperation among the Governments of the Member Countries of the Association of Southeast Asian Nations and the Republic of Korea (the "ASEAN–Korea DSM", Kuala Lumpur, 13 December 2005), available at http://www.aseansec.org/18130.htm (last accessed 27/12/2008).

[104] The ASEAN–China DSM, Article 8.4; the ASEAN–Korea DSM, Article 14.1; the AJACEP, Article, 69.8.

international agreement.[105] Nevertheless, once parties have chosen either of the two dispute settlement mechanisms, the other procedure is to be excluded.[106] The request for establishment of a panel or referral of a dispute to a dispute settlement panel is deemed as the selection of the forum.[107]

Prior to the composition of an arbitral tribunal, the consultation process should first be conducted. Two types of complaints are identified by the ASEAN–China DSM: any benefit accruing to the complaining party directly or indirectly under the Framework Agreement being nullified or impaired, and the objective of the Framework Agreement being impeded.[108] This arrangement basically models the ASEAN DSM/EDSM, which indirectly traces back to the WTO DSM. The ASEAN–Korea DSM regulates slightly differently. A Party can request consultations in the case of (a) the existence of a measure, instigated by the party complained against, inconsistent with its obligations under the agreements which are covered, or (b) the failure of the party complained against to carry out its obligations under the agreements which are covered that results in nullification and impairment of any benefits accruing to the complaining party by the covered agreements, or the impediment of the attainment of any objective of the covered agreement.[109] In contrast, the AJACEP does not cover the impediment of the objective of the AJACEP. It focuses mainly on the nullification or impairment of any benefit accruing to parties by the agreement as a result of a party's failure to carry out its obligations under the agreement or a party's action that is in conflict with the agreement.[110]

In respect of the function of the arbitral panel, the ASEAN–China DSM and the ASEAN–Korea DSM have almost the same wording. As provided in the ASEAN–China DSM:

> [T]he function of an arbitral tribunal is to make an objective assessment of the dispute before it, including an examination of the facts of the case and the applicability of and conformity with the Framework Agreement. Where the arbitral tribunal concludes that a measure is inconsistent with a provision of the Framework Agreement, it shall recommend that the party complained against bring the measure into conformity with that provision. In addition to its recommendations, the arbitral tribunal may suggest ways in which the party complained against could implement the recommendations. In its findings and recommendations, the arbitral tribunal cannot add to or diminish the rights and obligations provided in the Framework Agreement.[111]

According to this provision, the arbitral tribunal is mandated to make an objective assessment of facts and legal issues of the dispute before it. In addition, the

[105] ASEAN–China DSM, Article 2.5; AJACEP, Article 60.3; ASEAN–Korea DSM, Article 2.4.

[106] ASEAN–China DSM, Article 2.6; AJACEP, Article 60.4; ASEAN–Korea DSM, Article 2.5.

[107] ASEAN–China DSM, Article 2.8; AJACEP, Article 60.5; ASEAN–Korea DSM, Article 2.6.

[108] ASEAN–China DSM, Article 4.1.

[109] ASEAN–Korea DSM, Article 3.1.

[110] AJACEP, Article 62.1.

[111] ASEAN–China DSM, Article 8.1.

arbitral tribunal shall recommend the party to bring the measure into consistency when the panel finds the existence of inconsistency with the Framework Agreement. In the case of this finding, the arbitral tribunal may also suggest the way to implement its recommendation. However, this provision cautions the arbitral tribunal not to add to or diminish rights and obligations provided in the Framework Agreement. The ASEAN–China DSM then directs the arbitral tribunal to make its decision in accordance with the Framework Agreement and rules of international law applicable between the parties to the dispute.[112] Based on similar wording, the ASEAN–Korea DSM further instructs the arbitral tribunal to interpret the relevant provisions of the agreements which are covered in accordance with customary rules of interpretation of public international law, the wording being identical to Article 3.2 of the Understanding on Rules and Procedures Governing the Settlement of Disputes. Those elements are also included in the AJACEP, although regulated in a different fashion.[113]

Finally, as regards the effect of the decision of the arbitral tribunal, it should be final and binding. It is again underlined that preference should be given to prompt compliance with the decision of the arbitral panel. The compensation and suspension of the concessions or benefits are temporary measures available. Compensation is voluntary and should be inconsistent with the framework agreements.[114] When implementation is not possible, the complaining party may have recourse to the original arbitral tribunal to rule on the suspension of concessions and benefits.[115] The ASEAN–Korea DSM and AJACEP contain similar provisions.[116] The preference for prompt compliance is understandable, since the suspension of concessions and benefits merely resumes the state of art prior to the negotiation, which subsequently turns the effort of negotiation fruitless. Nevertheless, it is far too early to predict how effective these dispute settlement mechanisms will be, since they entered into force only recently.

Conclusion

This paper examines the economic regionalism within ASEAN and that extending from ASEAN to its East Asian Counterparts, China, Japan and Korea. I focus on the institutionalisation of ASEAN and ASEAN+3 by looking at their legal architecture. In this paper, I argue that market-driven economic regionalism gradually calls for legalisation and increases the demand for institutionalisation. In respect of ASEAN, I argue that the conferral of legal personality to ASEAN is a significant step forward

[112] ASEAN–China DSM, Article 8.3 (b).

[113] Cf. AJACEP, Article 67.1.

[114] ASEAN–China DSM, Article 13.1.

[115] ASEAN–China DSM, Article 13.3.

[116] ASEAN–Korea DSM, Article 15; AJACEP, Article 72.

both in terms of legalisation and of institutionalisation. The ASEAN DSM and ASEAN EDSM are major efforts for the legalisation of ASEAN. Nevertheless, the ASEAN DSM turned out to be a failure, as the SEOM, in accordance with its discretionary power, decided not to establish a panel. The ASEAN EDSM aims to correct the defects of the ASEAN DSM through compulsory jurisdiction, the establishment of the Appellate Body and automatic adoption of panel and Appellate Body reports. China's willingness to go beyond amicable negation in settlement of its disputes with ASEAN arising from the Framework Agreement and other agreements which are covered also signals the legalisation of the economic regionalism therein. In addition, I point to the development gap within ASEAN member states, which adds complexities and difficulties in shaping its external economic relations and may thus prevent ASEAN countries from maintaining common positions. Regardless of this weakness, given the political antagonism and historical resentment between China and Japan on the one hand and China and Korea on the other, ASEAN, building upon its existent institution, has managed to achieve "ASEAN centrality" in the process of economic regionalism within ASEAN+3. By exploring the negotiations between ASEAN and China, Japan and Korea, I found that some patterns can be registered. The negotiations were initiated through a framework agreement under which agreements on specific sectors were subsequently concluded. In addition, a clear competition among China, Japan and Korea in their FTA games with ASEAN can be delineated. In these FTA games, China's non-market economy status in the WTO and ASEAN's non-WTO member state, namely, Lao PDR, present some peculiar features in their designation in correspondence with the WTO law. China aims to disapply Section 15, 16 of its Accession Protocol and paragraph 242 of its Working Party Report in its economic relations with ASEAN. By contrast, ASEAN asks for WTO-consistent Most-Favoured-Nation Treatment for its non-WTO member state. I also emphasise the importance of the Asian financial crisis, which is actually the starting point of this paper, in shaping economic regionalism in ASEAN and ASEAN+3. While trade liberalisation is the major element in pursuit of economic regionalism, the historical experiences taught Asian countries to pay equal attention to financial cooperation.

Part III
International Economic Institutions

The Doha Development Agenda at a Crossroads: What Are the Remaining Obstacles to the Conclusion of the Round?

Edwini Kessie

Introduction: The Trajectory of a Troubled Round

The Doha Round was launched in November 2001 with the expectation that it would breathe new life into the global economy, which had been sent into a tailspin following the attacks of 11 September 2001, and strengthen the multilateral trading system to enable it to meet the challenges of the twenty-first century. A number of studies have indicated that a successful Round would boost global trade and enhance global welfare by several billions of dollars. The World Bank has postulated that a reduction of barriers in the agriculture sector would increase global income by as much as US $400 billion by 2015, and that a 50% reduction in barriers to services trade would result in gains four times larger than gains from liberalisation of non-services trade.[1] Professors Stern, Deardoff and Brown have estimated that reducing barriers to trade in agriculture, manufacturing and services by a third could increase global income by US $686 billion, while doing away with

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[1]World Bank, "Global Economic Prospects and Developing Countries: Making Trade Work for the Poor", Washington, 2002 and "Global Economic Perspectives 2004: Realizing the Development promise of the Doha Agenda", 2004. See also speech delivered by the former Director-General Supachai Panitchpakdi, to the World Summit on Sustainable Development entitled "Trade and Sustainable Development: The Doha Development Agenda", in Johannesburg on 3 September 2002 quoting the World Bank report.

C. Herrmann and J.P. Terhechte (eds.), *European Yearbook of International Economic Law 2010*, European Yearbook of International Economic Law,
DOI 10.1007/978-3-540-78883-6_16,

all trade barriers could increase global income by as much as US $2.1 trillion dollars.[2] A recent study by the International Food Policy Research Institute (IFPRI) indicates that failure to conclude the Round would prevent a US $336 billion increase in world trade that would have come from a reduction in tariffs and domestic support.[3]

With so much goodwill and optimism, WTO Members set themselves the ambitious goal of concluding the Doha Round by 1 January 2005. The negotiations began at high tempo leading to the circulation of draft modalities for agriculture in February 2003. There was the realisation and tacit understanding among WTO Members that without progress on agriculture, it would be difficult to see any substantive movement on the other negotiating issues. However, Members failed to agree on the draft modalities in March 2003 providing the first wakeup call that the negotiations were not going to be easy and that the deadline of 1 January 2005 may not be met. What was particularly revealing were the sharp positions taken by Members on the issues under consideration and the vigour with which they defended and stuck by them.

Despite intensified negotiations, Members were not able to bridge their differences in time for the fifth Ministerial Conference in Cancún, Mexico in September 2003. Following the collapse of the Conference, Members regrouped and made another attempt to agree on the modalities for agriculture and non-agricultural market access (NAMA). With ominous signs of failure, Members managed to scrape home a framework agreement on agriculture, NAMA and other areas of the negotiations and committed themselves to working “towards the conclusion of a balanced overall outcome of the Doha Development Agenda in fulfilment of the commitments Ministers took at Doha”.[4] They were conscious that another failure would have made it extremely difficult to sustain interest in the negotiations with the possibility of their demise. However, Members were unable to build on the momentum generated by the framework agreement and failed to agree on the modalities for agriculture and NAMA in July 2005.

With the appointment of Pascal Lamy as Director-General of the WTO in September 2005, there was renewed optimism that the modalities could probably be adopted at the Sixth WTO Ministerial Conference in Hong Kong, China in December 2005 and the negotiations concluded by the end of 2006. Given a hardening of the negotiating positions of the major players on the key issues and the unwillingness to compromise and accommodate the interests of other Members, DG Lamy exhorted Members to recalibrate their expectations of the Ministerial Conference. This advice was realistic and very appropriate as heightened expectations carried the risk of undermining the credibility of the WTO should the

[2]Multilateral, Regional, and Bilateral Trade-Policy Options for the USA and Japan, 2002: http://www.fordschool.umich.edu/rsie/workingpapers/Papers476-500/r490.pdf. See further Brown/Deardoff/Stern, Computational Analysis of Multilateral Trade Liberalization in the Uruguay Round and the Doha Development Round, Discussion Paper 489, 2002.

[3]Bouët/Laborde, The Potential Cost of a Failed Doha Round, IFPRI Issue Brief 56 (2008): http://www.ifpri.org/pubs/ib/ib56.pdf.

[4]Decision of the General Council on the Doha Work Programme, WT/L/579; 2 August 2004.

Conference fail to produce any tangible results. As expected, Members could not bridge their differences and agree on the modalities for agriculture and NAMA at the Conference, but they resolved "to complete the Doha Work Programme fully and to conclude the negotiations launched at Doha successfully in 2006".[5]

Given the ambitious goal to agree on the modalities by April 2006 and complete the negotiations by December 2006, the year started with a flurry of activity but no substantive progress was made in narrowing the differences in the positions of Members prompting the Director-General to suspend the negotiations in July 2006. The suspension of the negotiations forced Members to confront the distinct possibility of a possible breakdown in the negotiations and convinced them of the need to make the necessary compromises to achieve the modalities for agriculture and NAMA. The negotiations were formally resumed in February 2007 and revised draft texts were presented in July 2007 by the chairpersons of the agriculture and NAMA negotiations for the consideration of Members. After intensive negotiations both in Geneva and in capitals, some progress was made in narrowing the differences in Members' positions on the key issues prompting the Director-General to convene a Ministerial meeting in Geneva in July 2008 with a view to adopting the modalities and concluding the Round by December 2008.

The meeting got off to a bad start, but the atmosphere greatly improved with the acceptance by the United States of a 70% reduction of its overall trade-distorting support. It had earlier proposed that its support should be reduced by 53%, which was rejected by the G-20. The EC also accepted deeper cuts to its tariffs and reached an agreement on bananas with the MFN suppliers at the margins of the meeting. Most of the contentious issues in the negotiations were resolved, but unfortunately agreement could not be reached on the conditions which should be imposed on the activation of the Special Safeguard Mechanism (SSM) for developing countries. Specifically, there was disagreement as to the level by which imports should increase before a developing country could resort to the safeguard mechanism. Whereas India and China pressed for a lower threshold, the United States pressed for a higher threshold to prevent abuse of the mechanism by developing countries.

A further attempt to agree on the modalities in December 2008 was abandoned after it became clear that negotiating positions had not evolved significantly and that the outgoing US Administration was reluctant to accede to a major agreement just before it was about to leave office. Members were also uncertain whether such an agreement would receive congressional approval, especially considering the lapse of the Trade Promotion Authority of the US President. Currently, it appears that WTO Members are waiting for the new US Administration to settle down before making a fresh attempt to agree on the modalities.[6] The new USTR, Ron

[5]The Hong Kong Ministerial Declaration, WT/MIN(05)/DEC; 22 December 2005, para. 1 at p. 1.

[6]The WTO Director-General, Pascal Lamy is quoted as saying that a renewed push to conclude the Doha Round cannot begin until the USA was ready to engage: http://www.forbes.com/feeds/reuters/2009/04/24/2009-04-25T030504Z_01_N24461769_RTRIDST_0_TRADE-LAMY-UPDATE-2.html.

Kirk, is reported to have said that it would be premature for a WTO Ministerial meeting to be held in the summer, as the USA was in the process of assessing the Doha package and determine the benefits for the USA.[7] In the meantime, the global economy has suffered one of the worst recessions since the Great Depression and world trade is forecast to contract by almost 10% in 2009. There is no doubt that a successful conclusion of the Doha Round would re-inject confidence among investors and give a vital boost to the flagging global economy.

The objective of this paper is to underline the key issues in the agriculture and NAMA negotiations and assess if the July 2008 Ministerial meeting brought Members closer to fulfilling the Doha mandates. In that context, it highlights the main areas where significant differences still remain in Members' positions and as such make it difficult for modalities to be elaborated paving the way for the conclusion of the Doha Round. An overview is also provided of the key issues in the other negotiating areas. The paper concludes by noting that if the Doha mandates are to be fulfilled, all Members – developed and developing – should be prepared to move from their entrenched positions and make compromises which would pave the way for the quick adoption of the modalities for agriculture and NAMA. The developed countries should substantially reduce their tariffs and subsidies, and developing countries should endeavour to increase their level of ambition by not seeking broader exemptions from the rules which already grant them special and differential treatment (SDT) and improve the quality of their offers in the services negotiations. In the current global economic environment, an agreement would only be possible when all Members feel that they have obtained significant concessions in comparison with what they had to give up. Any imbalanced agreement would not be accepted and only delay the conclusion of the Doha Round.

Scope of the DDA Negotiations[8]

A distinction needs to be drawn between issues falling under the single undertaking and those falling outside of it. Among the issues falling under the former are agriculture and services, in respect of which negotiations were already foreseen under the Uruguay Round Agreements on Agriculture and Services, NAMA, rules (anti-dumping, subsidies and countervailing measures, regional trade agreements), trade and environment, dispute settlement and the establishment of a multilateral register of geographical indications for wines and spirits. There is disagreement

[7]Kirk, Trade and the Economic Agenda: Serving America's Families and the Global Economic Recovery: speech delivered at the Georgetown University Law Centre in Washington DC on 23 April 2009.

[8]This section draws on earlier publication by the author on the same subject: The Doha Development Agenda after the Hong Kong Ministerial Conference: Narrowing the Gaps in Members' Negotiating Positions, in: Hofman/Tondl, *The European Union and the WTO Doha Round*, 2007.

among developed and developing-country Members on whether implementation and SDT are part of the single undertaking. To some extent, this issue is moot, as developing countries would like to see tangible progress on these issues whether or not they are considered as part of the single undertaking.

The following issues are part of the Doha-Development Agenda but outside the single undertaking. TRIPS and Public Health, moratorium on non-violation complaints in relation to the TRIPS Agreement, Small Economies, Trade, Debt and Finance, Trade and Transfer of Technology, Technical Co-operation and Capacity Building, Least-Developed Countries and Electronic Commerce. Work on these issues is being undertaken in WTO regular bodies under the overall supervision of the General Council. As previously pointed out, the focus of this paper is on agriculture and NAMA given their centrality to the Doha negotiations.

Agriculture

With respect to agriculture, Ministers at the Doha Ministerial Conference took note of the work already undertaken pursuant to Article 20 of the Uruguay Round Agreement on Agriculture and reconfirmed that the long term objective of the reform of the agriculture sector was “to establish a fair and market-oriented trading system through a programme of fundamental reform encompassing strengthened rules and specific commitments on support and protection in order to correct and prevent restrictions and distortions in world agricultural markets”.[9] They committed themselves to comprehensive negotiations aimed at “substantial improvements in market access; reductions of, with a view to phasing out, all forms of export subsidies; and substantial reductions in trade-distorting domestic support”. Members agreed to provide effective SDT to developing countries and also to take into account the non-trade concerns of Members. They further agreed to establish full modalities by 31 March 2003 and submit comprehensive draft Schedules based on the modalities no later than the date of the Fifth Session of the Ministerial Conference, which took place in Cancún, Mexico from 10–14 September 2003.[10]

In the WTO, it could be said that there are two broad schools of thought on how the agricultural sector should be reformed. On the one hand are countries which believe that the agricultural sector is not significantly different from other sectors such as non-agricultural products and services, and should be subjected to the same disciplines prevailing in these sectors, including the prohibition of subsidies and the elimination or substantial reduction of tariffs. While they recognise the importance of issues such as food security, preservation of rural life and the environment, they believe that these considerations should not impede market access and thwart the reform of this sector. On the other hand are countries which believe that the

[9]Paragraph 13 of the Doha Ministerial Declaration, WT/MIN(01)/DEC/1.

[10]Paragraphs 13 and 14 of the Doha Ministerial Declaration, *ibid.*

agricultural sector is unique and distinct from other sectors. They believe that governments should have the possibility to support agriculture through a range of policies, including subsidies and tariffs to further the interests of domestic producers.[11]

The Doha mandate was seen as very ambitious by many Members who expected a very high level of market opening through the substantial reduction of tariffs and domestic support. They also expected the distortions created by exports subsidies and related instruments to be eventually phased out. It has been obvious in the negotiations that Members do not have a common understanding of the scope of the mandate in agriculture. Whereas agricultural exporting nations have a very high level of ambition, countries which maintain restrictive policies have urged gradual reform of the agricultural sector. A major sticking point in the negotiations is how to accommodate the non-trade concerns of countries and how to give effective SDT to developing countries without undermining the very structure of the Agreement and the overall Doha mandate that there should be a substantial improvement in market access and a substantial reduction of trade-distorting domestic support.

It has been debated whether the non-trade concerns of countries should be accommodated through lower reduction commitments in respect of tariffs and subsidies, particularly for the so-called sensitive products. Similarly, differing views have been offered as to how best to accommodate the interests of developing countries. While some developing countries do not want to take on any significant obligations and are seeking broader exemptions from the agreed rules, other Members have expressed the view that apart from least-developed countries (LDCs), all developing countries, particularly the economically-advanced ones, should take on responsibilities commensurate with their levels of development.

An analysis of the latest draft modalities text[12] below shows how it has been difficult to merge the contradictory and opposing views of WTO Members.

Market Access Pillar

One of the principal reasons for launching the Doha Round was to improve market access for agricultural products. Most developing countries are dependent on the agricultural sector and it was clear that without the pledge to substantially improve market access for agricultural products, they would not have supported the decision to launch the Round. For a number of them, an acid test of the success of the Doha Round would depend on how far this undertaking is delivered. Realising the pivotal role of this sector in the overall Doha negotiations, Members have worked painstakingly through the issues under this pillar.

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[11]See speech delivered by the Director-General Pascal Lamy to the International Institute of Economics entitled “The Doha Development Agenda: Sweet Dreams or Slip Slidin’ Away” in Washington DC, 17 February 2006.

[12]Revised Draft Agriculture Modalities Text, TN/AG/W/4/Rev.4; 6 December 2008.

At the Hong Kong Ministerial Conference, it was agreed that a tiered formula would be used to reduce Members' tariffs which were to be grouped in four bands. While there was broad agreement on the first three bands, there were sharp differences on the cut to be made in the top band. Whereas the USA had proposed that tariffs in the top band be reduced by between 85% and 90%, the G-20 and the EC had proposed cuts of 75 and 60%, respectively. Unable to find common ground among the key players, the Chairman proposed that tariffs in the top band should be reduced by between 66% and 73%. During the July 2008 meeting, after much haggling and prodding by DG Lamy, the parties agreed to a 70% cut in the top band.

In exchange for agreeing to an average cut of 54%, Members such as Japan, Switzerland and the EC insisted on flexible treatment for their sensitive products. The EC had proposed that developed-country Members should be allowed to designate 8% of their tariff lines as sensitive products, while Japan, Switzerland and their G-10 partners had proposed 15%. The USA and Brazil favoured a very low figure as they feared that greater flexibility would undermine Members' market access commitments. With a hardening of Members' positions on this issue, the Chairperson proposed that developed-country Members be allowed to designate either 4% or 6% of their tariff lines as sensitive. Where a Member had more than 30% of its tariffs in the top band, it could designate an additional 2% to make it either 6% or 8%. In terms of treatment for eligible products, the chairperson proposed that there could be a two-thirds, one-half or one-third deviation from the envisaged regular cuts. As compensation for this special treatment, Members would be expected to establish tariff quotas which shall result in new access opportunities equivalent to 4%, 3.5% and 3% of domestic consumption depending on the deviation from the regular cut.

While there is broad agreement on the envisaged treatment, there are sharp divisions on the number of tariff lines that could be designated as sensitive by developed-country Members and the method of designation.[13] At the July 2008 meeting, DG Lamy's proposal that the number be limited to 4% was broadly welcomed by a number of agricultural-exporting countries. However, as recorded in the latest draft modalities text, this proposal has been opposed by Canada and Japan who are pressing for further flexibilities.[14] There is also no agreement on which products could be declared sensitive. Some Members maintain that it should not be possible for new tariff quotas to be created. In other words, eligible products must be those which already had tariff quotas before the Doha Round commenced. The alternative view is that any product may be declared sensitive. There is also no agreement on whether a tariff cap should be imposed. The Chairman offers a hybrid solution in the latest draft modalities text. As a general rule, tariffs can exceed 100% on sensitive products, but Members would be expected to compensate for that by increasing the tariff quota for that product by 0.5% of domestic consumption.

[13]Revised Draft Modalities for Agriculture, Sensitive Products: Designation, TN/AG/W/5; 6 December 2008.

[14]Revised Draft Agriculture Modalities Text, *supra* note 12 at p. 16.

In a limited number of cases, tariffs for non-sensitive products could exceed 100%.[15]

Another issue on which substantial progress has been made but some loose ends may have to be tied is the issue of special products. Under the Chairman's proposal, developing countries could designate 12% of their tariff lines as "special products" on the basis of food security, rural development and livelihood security. Five percent of the tariff lines would be subjected to no tariff cuts and the average tariff cut shall not exceed 11%.[16] There are special rules for small and vulnerable economies and recently-acceded Members. The G-33 wants further flexibilities but some developed and developing countries think the existing provisions are more than adequate. They are concerned that with the possibility to also designate 5.3% of their tariff lines as "sensitive", developing countries would be able to effectively restrict access to their markets.

There has been little progress on the conditions which should be attached to the SSM, which would allow developing countries to increase their tariffs in the event of import surges or a decline in the prices of commodities. Under the envisaged disciplines, the SSM would be available for all agricultural products, but the volume trigger and the price trigger cannot be imposed simultaneously, nor can the SSM be activated in respect of a product which is already facing restrictions under Article XIX of the GATT 1994 or under Article 5 of the Agreement on Agriculture.[17] It will be recalled that the July 2008 Ministerial meeting reportedly collapsed as a result of the differences between the United States and India over the threshold of the volume trigger. Whereas India wanted developing countries to be able to activate the SSM when imports increase by 15%, the United States and other agricultural producing countries were in favour of a higher threshold – 40% – as they were concerned about potential abuse by developing countries.[18] The G-33 has cautioned that the conditions should not be too stringent to prevent recourse to the mechanism by developing countries. There is also no agreement on the scope of the remedy in the event of the invocation of the mechanism. Whereas some developing-country Members insist that they should be able to exceed their pre-Doha bound rates, others disagree. In the latest draft modalities text, it would be possible for the pre-Doha bound rates to be exceeded but the magnitude of the remedy would be dependent on the level at which the base imports is exceeded.

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[15] Revised Draft Agriculture Modalities Text, *ibid*, paras 71–76, pp. 16–17.

[16] Revised Draft Agriculture Modalities Text, *ibid*, para. 129 at p. 23.

[17] Revised Draft Agriculture Modalities Text, *ibid*, paras 132–145, pp. 24–26.

[18] Baldwin, Resolving the Conflict Leading to the Collapse of the Doha Round, 25 September 2008, http://www.voxeu.org/index.php?q=node/1697.

Domestic Support Pillar

Considerable progress has been made on the issues falling under the domestic support pillar since the Hong Kong Ministerial Conference, where some important decisions were taken. It was agreed by Ministers that there would be three bands for reductions of Members' Final Bound Total Aggregate Measurement of Support (AMS) and the Overall Trade-Distorting Domestic Support (OTDS), and that the EC would be in the first band, followed by Japan and the USA in the second band and other Members in the third band. Ministers also endorsed the progressivity principle by stating that there would be higher linear cuts in higher bands.[19]

What could not be decided in Hong Kong, China was the level of cuts to be made in each of the bands, particularly as regards the OTDS. In its October 2005 proposal, the USA had proposed the following rate of reductions: first band ($60 billion+:75% cut); second band ($10–60 billion: 53% cut) and third band ($0–10 billion:31% cut). This proposal provoked a strong reaction from Members, particularly those belonging to the G-20 and the Cairns Group, who believed that the proposed cut in the second band was grossly inadequate and would allow the USA to provide support far in excess of what it was actually granting.

Substantial progress was made on this issue during the Ministerial meeting in July 2008 when the USA indicated that it was prepared to accept a cut of 70%, which would bring its support from US $48.2 billion to US $14.5 billion. This progress is captured in the Chairman's text, which now proposes a reduction of 80% by the EC, a 75% cut by Japan, a 70% cut by the USA and a 55% cut by other Members.[20] There is also broad agreement on the rate of reductions of Members' AMS; in his text, the Chairman proposed that the EC should make a cut of 70%, Japan and the USA a cut of 60% and other Members a cut of 45%.[21] There is also broad agreement on product-specific AMS limits to ensure that support is spread out and not concentrated on a few products.[22]

A number of understandings have also been reached on the other issues under the domestic support pillar. There is broad consensus that the *de minimis* support of developed-country Members would be reduced by 50% from 5% to 2.5% of the total value of agricultural production.[23] Developing countries with AMS support would be expected to reduce their support by 33.3% from 10% to 6.7% of the total value of agricultural production.[24] There is agreement that blue box support will be capped at 2.5% and 5% of the total value of agricultural production for developed and developing countries, respectively.[25] Members have also agreed on tightened

[19]The Hong Kong Ministerial Declaration, *supra* note 5, para. 5 at p. 1.

[20]Revised Draft Agriculture Modalities Text, *supra* note 12, para. 3 at p. 4.

[21]Revised Draft Agriculture Modalities Text, *ibid*, para. 13 at p. 6.

[22]Revised Draft Agriculture Modalities Text, *ibid* at paras. 21–29, pp. 7–8.

[23]Revised Draft Agriculture Modalities Text, *ibid* at para. 30 at p. 9.

[24]Revised Draft Agriculture Modalities Text, *ibid* at para. 31 at p. 9.

[25]Revised Draft Agriculture Modalities Text, *ibid* at paras. 35–52, pp. 10–12.

disciplines to ensure that blue box support payments do not become more trade-distorting than amber-box support.[26] Strengthened disciplines on the Green Box have also been agreed to ensure that support payments do not cause or minimally cause distortions to production and trade.[27]

Overall, most of the contentious issues under the domestic support pillar have been resolved and there can be guarded optimism that none of the issues would be a deal breaker in any future round of negotiations with the possible exception of cotton, in respect of which developed-country Members are being asked to reduce their support over and above the agreed cut for other agricultural products within a limited timeframe.[28] This is intended to fulfil the commitment to address the cotton issue “ambitiously, expeditiously, and specifically, within the agriculture negotiations”.[29] While there is broad support for the Chairman’s proposal, it is not clear whether it enjoys the support of the United States which provides massive support to its cotton sector. It will be recalled that the cotton issue was not discussed at the July 2008 Ministerial meeting following the floundering of the negotiations over the SSM issue.

Export Competition Pillar

Unlike the market access and domestic support pillars where there are still a number of unresolved issues, there is virtually agreement or broad understandings on almost all the issues under the export competition pillar. Given the very harmful effects of export subsidies, particularly on developing countries, agreement was reached at the Hong Kong Ministerial Conference in December 2005 that export subsidies and measures having equivalent effect, including export credits shall be eliminated by 2013, with a substantial part to be eliminated in the first half of the implementation period.[30] While this decision was welcomed by several Members, others were less than enthusiastic. These Members pressed for their elimination at the latest by 2010, but the EC insisted on 2013 in line with the reform of its Common Agricultural Policy. Given that it was a unilateral offer from the EC, Members eventually agreed to the proposed date of elimination. The time-frame for developing countries was

[26]See generally Sophia/Suppan, The New Blue Box: A Step Back for Fair at http://www.iatp.org and Jales, Blue Box Criteria: Assuring that the New Blue Box is Significantly Less Trade-Distorting at http://www.iconebrasil.org.br/Publicacoes/Jales_Blue%20Box%20Criteria.pdf:2005.

[27]Revised Draft Agriculture Modalities Text, *supra* note 12, para. 53 at p. 12 and Annex 2, pp. 39–43.

[28]Revised Draft Agriculture Modalities Text, *ibid*, paras 54–58 at p. 13.

[29]Decision of the General Council on the Doha Work Programme, *supra* note 4, para. 4 of Annex A at p. A-1.

[30]The Hong Kong Ministerial Declaration, *supra* note 5, para. 6 at p. 2.

subsequently extended to 2016.[31] In other words, they have been given an additional three years to phase out all forms of export subsidies.

Broad agreement has also been reached on other contentious issues under the export competition pillar, including export credit guarantees,[32] state trading enterprises[33] and international food aid.[34] With respect to export credit guarantees, there is agreement that they should not confer subsidies on the recipients. To that end, the Chairman's text provides that they should operate on commercial terms, including repayment periods no longer than 180 days. The programmes should also be self-financing in the sense that costs should be recovered according to a commercially viable standard over a rolling period of 4–5 years. SDT is envisaged when a developing country is providing the credit, and when the payee is a least-developed or net food-importing developing country in which case they would be allowed between 360 and 540 days to repay.[35]

Regarding agricultural state trading enterprises (ASTEs), there is an understanding that they should operate in accordance with commercial considerations as foreseen in Article XVII of the GATT 1994 and the Understanding on its Interpretation. They would be obliged to eliminate export subsidies and their preferential access to capital and special privileges with respect to government financing and re-financing facilities would be severely restricted. The underwriting of losses, reimbursement of costs, or write-downs or write-offs of debts owed to, or by an ASTE shall be prohibited. One issue which has not been completely resolved is whether monopoly powers of ASTEs should be outlawed or merely disciplined.[36] With respect to international food aid, there is broad agreement that it should not lead to commercial displacement. To that end, the Chairman's text contains a number of principles which would ensure the achievement of this objective. It is envisaged that weaker disciplines would apply to food aid given in response to an emergency declared by the United Nations or the recipient country.[37]

Non-Agricultural Market Access

Although average tariffs in OECD countries are around 3.8%, developing countries pressed for the inclusion of this issue in the DDA. They argued that the low figure of 3.8% obscured the fact that major exports such as leather and leather products,

[31]Revised Draft Modalities for Agriculture, TN/AG/W/4/Rev.1; 8 February 2008, para. 155 at p. 24.

[32]Revised Draft Agriculture Modalities Text, *supra* note 12, para. 165 at p. 30 and Annex J, pp. 66–68.

[33]Revised Draft Agriculture Modalities Text, *ibid*, para. 166 at p. 30 and Annex K, pp. 69–70.

[34]Revised Draft Agriculture Modalities Text, *ibid*, para. 167 at p. 31 and Annex L, pp. 72–74.

[35]Revised Draft Agriculture Modalities Text, *ibid*, Annex J, pp. 66–68.

[36]Revised Draft Agriculture Modalities Text, *ibid*, Annex K, pp. 69–70.

[37]Revised Draft Agriculture Modalities Text, *ibid*, Annex L, pp. 70–72.

textile and clothing products and fish and fish products continue to face high tariffs in developed countries. While most of the tariff peaks of developed countries fall in the range of 12–30%, there is a considerable number that exceeds 30%. In that context, it has been pointed out that one-fifth of US peak tariffs, one-quarter of those of the European Union, almost a third of Japan's and one-seventh of Canada exceed 30%.[38] The prevalence of tariff peaks and tariff escalation has been cited as one of the main reasons why developing countries, particularly LDCs, cannot increase and diversify their export base to increase earnings and achieve rapid economic growth. Developed countries also welcomed the broadening of the negotiations to cover non-agricultural products given the very high tariffs of developing countries on products of export interest to them.

Given the consensus among Members about the inclusion of NAMA in the DDA negotiations, the Declaration attempted to merge the interests of all countries. Paragraph 16 thereof provides that the negotiations "shall aim at reducing or as appropriate the elimination of tariffs, including the reduction or elimination of tariff peaks, high tariffs and tariff escalation, as well as non-tariff barriers, in particular for products of export interest to developing countries". It also provides that developing countries should be given SDT and that account should be taken of the principle of less than full reciprocity in tariff concessions. As to what these exactly mean have been a bone of contention between developing and developed countries. It is widely assumed that the reference to high tariffs was meant to reflect the interests of developed countries, which have been insisting that key developing countries should significantly reduce their tariffs so as to provide them with new export opportunities. For several developed countries, this objective would not be met if developing countries reduced and bound their tariffs above their current applied rates.

Like the mandate on agriculture, the one on NAMA has also been interpreted differently by Members. Developed countries and some developing countries have a very high level of ambition and would like to see significant reduction and elimination of tariffs where possible, while other developing countries are concerned about the loss of tariff revenue and the need to protect their nascent industries from competition. Notwithstanding the different views on the scope of the Doha mandate, considerable progress has been made in the NAMA negotiations as can be seen from the latest draft modalities text.

[38]Nmai, *Africa's Interests in the NAMA negotiations*, 2004; see further the Joint Study by UNCTAD and WTO on "The Post-Uruguay Round Tariff Environment for Developing Country Exports: Tariff Peaks and Tariff Escalation"; TD/B/Com.1/14/Rev.1; 28 January 2000. See further commentary on the study by the Third World Network: http://www.twnside.org.sg/title/undpref.doc.

Formula and Flexibilities

Considerable progress has been made since the Hong Kong Ministerial Conference where Ministers committed themselves to using the Swiss Formula as the main modality to achieve substantial tariff cuts.[39] What was not decided at Hong Kong was whether it was going to be a simple Swiss formula with two coefficients, one for developed countries and the other for developing countries, or whether it was going to be a Swiss-type formula where account would be taken of Members' average tariff rates. The linkage between the formula and flexibilities for developing countries was also not thoroughly clarified in the Declaration. There is now agreement that a simple Swiss formula would be used and that developed countries would use a co-efficient of 8, while developing countries would have the choice of 20, 22 and 25 depending on the flexibilities chosen.[40] Should a developing country choose a co-efficient of 20, it would be entitled to make less than formula cuts on 14% of its tariff lines provided that the cuts are no less than half the formula cuts and that these tariff lines do not exceed 16% of the total value of a Member's non-agricultural imports. Alternatively, that Member can keep as unbound 6.5% of its tariff lines or exempt them from any cuts, provided they do not exceed 7.5% of the total value of that Member's non-agricultural imports.[41]

Where a co-efficient of 22 is chosen, the developing-country Member could make less than formula cuts on 10% of its tariff lines provided that the cuts are no less than half the formula cuts and that these tariff lines do not exceed 10% of the total value of a Member's non-agricultural imports. Alternatively, that Member can keep as unbound 5% of its tariff lines or exempt them from any cuts, provided they do not exceed 5% of the total value of that Member's non-agricultural imports.[42] Where a co-efficient of 25 is chosen, the Member would not be entitled to exempt or make less than formula cuts on any of its tariff lines.[43] There is also broad agreement that developing-country Members would not use these flexibilities to exclude entire HS Chapters from tariff cuts. To that end, the Chairman's text proposes that "full formula tariff reductions shall apply to a minimum of either 20% of national tariff lines or 9% of the value of imports of the Member in each HS Chapter".[44]

[39]The Hong Kong Ministerial Declaration, *supra* note 5, para. 13 at p. 4.

[40]Revised Draft NAMA Modalities Text, TN/MA/W/103/Rev.3; 6 December 2008, para. 5 at p. 2.

[41]Revised Draft NAMA Modalities Text, *ibid*, para. 7(a) at p. 3.

[42]Revised Draft NAMA Modalities Text, *ibid*, para. 7(b) at p. 4.

[43]Revised Draft NAMA Modalities Text, *ibid*, para. 7(c) at p. 4.

[44]Revised Draft NAMA Modalities Text, *ibid*, para. 7(d) at p. 4.

Treatment of Unbound Tariffs and Members with Low Binding Coverage

Regarding unbound tariffs, there was the initial suggestion that the base rate should be established by doubling the MFN applied rate, but this was strongly opposed by countries with low applied tariffs. They favoured a constant non-linear mark up of the MFN applied rate. There is now agreement that the base rate would be established by adding 25 to the MFN applied rate. With respect to Members with low binding coverage, there is now broad consensus that they would bind either 75% or 80% of their tariffs at an average rate of 30%.[45]

Preference Erosion

One of the sticking points in the negotiations has been how to address the issue of the erosion of preferences, which will occur as a result of the reduction of MFN tariffs. With the decision that developed countries would use a co-efficient of 8, no tariff of theirs any developed-country Member would exceed 8% and consequently would affect the margins of preferences enjoyed by LDCs and other poorer developing countries in the key markets, particularly the European Union and the United States. In response to this, the ACP Group of countries initially proposed a correction co-efficient to be used in the formula so as to protect their preferences. They stressed that it was important for their industries to be given time to adjust, otherwise they would lose market share and impede efforts aimed at enhancing their participation in the multilateral trading system. Their proposal did not attract broad support, particularly from other developing countries who argued that the very purpose of the Doha negotiations was to improve and not to restrict market access.

In the latest draft modalities text, the Chairman acknowledged that "MFN liberalization resulting from the DDA will erode non-reciprocal preferences in respect of a limited number of tariff lines which are of vital export importance for developing Members beneficiaries of such preferences" and that it was important for them to be given additional time for adjustment.[46] To that end, he proposes that instead of the implementation of tariff cuts in six equal instalments over five years, preference-granting countries would be expected to implement cuts on the eligible tariff lines in nine instalments, with the first cut taking place two years after the entry into force of the DDA results. The Chairman also urges donor countries to increase their assistance to these countries through initiatives such as the Enhanced Integrated Framework and other Aid for trade initiatives.[47]

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[45]Developing countries (Cameroon; Congo; Côte d'Ivoire; Cuba; Ghana; Kenya; Macao, China; Mauritius; Nigeria; Sri Lanka; Suriname; and Zimbabwe) which have bound less than 15% of their tariff lines would be expected to increase the level of their binding to 75%, while those which have bound more than 15% will be expected to increase the level to 80%: Revised Draft NAMA Modalities Text, *ibid*, para. 8 at p. 5.

[46]Revised Draft NAMA Modalities Text, *ibid*, para. 28 at p. 11.

[47]Revised Draft NAMA Modalities Text, *ibid*.

Reflecting the opposition to the demands of the ACP Group by other developing countries, the Chairman's text also recognises that a group of countries (Bangladesh, Cambodia, Nepal, Pakistan and Sri Lanka) would be disproportionately affected by the contemplated measures as they export the eligible products without preferences to the United States and the European Union. To that end, the text proposes that tariff cuts "on the relevant tariff lines shall be implemented, by waiver of Article I of the GATT of sufficient duration to cover the full implementation period, in six equal rate reductions, in the relevant preference granting markets", with the first reduction taking place one year after the entry into force of the DDA results.[48] This proposal was initially objected to by the ACP states, but it appears that they have softened their stance in the spirit of compromise.

Sectorals

The July 2004 General Council Decision provides that Members may wish to consider sectoral negotiations as a supplementary modality to achieve the objective of improving market access for non-agricultural products.[49] In sectoral negotiations, the Members may agree to eliminate or substantially reduce duties in a particular sector, thus going beyond what may be achieved by the main tariff modality. For a sectoral to be effective, it is imperative that there be a critical mass of countries which account for the bulk of trade in that sector. Two key principles have been agreed by Members regarding the conduct of sectoral negotiations, namely that participation is not mandatory and that the results of the negotiations would be applied on a non-discriminatory basis.

Developed-country Members have been strong proponents of sectoral negotiations, as they believe that with the many exemptions from the formula, it is one of the principal mediums through which an ambitious result may be obtained. To that end, they would like key developing countries to participate in some sectoral initiatives, otherwise any eventual agreement may not achieve the desired objectives. However, some key developing countries have not been enthusiastic about sectorals, mainly because of the desire to shield their domestic companies from competition and also to safeguard customs revenue. To that end, they insist on the strict observance of the voluntary nature of such negotiations and reject any attempt to require countries to participate in them.

In attempting to break the deadlock on this issue, DG Lamy proposed at the July 2008 Ministerial meeting that developing countries which join sectorals should be allowed to use a higher co-efficient: "Any developing country Member participating in final sectoral initiatives will be permitted to increase its coefficient (in such increment as will be determined no later than two months from the date of establishment of these modalities) commensurate with its level of participation in

[48] Revised Draft NAMA Modalities Text, *ibid*, para. 7(d) at p. 4.

[49] Decision of the General Council on the Doha Work Programme, *supra* note 4, para. 7 at p. B-2.

sectoral initiatives".[50] This proposal was not well-received by some developing countries which argued that it ignored the agreed principle that participation in sectorals is non-mandatory. By linking participation to the co-efficient that could be used, developing countries were indirectly being coerced into participating in sectorals.

It has been reported that China and India found it difficult to accept the proposed language on sectorals, as it would have obliged it to commit to negotiating the terms of at least two sectoral tariff negotiations.[51] To assuage the fears of China, India and other developing countries, the Chairman's latest text drops the connection between coefficients and participation in sectorals, and makes it clear that participation in a sectoral negotiation would be on a self-identified basis and without prejudice to its outcome: "participation in the negotiation of the terms of a sectoral initiative shall not prejudge a Member's decision to participate in that sectoral initiative the negotiations".[52] Notwithstanding the clarification, there still has not been progress on this issue. As noted by the Chairman in the introduction to his text, "[e]ven though the included text is accepted as a basis for further work, we are far from a consensus among Members".[53] Some developed countries consider that the current text dilutes the Lamy text which would have committed some countries to participating in at least two sectoral negotiations.

Other Areas of the Negotiations

Services

With respect to Services, Ministers took note of the work that had already been undertaken pursuant to Article XIX of the GATS and the relatively large number of proposals that had been submitted by Members covering a wide range of sectors, several horizontal issues as well as the movement of natural persons. The Doha mandate also noted the contribution that could be made by services to the economic growth and development of countries, particularly developing countries. It reaffirmed that the negotiations were going to be conducted in accordance with the "Guidelines and Procedures for the Negotiations on Trade in Services", and called upon countries to submit their initial requests for specific commitments by 30 June 2002 and initial offers by 31 March 2003.[54]

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[50] Report of the Chairman of the Negotiating Group on Market Access to the Trade Negotiations Committee, Job(08)/96; 12 August 2008, para. 9 at p. 5.

[51] See statement of Frank Vargo, Vice President of the National Association of Manufacturers; 28 July 2008: http://www.nam.org/NewsFromtheNAM/Press%20Releases/IEAP/NAMASectoralsEssential.aspx.

[52] Revised Draft NAMA Modalities Text, *supra* note 47, para. 9 at p. 6.

[53] Revised Draft NAMA Modalities Text, *ibid,* para. 1 at p. 1.

[54] Paragraph 15 of the Doha Ministerial Declaration.

As of that date, only 12 offers had been tabled by Members counting the EC-25 as one. The low number of offers and their poor quality could be attributed to a number of factors, including the lack of substantive progress in the agriculture and NAMA negotiations, inadequate offers on mode 4 by developed countries, the weak state of the services industry in most developing countries and the belief that liberalisation would lead to the dominance of foreign service providers and pose a significant challenge for domestic service industries and providers. There was also the related concern that liberalisation would lead to increased prices for public utilities such as water and electricity and result in reduced services to remote parts of countries.

With no apparent movement, developed countries threw down the gauntlet and demanded greater commitments from developing countries in the services negotiations. They hinted that the extent of their commitments in agriculture and NAMA would depend on the commitments assumed by developing countries. In the run up to the Hong Kong Ministerial Conference, several developing countries, including Cuba, South Africa and Venezuela criticised as unbalanced the services text submitted by the Chairman of the Special Session of the Council for Trade in Services and included in the draft Ministerial Declaration that was forwarded to Hong Kong for the consideration of Ministers on the ground that it ignored the negotiating guidelines[55] that Members had agreed, and sought to oblige developing countries to undertake extensive commitments in more services sectors. They insisted on Members' right to choose which sectors that they wanted to liberalise and their ability to regulate trade in services in their territories taking into account the level of development and broader government objectives.

With the possibility of being a deal breaker, the draft services text was heavily negotiated in Hong Kong and resulted in the dilution of a number of provisions to provide the necessary comfort for developing countries. While most developing countries appreciated the need for Members to table substantive offers that would result in new market access opportunities, they were against the adoption of a substantively new approach to achieve that objective. To reassure them, the Hong Kong Declaration affirmed the objectives and principles stipulated in the GATS, the Doha Ministerial Declaration, the Guidelines and Procedures for the negotiations adopted on 28 March 2001 and the Modalities for the Special Treatment for LDCs adopted on 3 September 2003, as well as Annex C of the General Council Decision of 1 August 2004. It highlighted the need for appropriate flexibility for individual developing countries based on the respective sizes of their economies, both overall and in individual sectors.

The Declaration also affirmed that the request-offer approach would "remain the main method of negotiation, with a view to securing substantial commitments". It, however, provided that in addition to bilateral negotiations, the request-offer negotiations should also be pursued on a plurilateral basis in accordance with the

[55]Guidelines and Procedures for the Negotiations on Trade in Services, S/L/93; 29 March 2001, para. 3 at p. 1.

principles of the GATS and the Guidelines with a view to securing substantial commitments. In that connection, it mandated that Members should submit their plurilateral requests by 28 February 2006. It also requested Members which had not submitted their initial offers to do as soon as possible and mandated that Members submit their revised offers by 31 July 2006. It further provided that Members should submit their final draft schedules by 31 October 2006 given the expectation of the conclusion of the negotiations in December 2006. Pursuant to the Declaration and following intensive consultations among Members, 21 collective requests have been made by Members in almost all the services sectors and modes of supply.[56]

It remains to be seen whether the plurilateral process would produce significant offers providing genuine market access opportunities to foreign service providers, as several of the offers on the table mostly reflect current market access opportunities, and in some cases, have taken a step backwards. At the margins of the July 2008 Ministerial meeting a "Signalling Conference" was held with a view to gauging the improvements that Members were prepared to make to their offers.[57] The Conference was adjudged a success as Members' comments on possible improvements touched on almost all services sectors and modes of supply. The challenge, however, is whether Members would deliver on the signals and substantially improve on their offers, so that foreign service suppliers would have new market access opportunities. To some extent, that would depend on movement in agriculture and NAMA. Without substantive results in these areas, it would be difficult to expect developing countries to enhance their GATS commitments. Progress has also been slow in the negotiations of GATS rules; apart from domestic regulations where Members are currently considering a draft text, there has not been any substantive movement on emergency safeguards, subsidies and government procurement.

Development

It is generally acknowledged that the Doha Round is about development and that its central objective is to facilitate the integration of developing countries, particularly LDCs, into the multilateral trading system. It is expected that these countries would have improved market access for their principal exports which, in turn, would generate the necessary resources to underpin the diversification of their economies

[56]Air Transport; Architectural, Engineering and Integrated Engineering Services; Audiovisual Services; Computer and Related Services; Construction Services; Distribution Services; Education Services; Energy-Related Services; Environmental Services; Financial Services; Legal Services; Logistics Services; Maritime Transport Services; Postal and Courier Services; Services Related to Agriculture; Telecommunication Services; Tourism Services; Cross-Border Supply (Modes 1 and 2); Mode 3; Mode 4; and MFN Exemptions. See the report of the Chairman of the Special Session of the Council for Trade in Services entitled "Elements Required for the Completion of the Services Negotiations", TN/S/34; 28 July 2008.

[57]See the report of the Chairman of the Special Session of the Council for Trade in Services on the Signalling Conference, Job (08)/93; 30 July 2008.

and their eventual integration into the multilateral trading system. Given this overarching objective, development permeates all areas of the DDA, including agriculture, NAMA and services. In addition, the Doha Declaration covers SDT and implementation issues.[58]

As regards SDT, Ministers reaffirmed that they are an integral part of WTO Agreements and noted the concerns regarding their ineffectiveness in facilitating the integration of developing countries into the multilateral trading system. In that regard, Ministers mandated that all SDT provisions should be "reviewed with a view to strengthening them and making them more precise, effective and operational".[59] They endorsed the Work Programme on SDT set out in the Decision on Implementation-Related Issues and Concerns, which mandated that the Committee on Trade and Development (CTD) should complete its review of all SDT provisions and present clear recommendations to the General Council for a decision by July 2002.

Notwithstanding intensive work on the 88 agreement-specific proposals that developing countries had tabled pursuant to paragraph 44 of the Doha Declaration, the deadline was not met. In the run-up to the Cancún Ministerial Conference, agreement was reached in principle on 28 of the proposals but developing countries refused to "harvest" them, as they thought that they lacked economic value. Progress was made at the Hong Kong Ministerial Conference on four issues of importance to LDCs, the most significant being on duty-free, quota-free access for LDC products. While the initial idea was to exempt all LDC products from any quotas and tariffs, some Members (USA and Japan) said that they needed time to implement such a decision. In the event, the Hong Kong Declaration provides that developed countries and developing countries, declaring themselves in a position to do so, shall provide duty-free and quota-free market access to products originating in LDCs by 2008 or no later than the start of the implementation period. It further provides that where this is not possible, such treatment shall be extended to 97% of LDC products defined at the tariff level.

While this decision has been welcomed, there are concerns that developed countries would exclude sensitive sectors such as textiles and clothing products, fish and fish products, leather and footwear from the coverage of their schemes. Some LDCs, including Bangladesh have warned that the decision would be meaningless if their major exports are excluded. LDCs have also entreated developed and other donor countries to enact flexible rules of origin, otherwise it would be difficult for them to take advantage of these schemes to attract investment, increase and diversify their exports. Since the Hong Kong Ministerial Conference, there has not been any substantive progress on the remaining issues.

With respect to implementation-related issues, about half of the 100 issues raised by developing countries were resolved at Doha. With respect to the unresolved

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[58]As previously pointed out, the Doha Declaration covers a number of development-related issues which are being addressed under the auspices of the General Council: TRIPS and Public Health, Small Economies, Trade, Debt and Finance, Trade and Transfer of Technology, Technical Co-operation and Capacity Building and Least-Developed Countries.

[59]The Doha Ministerial Declaration, *supra* note 9, para. 44 at p. 9.

issues, Ministers mandated that those issues in respect of which they had provided a negotiating mandate such as agriculture or rules should be dealt with under the negotiations, while those in respect of which no negotiating mandate had been provided should be dealt with by the relevant WTO bodies. These bodies were required to report to the Trade Negotiations Committee by the end of 2002 for it to review progress and take appropriate action.[60] The deadline was not met and new ones were also not met either.

Like SDT, not much progress has been made on the implementation-related issues. This is partly due to the difficult nature of the remaining issues, particularly those raised under the TRIMs Agreement which would grant additional flexibilities to developing countries to impose TRIMs such as local content rules and trade balancing requirements, and those raised under the TRIPs Agreement, particularly the issue relating to the extension of the additional protection provided to wines and spirits to other products (GI extension issue). Another difficult issue is the demand by developing countries that the TRIPS Agreement should be amended to make it consistent with the Convention on Biological Diversity (CBD).

The differences in views on the scope of the Doha mandate have meant that there has not been any substantial progress on both the outstanding agreement-specific proposals and implementation-related issues. The lack of progress is primarily due to the different perceptions by developed and developing countries of the role of SDT in facilitating the integration of developing countries in the multilateral trading system. It is the view of developed countries that instead of focussing on the traditional SDT measures, developing countries would gain more from the market access negotiations in agriculture, NAMA and services and from initiatives such as Aid for trade and the Enhanced Integrated Framework.

For now, the strategy of developing countries, particularly LDCs and African countries is to pursue both tracks – work under paragraph 44 of the Doha Ministerial Declaration and in the market access negotiations in agriculture, NAMA and services. They believe that the two tracks are not mutually exclusive and that the more flexibilities they have the increased chances of integrating their countries into the multilateral trading system. Some have protested about the lack of progress on these issues and warned that in evaluating the overall results of the DDA, they would take into account the results in these two areas in order to determine whether the appropriate balance has been struck.

Rules

The decision to include rules – antidumping, subsidies and countervailing measures – in the DDA was not an easy one. On the one hand, Members such as United States and Egypt believed that the current WTO rules were working well and that there was no need to negotiate new rules which might make it difficult for countries to

[60]The Doha Ministerial Declaration, *supra* note 9, para. 12 at pp. 2–3. See further the Ministerial Decision on Implementation-Related Issues and Concerns, WT/MIN (01)/17.

respond effectively to unfair trading practices of other countries. In the run up to the Doha Ministerial Conference, 61 senators wrote to President George Bush informing him that that they would oppose any international trade agreement that weakened antidumping and other trade remedy laws of the United States.[61] On the other hand, Members such as China, Japan, South Korea and Hong Kong, China believed that the current WTO disciplines were too flexible and gave countries wide discretionary powers to impose anti-dumping duties. For these countries, the DDA would be incomplete without a review and the strengthening of trade remedy rules to ensure that they are not abused by Members.

The mandate attempted to strike a careful balance between the competing interests of countries. It stated that given the increasing use of trade remedy measures, the negotiations shall aim at "clarifying and improving disciplines under the Agreements on Implementation of Article VI of the GATT 1994 and on Subsidies and Countervailing Measures, while preserving the basic concepts, principles and effectiveness of these Agreements".[62] The language used was reassuring for some Members, since it made it clear that the rationale for antidumping measures was not going to be discussed in the negotiations. The mandate also referred specifically to fisheries subsidies, which have been blamed for the overfishing and depletion of stocks around the world, and also the rules and procedures governing regional trade agreements. It was foreseen that the negotiations would be conducted in two phases. In the first phase, Members were expected to identify the provisions which could benefit from further clarification and improvement. The second phase was to be devoted to the actual clarification and improvement of the relevant WTO disciplines. In other words, real negotiations were to begin in the second phase.

While considerable progress had been made by the Negotiating Group on Rules in identifying the issues that had to be clarified and improved, Members thought it appropriate to move into a text-based negotiation. At the Hong Kong Ministerial Conference, Ministers mandated the Chairman of the Negotiating Group on Rules to prepare as soon as possible consolidated texts of the AD and SCM Agreements which "shall be the basis for the final stage of the negotiations".[63] Members have tabled comprehensive proposals on almost all the topical issues making it possible for them to make progress on the twin objectives of avoiding the "unwarranted use of anti-dumping measures, while preserving the basic concepts, principles and effectiveness of the instrument and its objectives where such instruments are warranted" and the "desirability of limiting the costs and complexity of proceedings for interested parties and the investigating authorities alike, while strengthening the due process, transparency and predictability of such proceedings and measures".[64]

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[61]Letter was dated 7 May 2001: http://www.useu.be/ISSUES/ProtectingUSTradeLaws050701.html.

[62]The Doha Ministerial Declaration, *supra* note 9, para. 28 at p. 6.

[63]The Hong Kong Ministerial Declaration, *supra* note 5, para. 28 at p. D-2.

[64]*Ibid*, para. 3 at p. D-1.

Members have also submitted detailed proposals aimed at strengthening the relevant WTO disciplines on subsidies and countervailing measures. Progress has also been made at agreeing on disciplines on fisheries subsidies which would represent a triumph for both trade and the environment, as well as on disciplines to regulate regional trade agreements to ensure their complementarity with the multilateral trading system.

After intensive consultations in 2006 and 2007, the Chairman circulated a consolidated text for Members' consideration on 30 November 2007.[65] With respect to anti-dumping, the text makes proposals for changes to 13 out of the 18 Articles of the Anti-dumping Agreement, including those covering issues such as the initiation of investigations, due process and transparency, injury determinations, dumping margin calculations and reviews and duration of measures. The text did not, however, address issues such as the lesser duty rule, negligible imports, SDT and *de minimis* thresholds. With regard to subsidies and countervailing measures, the text addresses a number of issues, including the definition of a benefit, allocation of benefits, export credits, specificity and regulated prices and benefit calculation. It did not, however, address issues such as dual pricing, non-actionable subsidies and presumption of serious prejudice.

Regarding fisheries subsidies, Ministers mandated the strengthening of disciplines on subsidies in the fisheries sector, including through the prohibition of certain forms of fisheries subsidies that contribute to overcapacity and over-fishing. In the consolidated text, the Chairman proposed the prohibition of a range of subsidies, including those for the acquisition and modernization of fishing and service vessels, subsidies to cover operating costs for bait, ice, fuel, insurance, personnel charges, subsidies for fishing port infrastructure, subsidies for price and income supports. The text foresees a number of SDT provisions for developing countries, particularly LDCs.

The Chairman's text was cautiously welcomed by Members as a basis for further discussions. However, concern was expressed by several Members on the treatment of zeroing in the text. It was felt that the proposals did not properly reflect the jurisprudence of the Appellate Body which had declared the practice of zeroing to be inconsistent with the Anti-dumping Agreement. There was also concern about the issues that were not covered in the text. In that regard, the Chairman was urged by several Members to revise his November 2007 text before the July 2008 Ministerial meeting. He declined on the ground that Members' positions on several issues differed sharply and that he did not have the basis to issue such a text. Instead, he issued a detailed working document covering almost the same ground as the consolidated text.[66]

[65] Draft Consolidated Chair Texts of the Antidumping and Subsidies Agreement, TN/RL/W/214; 30 November 2007.

[66] Working Document from the Chairman of the Negotiating Group on Rules, TN/RL/W/232, 28 May 2008.

On regional trade agreements, Ministers at Hong Kong, China took note of the substantive progress that had been made on procedural issues and instructed the Negotiating Group "to intensify its efforts to resolve outstanding issues, with a view to a provisional decision on RTA transparency by 30 April 2006". This deadline was not met until December 2006 when Members agreed to implement the new Transparency Mechanism on a provisional basis. It is expected that it would streamline the examination process and assist the CRTA to make decisions on the consistency or otherwise of regional trade agreements. Progress on substantive issues has, however, been limited given the divergences in Members' interpretation of the relevant disciplines in Article XXIV of the GATT 1994, Article V of the GATS and the Enabling Clause.

Given the difficult and sensitive nature of the issues in the rules negotiations, progress can only be made if Members engage constructively and demonstrate greater flexibility in accommodating issues of interest to others. Needless to say, progress in other negotiating areas, particularly in agriculture and NAMA would also shape the evolution of the negotiations in the rules area.

Trade Facilitation

The four Singapore issues are trade and investment, trade and competition policy, transparency in government procurement and trade facilitation. They were given parallel treatment in the Doha Declaration to the extent that Members agreed to work on them further so as to increase understanding of the relevant issues and negotiate on them on the basis of an explicit consensus after the Fifth Ministerial Conference, which was held in Cancún from 10–14 September 2003. While the clarificatory period proved useful in terms of shedding further light on the relevant issues in the four areas and helped build the capacity of developing countries to negotiate effectively and implement the results of the negotiations, the issues remained controversial and contributed to the failure of the Cancún Ministerial Conference.

At the heart of the disagreement among Members was whether the four issues should be treated together ("bundled") or treated differently depending on their respective degrees of ripeness for negotiations ("unbundling"). Some of the proponents, particularly the European Communities, Japan and Korea insisted on bundling, while the majority of developing countries, especially those belonging to the ACP Group insisted on the unbundling of the issues on the ground that there were stark differences between them and that while some were ripe for negotiations, others were not. Several developing countries had broadly hinted that they could accept negotiations on trade facilitation but not the other three for reasons ranging from the lack of experience with some of the subjects to the need to maintain control in order to further national interests.

The inability to bridge these positions was reflected in the letter sent to Minister Derbez of Mexico by the Chairman of the General Council:

> In each of the four areas there is a first bracketed option containing a decision to launch negotiations and setting forth the modalities for such negotiations. The second bracketed

> option refers the matter back to the respective bodies for further clarification. Clearly, these brackets reflect the fact that there are still considerable differences among Members, although the scope of divergence is greater in some areas than others.[67]

At the Cancún Ministerial Conference, the proponents accepted unbundling of the issues and proposed that negotiations take place only on trade facilitation, but this compromise was rejected by the ACP Group. The impasse was not resolved until July 2004 when Members agreed to negotiate only on trade facilitation and pledged that there would not be any negotiations on the remaining three issues during the Doha Round.

Although negotiations on trade facilitation did not commence until October 2004 with the establishment of the Negotiating Group on Trade Facilitation, enormous progress has been made and the time lost almost recovered. It is usually mooted that trade facilitation could be a prime candidate for an "early harvest" in the DDA negotiations. In fact, the report of the Negotiating Group on Trade Facilitation was the only one which attracted consensus among Members in the run up to the Hong Kong Ministerial Conference. This report was subsequently endorsed by Ministers at Hong Kong. They encouraged Members to continue sharing national experiences on trade facilitation reform processes and instructed the Negotiating Group to intensify its work all aspects of its mandate on the basis of proposals submitted by Members and those which may be submitted later. Given the expected completion of the Round in December 2006, Ministers highlighted the need for focussed drafting "so as to allow for a timely conclusion of text-based negotiations on all aspects of the mandate".[68]

Since then, negotiations have been intensified and Members have submitted text-based proposals on almost all the issues under consideration. The main challenge for negotiators would be to agree on effective multilateral disciplines, while according effective SDT to developing countries, particularly the LDCs in light of their individual needs and the cost implications of any new multilateral disciplines. It is recalled that paragraph 3 of Annex D of the July 2004 General Council Decision provides that "[l]east-developed countries will only be required to undertake commitments to the extent consistent with their individual development, financial and trade needs or their administrative and institutional capabilities". Innovative approaches to these issues have been floated by Members and they are being considered in the Negotiating Group.

While substantive progress has been made in the negotiations, they are far from over. The next decisive phase in the negotiations would depend not only on the crafted solutions to the difficult issues that have been thrown up, including the linkage of capacity to implementation of the any greed disciplines, but also developments elsewhere, particularly in agriculture and NAMA. It is doubtful at this stage if Members would agree to conclude the negotiations on trade facilitation even if all the remaining negotiating issues are resolved.

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[67]Letter was dated 31 August 2003.

[68]The Hong Kong Ministerial Declaration, *supra* note 5, para. 4 at pp. E-1-2.

Other Issues

TRIPS Issues

On other issues including the negotiations on the establishment of a multilateral system of notification and registration of geographical indications (GIs) for wines and spirits, not much progress has been made on the twin issues of participation and legal effects. Whereas some Members, including the European Communities would like participation in the system to be mandatory, and the registration of a GI to create a "rebuttable presumption" that it would be protected in other WTO Members, except in a country that has lodged a reservation within a specified period,[69] others prefer a voluntary system where notified GIs would be registered in a database. Participating countries would have to consult the database before taking decisions on protection within their own countries, while non-participating countries would not be obliged but encouraged to consult the database when taking decisions.[70] Given the diametrically opposing views, Hong Kong, China has proposed a compromise where a registered term would enjoy a more limited "presumption" than under the EC proposal, and only in participating countries.[71]

Progress has also been slow on the question of the extension of the protection given to wines and spirits to other products. Whereas the EC and several Members, including India are in favour, others such as Australia and the United states are strongly opposed. They dispute the claim that the Doha Declaration provides a mandate for these negotiations and want them delinked from the rest of the negotiations. Given the differences in views, the discussions have taken place in the TRIPS Council and more recently in informal consultations chaired by the Director-General or one of his deputies.

Trade and Environment[72]

The decision to include environment in the Doha mandate was primarily because of the belief among WTO Members that trade liberalisation and the environment are not mutually exclusive and could reinforce each other and assist countries, particularly developing countries, to achieve sustainable growth and development. Initially, some developing countries questioned the motives of the demandeurs for disciplines at the multilateral level. They believed that their exports would be restricted if they did not comply with the requisite standards in the importing country. Because of these concerns, the mandate was circumscribed. While stating

[69]EC proposal, TN/IP/W/11.

[70]Joint proposal sponsored by a number of countries, TN/IP/W/10/Rev.2.

[71]Compromise proposal by Hong Kong, TN/IP/W/8; XXXXXX. See further compilation by the WTO Secretariat, TN/IP/W/12; 14 September 2005 and http://www.wto.org/english/tratop_e/trips_e/gi_background_e.htm#wines_spirits.

[72]See http://www.wto.org/english/tratop_e/envir_e/envir_negotiations_e.htm.

that the negotiations should aim at enhancing the mutual supportiveness of trade and environment, Ministers also made it clear that outcome of the negotiations should not be prejudged, thus preserving the positions of Members on the appropriate interface between trade and environment.

Paragraph 31 (i) provides that there would be negotiations on the relationship between existing WTO rules and specific trade obligations set out in multilateral trade agreements (MEAs). It further provides that the negotiations would be limited in scope to the applicability of relevant WTO rules among the parties to the MEAs in question. Paragraph 31 (ii) mandates Members to draw up procedures for regular information exchange between MEA Secretariats and the relevant WTO committees, and the criteria for the granting of observer status. Paragraph 31 (iii) provides for negotiations aimed at reducing or, as appropriate, eliminating tariff and non-tariff barriers on environmental goods and services.

Ministers also instructed the regular Committee on Trade and Environment to give special consideration to the following issues in its work programme: (1) the effect of environmental measures on market access, especially in relation to developing countries, in particular the least-developed among them, and those situations in which the elimination or reduction of trade restrictions and distortions would benefit trade, the environment and development; (2) the relevant provisions of the Agreement on Trade-Related Aspects of Intellectual Property Rights; and (3) labelling requirements for environmental purposes. The Committee was instructed to report on progress and provide recommendations to Ministers at the Cancún Ministerial Conference on future course of action, including the desirability of commencing negotiations on these issues.

Whereas progress has been made on all parts of the mandate, particularly on environmental goods and services where two approaches are being advocated – a list approach and a group approach – there is still a long way to go before the negotiations are finalised. The immediate challenge is to move into a text-based negotiation so that the parameters would be fully delineated.

Dispute Settlement

There is the recognition among WTO Members that the dispute settlement system has been working quite well and has thus far confirmed that it is a central element in providing security and predictability to the multilateral trading system. However, experience has taught Members that certain provisions of the Dispute Settlement Understanding (DSU) could benefit from improvements and clarifications. Accordingly, Ministers agreed to launch negotiations with this limited objective in view; they instructed that the negotiations to improve and clarify the DSU should be based on the work done thus far as well as any additional proposals by Members. Given that the intention was not a comprehensive review of the DSU, Ministers mandated that the negotiations should conclude not later than May 2003.[73] They

[73]The Doha Ministerial Declaration, *supra* note 9, para. 30.

further agreed that the DSU negotiations should not be part of the single undertaking, thus avoiding linkages with other negotiations taking place under the DDA.[74] This decision was motivated by the belief that a strengthened dispute settlement system was in the interest of all Members and as such the results of the results of the negotiations should not be subject to horse trading.

Although good progress was made in the negotiations, Members could not agree on the adoption of Chairman Balas' text.[75] The deadline was extended to May 2004, but Members could not still agree on the improvements and clarifications to be made to the DSU. The inability of Members to come to an agreement could be attributed to the general satisfaction of Members with the current DSU and the fear that any new rules might make the system unwieldy and compromise its effectiveness. Another reason is the linkage that has been made by some Members between the DSU negotiations and the other negotiating issues. This may sound implausible given the exclusion of the DSU negotiations from the single undertaking. For now, Members are intensively negotiating on the basis of text-based proposals on a limited number of issues, including enhancement of third party rights, sequencing between Article 21.5 and Article 22 of the DSU, remand authority for the Appellate Body and enhanced transparency of the dispute settlement process. It is doubtful at this stage if the DSU negotiations would be completed before the rest of the negotiations.

Concluding Remarks

The DDA has had a long and chequered history since its launch in November 2001. It was seen as a unique opportunity to strengthen the rules-based, non-discriminatory multilateral trading system and prepare it for the challenges of the twenty-first century. Studies undertaken by the WTO, OECD, the World Bank and research institutions have all indicated that a successful Round would increase global income by several billions of dollars and enhance global welfare. Developing countries were ecstatic, as for the first time issues of interest to them were at the core of the negotiations. There was so much goodwill that Members thought that they could conclude the negotiations in four years, thus shortening almost by half the time it took to conclude the Uruguay Round. However, their optimism was soon replaced by pessimism and mistrust leading to the failure to agree on modalities for agriculture in March 2003 and the subsequent collapse of the Cancún Ministerial Conference in September 2003. Since then, the WTO has not fully recovered despite numerous attempts to finalise the modalities and work towards the conclusion of the negotiations.

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[74]The Doha Ministerial Declaration, *ibid*, para. 47.

[75]TN/DS/9; 6 June 2003.

WTO Members realise that there is no credible alternative to the rules-based, non-discriminatory multilateral trading system which has contributed immensely to the expansion of the global economy in the last 60 years. While bilateral and regional trade agreements can result in market openings and increase the welfare of the participating countries, they cannot be a perfect substitute for the multilateral trading system. Issues such as agricultural subsidies can only be negotiated multilaterally. There is consensus that in the current climate of uncertainty in the financial markets, the conclusion of the Doha Round will calm the markets and provide a boost to the global economy. It would help preserve the recent economic gains that have been made by LDCs and assist them to meet some of the Millennium Development Goals. A number of studies have warned that failure to conclude the Round would increase protectionist tendencies, affect investor confidence and generally lead to a reduction of global welfare. If all these are not disputed, why have WTO Members failed to take the necessary decisions which would pave the way for the conclusion of the Round?

In a speech to CUTS International and Partners in New Delhi following the collapse of the July 2008 Ministerial meeting, DG Lamy observed that Members came very close an agreement and that it was unfortunate that they could not close the deal.[76] It is obvious that if the negotiations are to succeed, all Members would have to show flexibility and put the global interest ahead of their own. The mercantilist approach to negotiations should be discarded and Members should be prepared to try new approaches which would accommodate the interests of all Members. It is only a balanced agreement which would succeed in breaking the current stalemate. Every effort should be made to address and accommodate well-founded sensitivities of countries within the agreed framework. Departing from the agreed framework would undermine confidence in any eventual agreement and compromise the objective of reducing distortions in the agricultural sector.

In the area of agriculture, Members should particularly focus on the market access pillar, where a number of difficult issues remain. They should not lose sight of the fact that the guiding principle is the substantial improvement in market access for all agricultural products. That being the case, all Members should assume their responsibilities. Developed countries should agree to a substantial reduction of their tariffs so as to create new market opportunities for agricultural-exporting countries. With the acceptance by developed countries of an overall cut of 54%, it appears that there is a solid basis for agreement on this issue.

Given the concern that countries would attempt to limit access to their markets by designating products of interest to agricultural-exporting countries as “sensitive”, there should be stringent rules governing the number and treatment of such products. The Chairman’s proposal that developed countries should be allowed only to designate 4% of their tariff lines as sensitive seems to strike a careful balance between the competing interests, especially considering that there is the

[76] See speech delivered by DG Lamy to the Conference on “Global Partnership for Development”, New Delhi, 12 August 2008: http://www.wto.org/english/news_e/sppl_e/sppl97_e.htm.

possibility for a further 2% of tariff lines to be added when 30% or more of a country's tariffs fall in the top band, which normally should be reduced by 70%.

Likewise, developing countries should also restrain themselves in demanding further flexibilities as regards the number of tariff lines that they can designate as "special products". Under the Chairman's proposal, they can designate 12% of their tariff lines as "special products", out of which 5% would not be subject to any tariff cuts and the average tariff cut on the remaining tariff lines would not be more than 11%. Considering that developing countries would be able to designate around 5.3% of their tariff lines in addition to the 12% as "sensitive", there is scope for them to protect vulnerable products.

With regard to the SSM, which contributed to the derailment of the July 2008 Ministerial meeting, Members should do their utmost to agree on the thresholds for the volume trigger and the extent to which developing countries could exceed their pre-Doha bound rates. Given the potential of this issue to continue blocking progress in the negotiations, Members should seriously consider the new approach outlined by the Chairman in his latest text. Flexibility is required on all sides considering that this mechanism would be resorted to when other options have been exhausted. It may be advisable for Members to undertake that they would use this measure sparingly.

With respect to domestic support, there is broad agreement on most of the contentious issues. The decision by the United States to accept a 70% cut of its Overall Trade Distorting Domestic Support is significant in that regard. It would be reassuring if Members agreed to tighter disciplines on the Green Box to ensure that such they do not cause or minimally cause distortions to trade. A strengthening of the disciplines on the Blue Box together with its capping at 2.5% of the total value of agricultural production would also reassure Members which strongly believe that in its current form it provides a leeway for countries to circumvent their reduction commitments. It would also be important for developed countries to signal their acceptance of the Chairman's formula for the reduction of domestic support for cotton. This would boost the confidence of LDCs in the Doha negotiations and send a positive signal to the outside world that the WTO is committed to addressing the concerns of its poorest Members. From a public relations perspective, it would silence the critics of the WTO who peddle the falsehood that the WTO only promotes the interests of developed and advanced developing countries.

Given that there is a broad consensus on the formula and general flexibilities for developing countries as well as special treatment for individual developing countries and distinct groups of developing countries in the NAMA negotiations, including small and vulnerable economies and countries with low tariff bindings, the issue which merits very close attention is sectorals. A threshold question which needs to be decided is whether or not participation in sectoral negotiations should be made mandatory for certain developing countries based on identifiable objective factors, taking into account the fact that the effectiveness of these agreements depend on a critical mass of countries which account for the bulk of trade in that particular sector. If this issue is resolved, it would be easier to get agreement on the other ancillary issues such as the number of sectoral negotiations a Member has to participate in. If it is decided to maintain the principle that participation is voluntary, it would be difficult to get countries to commit to participating in negotiations, even if an assurance is given that this is without prejudice to their final decision to participate in any eventual agreement. Given that it would be difficult to get agreement on this issue, the best option would be to offer incentives to key developing countries to join sectoral negotiations by including effective SDT provisions in any agreement.

From the foregoing, it is clear that the issues on which agreement have eluded Members are not many and could be resolved if the leading WTO Members exercise political leadership and demonstrate flexibility by accommodating the interests of other Members and by focussing on the common good rather than their own narrow interests. Other WTO Members must not shirk their responsibility and should play a supporting role by offering concessions which would be attractive to the major players and encourage them to take the necessary decisions which would pave the way for the adoption of modalities in agriculture and NAMA and the eventual conclusion of the Round. In the current economic environment, where Members are keen to protect jobs by adopting protectionist measures, they would agree to give concessions only when they are convinced about the adequacy of the concessions they would get in return. The responsibility to conclude the Doha Round to rejuvenate the global economy is a collective responsibility and it is hoped that WTO Members would rise to the challenge and soon take the necessary decisions which would create the platform for the conclusion of the Doha Round.

Recent Legal Developments in the International Monetary Fund

Wolfgang Bergthaler and Wouter Bossu

Introduction and Roadmap

This article discusses recent legal developments in the International Monetary Fund ("IMF").[1] The IMF is an international financial organization with near universal membership – currently 185 member countries. The IMF's purpose is to promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems. The IMF also facilitates the expansion and balanced growth of international trade to contribute thereby to the promotion and maintenance of high levels of employment and real income, promotes exchange stability, and assists in the establishment of a multilateral system of payments. Another important purpose of the IMF is to make financial resources available to its members under adequate safeguards thus providing them with an opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.[2]

The IMF is established and governed by a specific legal framework that has been adapted to changing circumstances. At the core of that framework are the Articles of Agreement (the "Articles"), which were drafted at the United Nations Monetary and Financial Conference in Bretton Woods, New Hampshire in 1944. Throughout

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*The views expressed herein are those of the authors and should not be attributed to the IMF, its Executive Board, or its management. This article reflects the status as of March 2009; any later developments could not be covered. The authors would like to appreciate their gratitude to Mr. Ross Leckow, Deputy General Counsel of the IMF's Legal Department, for his advice and guidance in authoring this article.

[1] This article does not discuss other, more technical issues, such as the IMF's role in current account convertibility (Article VIII of the IMF's Articles – so-called "IMF jurisdiction"), data provision under Article VIII of the IMF's Articles, IMF technical assistance, or the SDR Department.

[2] Article I of the IMF's Articles.

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its almost 65-year history, the IMF has adapted its legal framework – including by amending the Articles three times – to events such as the collapse of the Bretton Woods system, the Latin American debt crisis of the 1980s, the fall of the Iron Curtain, or the Asian Financial Crisis of the late 1990s. More recently, the IMF has faced some of its most serious challenges since its inception, which in turn have required profound changes to the IMF's legal framework.

Part I provides the context by sketching those challenges faced by the IMF. Part II outlines how the IMF has been addressing these challenges through reforms to its legal framework. Part III draws conclusions and closes with an outlook.

Challenges Faced by the IMF

The period between the Asian crisis and 2007 was largely characterized by world-wide economic prosperity, stable growth, and relative financial stability. Under the surface, however, tensions had been building up, such as heavy private sector indebtedness in advanced and emerging economies, as well as significant current account surpluses of export-focused emerging markets. This has erupted into a serious economic and financial crisis. Both the benign pre-crisis period and the crisis itself have called into question the mandate and role of the IMF as an institution charged with preventing and solving international financial crisis. The most serious questions confronting the IMF are the following:

- Can the IMF execute in a meaningful way its mandate to promote exchange system stability and to avoid competitive exchange depreciation? Before the crisis erupted, the view was expressed in some circles that several important currencies were undervalued, and the IMF was urged to assess exchange rates more firmly and to take stronger action against currency misalignments.
- Does the IMF have the financing instruments it needs to help the membership in preventing and resolving external crises? Before the financial crisis, many member countries had acquired access to capital markets, or built up large reserves, thus reducing their need for access to IMF financing.
- How can the IMF develop a governance framework that accords relative influence to its member countries in a manner that is proportionate to their respective share in the world economy? Since emerging markets have grown more rapidly recently, these IMF members need to be represented adequately in the IMF governance system.

Reform of the IMF's Legal Framework

These challenges have made the IMF to consider and implement important changes to its legal framework. As an international (financial) institution, the IMF is a subject of international law and operates under a specific *sui generis* legal framework of a twofold nature. The "primary layer" is composed of a multilateral treaty, i.e., the Articles.[3] In addition, the decision-making bodies of the IMF are empowered by the Articles to adopt regulatory decisions, which constitute the "secondary layer" of the IMF's legal system.[4]

What follows is an overview of the most recent reforms to this legal framework, which include two amendments to the Articles and several changes to the IMF's regulatory decisions.

Surveillance over Exchange Rate Policies

As noted, a key challenge of the IMF is to execute in a meaningful way its mandate to promote "orderly exchange arrangements and a stable system of exchange rates." The primary means through which the IMF does this is surveillance over the domestic and exchange rate policies of its members. The basis of the legal framework for surveillance is enshrined in Article IV of the Articles, which sets forth obligations for members, and also for the IMF.[5] The Articles enshrine the principle that members, subject to certain exceptions, may freely choose whatever exchange *arrangements* (including floating) they wish for their currencies.[6] This freedom was, however, accompanied by the establishment, in the new Article IV, Section 1, of several obligations for members regarding their domestic and exchange rate *policies*.[7]

First, members are under a general obligation to collaborate with the IMF and other members to assure orderly exchange arrangements and to promote a stable

[3]The provisions of the IMF's Articles can be found at http://www.imf.org/external/pubs/ft/aa/index.htm. The IMF's Articles are supplemented by the IMF By-Laws and the IMF Rules and Regulations.

[4]Legal acts are adopted by the Board of Governors (Resolutions) and the Executive Board (Decisions). The IMF's Selected Decisions are published at http://www.imf.org/external/pubs/ft/sd/2008/selected decisions and selected documents of the international monetary fund_thirty-second.pdf. For more detail, see Gianviti, "Decision Making in the International Monetary Fund," Current Developments in Monetary And Financial Law 1 (1999), p. 31.

[5]The present version of Article IV was incorporated into the Articles by the Second Amendment to the Articles in 1978. The original Articles had established the so-called "par value system," where under the ("par") value of a member's currency had to be expressed in gold, either directly or through the US dollar. Under that system, a member could not modify the par value of its currency beyond a limit without the concurrence of the IMF, and the IMF would concur only with such modification if it was satisfied that the change was necessary to correct a "fundamental disequilibrium." In response to its collapse in the early 1970s, the Second Amendment departed fundamentally from the par value system.

[6]Article IV, Section 2(b) of the Articles sets out several types of exchange arrangements that are authorized; generally, the only arrangement that is prohibited is the peg to gold.

[7]For a deeper analysis of the legal framework established by Article IV, see the IMF staff paper on "Article IV of the IMF's Articles of Agreement – An Overview of the Legal Framework," June 28, 2006, available on http://www.imf.org.

system of exchange rates. In addition, the members have undertaken four specific obligations, whose performance is considered to be of particular relevance to the general obligation to collaborate. These obligations are as follows:

- Members endeavor to direct their economic and financial policies toward the objective of fostering orderly economic growth with reasonable price stability.
- Members seek to promote stability by fostering orderly underlying economic and financial conditions and a monetary system that does not tend to produce erratic disruptions.
- Members will avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payment adjustment or to gain an unfair competitive advantage over other members.
- Members will follow exchange rate policies compatible with the previous undertakings.

Under Article IV, Section 3(a) of the Articles, the IMF is required to oversee the compliance of each member with the obligations of Article IV, Section 1.[8] In that regard, the IMF must specifically exercise firm surveillance over the exchange rate policies of members, and adopt specific principles for the guidance of members in the conduct of their exchange rate policies.[9]

Surveillance primarily takes the form of regular "Article IV consultations" between the IMF and each of its member countries. In principle, these Article IV consultations take place annually and focus on the state of the member's economy and its economic policies.[10] They include consideration of the observance by members of the principles discussed above as well as a member's obligations under Article IV, Section 1. Under the consultation mechanism, IMF staff first holds discussions with the member's authorities, and then the Executive Board discusses the staff report and reaches conclusions, which complete the consultations under Article IV.

[8]Article IV, Section 3(a) also requires the IMF to oversee the international monetary system to ensure its effective operation, which constitutes the legal basis for the IMF's so-called "multilateral surveillance."

[9]The IMF may also adopt principles for the guidance of members with regard to their domestic policies, but it is not required to do so. Since the principles to be adopted are intended to provide guidance on compliance with the obligations under Article IV, Section 1, a member that has observed all of the principles established by the IMF would be deemed to be in compliance with those obligations. On the other hand, the principles would not create new obligations, and nonobservance of such recommendation would not necessarily mean that a member is in breach of these obligations: a number of additional steps would need to be taken by the Executive Board before a member could possibly be found in breach.

[10]The Decision also provides for an "ad hoc consultation" when developments are likely to affect a member's exchange rate policies or the behavior of its currencies. In addition, the Executive Board can establish other consultation cycles, for instance for members that have a program supported by an IMF arrangement.

The original framework for Article IV consultations was laid down in an IMF Executive Board decision from 1977. The consultations developed under that framework had several shortcomings: they focused insufficiently on exchange rate policies and paid undue attention to issues that were more directly relevant to external stability. To remedy these weaknesses, the Executive Board adopted on June 15, 2007 a new decision with principles guiding the members and procedures for the surveillance of members' policies.[11] This "Surveillance Decision" is a typical example of how the IMF, through its secondary legal framework, regulates the international monetary system.[12] The main features of the decision are the following:

- Reflecting the obligation for members to collaborate with the IMF to promote a stable system of exchange rates, the Decision recognizes that such systemic stability is most effectively achieved by each country adopting policies that promote its own "external stability." That concept refers to a balance of payments position that does not, and is not likely to, give rise to disruptive exchange rate movements.
- In its surveillance, the IMF will focus on those policies of members that can significantly influence external instability. These policies will always include exchange rate policies, as well as monetary, fiscal and financial sector policies.[13]
- The Decision provides greater guidance to members in the conduct of their exchange rate policies. In particular, a principle enshrined in the Decision states that "members should avoid exchange rate policies that result in external instability."
- The Decision provides guidance on the meaning of the obligation of members set out in Article IV, Section 1(iii) not to manipulate exchange rates to gain an unfair competitive advantage over other members and specifies the conditions under which the IMF would find a member in breach of this obligation. To find a member in breach, the Decision stipulates that the IMF would need to determine that (1) the member is engaged in the policies for the purpose of securing fundamental exchange rate misalignment in the form of an undervalued exchange rate and (2) the purpose of such misalignment is to increase net exports.

[11]Decision No. 13919-(07/51) of June 15, 2007, on Bilateral Surveillance over Members' Policies. This decision replaces the first "surveillance decision," which was adopted in 1977 in the aftermath of the changes to the Articles of Agreement by the Second Amendment.

[12]Members of a currency union remain subject to all their obligations under Article IV, and each member is accountable for those policies that are conducted by union-level institutions on its behalf. The IMF will assess whether policies implemented at union level and at the level of members are promoting the external stability of the union.

[13]Paragraph 7 of the Decision sets out how this surveillance is applied to members of currency unions. The basic principle is that members of currency unions remain subject to all of their obligations under Article IV, Section 1. Accordingly, each member is accountable for those policies that are conducted by union-level institutions on its behalf.

IMF Financing

Another important role of the IMF is to make financial resources available to its members to assist them in correcting maladjustments in their balance of payments. This section discusses two aspects of IMF financing. First, it provides an overview of the conditions and circumstances under which the IMF may provide its financial resources to its members and of recent reforms to the IMF's financing instruments. Second, it discusses the IMF's income model (to defray its operational expenses) and its recent modernization.

IMF Financing Instruments

The IMF provides its resources to help resolve IMF members' balance of payments problems.[14] Typically, the IMF provides its resources in support of an IMF member's economic program that aims at resolving the member's balance of payments problem. The amount of IMF financing (access) available to IMF members is a percentage of the IMF member's quota. Dependent on the length and the type of IMF engagement, resources are provided either in the form of an arrangement or an outright disbursement/purchase. IMF arrangements[15] provide the member with assurances that the member will be able to make drawings under the arrangement for up to the specified amount and during a specified period of the arrangement, as long as the member meets the conditions[16] specified in the arrangement (such as the observance of performance criteria) and Executive Board reviews of the member's performance are completed. The most well-known IMF arrangements are the Stand-By Arrangement and the PRGF arrangement.

Under the IMF's Articles, the IMF provides financing to its members from two sources: (1) the general resources account (the "GRA"),[17] which are available to all IMF members, and (2) special trust funds, which are available only for low-income members.

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[14]See Article V, Section 3(a) and Section 3(b)(ii) of the IMF's Articles.

[15]An IMF arrangement is not an international agreement but a decision by the IMF's Executive Board to give assurances to the member that it can request IMF resources subject to certain conditions (so-called conditionality) being met; Gold, *The Stand-By Arrangements of the International Monetary Fund: A Commentary on Their Formal, Legal, and Financial Aspects*, 1970.

[16]Conditionality is a way for the IMF to monitor that its financing is being used effectively in resolving the IMF member's balance of payments problem, so that the IMF member will be able to repay promptly, and make the funds available to other members in need. Conditionality may include quantitative or structural performance criteria. For an in-depth discussion on IMF conditionality, refer to: Ross B. Leckow, Conditionality in the International Monetary Fund, Current Developments in Monetary and Financial Law, 3 (2005), pp. 53–64.

[17]GRA resources reflect the payment of quota subscriptions, use and repayment of IMF credit, collection of charges on the use of credit, payment of remuneration on creditor positions, borrowings and payment of interest and repayment of borrowings.

IMF Financing from the GRA

The IMF's financial resources (held in the GRA) are available to assist IMF members under policies adopted by the IMF, to help resolve their balance of payments problems in accordance with the provisions of the IMF's Articles and the purposes of the IMF. Different policies deal with different types of balance of payments problems.[18]

The IMF's financial assistance in the GRA takes the form of bilateral exchange transactions between the IMF, which provides "freely usable currencies" or special drawings rights ("SDRs"), and a member, which provides an equivalent amount of its own currency. This swap of currencies must be reversed by the member within a specified period (for instance, no later than 5 years), which may vary dependent on the policy under which the financial assistance was granted. The member pays a transaction charge at the time of the transaction and a periodic charge until the transaction is reversed.

Short-Term Liquidity Facility

Given that the IMF's financing tools are focused on structural reform (which entails a medium-term IMF engagement and structural changes to the members' policies which are set out in the member's program), it was recognized that the IMF did not have the appropriate financing tools to provide quick access to IMF resources for members – which have fundamentally strong and sound macroeconomic policies – affected by the global financial crisis in the course of 2008. Previously, different possible financing tools have been discussed with the membership but did not get the necessary traction.

To enhance the IMF's ability to mitigate the effects of the financial crisis and to restore confidence, the IMF created[19] the Short-Term Liquidity Facility ("SLF") designed to help members facing exceptional balance of payments difficulties arising from external market developments despite strong underlying fundamentals

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[18] IMF facilities include, the Extended Fund Facility which helps countries address longer-term balance of payments problems requiring fundamental economic reforms, the Supplemental Reserve Facility which was introduced to meet a need for very short-term financing on a large scale (the motivation for the SRF was the sudden loss of market confidence experienced by emerging market economies in the 1990s, which led to massive outflows of capital and required financing on a much larger scale than the IMF had previously provided), and the Compensatory Financing Facility which was established to assist countries experiencing either a sudden shortfall in export earnings or an increase in the cost of cereal imports, often caused by fluctuating world commodity prices. The IMF provides emergency assistance to countries that have experienced a natural disaster or are emerging from conflict.

[19] The SLF was created by a decision of the Executive Board with a majority of 85% of total voting power.

and domestic policies.[20] This new instrument represents a major addition to the IMF's set of financing instruments.

Under this Instrument, IMF members with strong policies, access to capital markets, sustainable debt burdens and a good track record may request assistance from the GRA when they are facing temporary liquidity problems arising from developments in external capital markets. Access to IMF resources can be up to 500% of a IMF member's quota, with a 3-month maturity and eligible members may draw a maximum of three times during any 12-month period.

IMF Financing from Trusts Funds

In addition to financing from GRA resources, the IMF has established trust funds for concessional lending to its low-income members. These resources originate from profits from the sale of the IMF's gold and from voluntary contributions made by a number of IMF members. These resources are now being used in the context of three IMF initiatives for low-income countries, namely, the Poverty Reduction and Growth Facility, the Heavily Indebted Poor Countries Initiative, and the Multilateral Debt Relief Initiative. Both types of assistance need to be consistent with the IMF's purposes.

There are a number of differences between GRA and trust fund financing. First, the type of balance of payments problem that needs to be addressed is broader in the context of trust funds. Second, in the context of trust funds, the IMF does not engage in reversible exchange transactions but instead extends loans. Grants are only used in limited circumstances, for instance, in the context of the provision of debt relief (MDRI). Third, the repayment/repurchase periods are significantly longer in the case of trust fund resources than in the case of financing from the GRA.

Review of the Exogenous Shocks Facility

In the course of 2008, there was a general recognition that the IMF did not have the necessary tools to quickly assist low-income members hit by exogenous shocks, such as the fuel and food price shock. To remedy this problem, the IMF adapted the ESF financing window in the Poverty Reduction and Growth Facility Exogenous Shocks Facility Trust[21] ("PRGF-ESF Trust") by reforming the high-access component and introducing a rapid-access component. The ESF window itself has been

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[20] The Executive Board paper on the SLF is available at http://www.imf.org/external/pp/longres.aspx?id=4299.

[21] The PRGF-ESF Trust has been established to provide lending in support of PRGF and ESF arrangements and to subsidize the market rate of interest down to the concessional interest rate of 0.5% per annum. Loan resources close to US $25 billion have been committed by 17 contributors to the Trust, while a larger number of IMF member countries have made subsidy contributions.

introduced into the PRGF-Trust and the IMF has been prepared to provide financing to low-income members affected by an exogenous shock (which is defined as being an event that has a significant negative impact on the economy and that is beyond the control of the government). The IMF Executive Board adopted these amendments in September 2008 and they entered into force in November 2008.[22] The two components' features are the following:

- A rapid-access component under which a country can access fairly quickly up to 25% of its quota for each exogenous shock, with resources normally being provided in a single disbursement.
- A high-access component, along the lines of the current ESF, with access up to 75% of quota for each arrangement in normal circumstances. Resources are provided in phased disbursements based on reviews, and programs are 1–2 years in length.

The reform in 2008 of the IMF's financing instruments clearly occurred in light of the food and fuel crisis that hit low-income members and the global financial crisis. It is contemplated to comprehensively review the IMF's financing instruments going forward to ensure its usefulness and effectiveness to its members.

IMF's Income Model

The IMF's operations are financed by the difference between the charges on outstanding IMF credits in the GRA and the remuneration paid to IMF members whose currencies are being used. In recent years, two major challenges to this financing model have arisen. First, in times of low financing needs of the membership, insufficient funds have been generated to finance the IMF's operations. Due to buoyant world economic growth and related high commodity prices, many emerging markets – the traditional clients for IMF financing – have experienced a steady inflow of foreign capital. Access to IMF resources for these members was no longer necessary. Second, the IMF's financing activities fund all the remaining activities of IMF (such as surveillance, technical assistance, IMF's lending to low-income members). The current model was based on the assumption that all IMF members could potentially be debtor members. In practice, however, the range of IMF debtors became increasingly restricted to a few emerging market countries (industrial members have had a creditor position with the IMF and low-income members borrow from the IMF's trust funds, whose resources are separate from the GRA). Even emerging market IMF members were increasingly able to tap financial markets for capital or have accumulated enough reserves and thus did not need to request resources from the IMF. Accordingly, many members considered it as

[22]The amendments to the PRGF-ESF Trust Instrument only entered into effect once all contributors to the trust funds had consented to the amendments. This was necessary since contributors' resources are used to finance eligible members' request for financing.

inequitable that a few members (those who use IMF resources) fund the remaining IMF activities and also not enough funds could be generated from the IMF's financing role.

In 2007, following an abrupt decrease in demand for IMF financing (which was dramatically reversed in the course of the second half of 2008), the IMF's income model had become outdated and in need of modernization. The IMF decided to modernize its financing model and, following a report of a Committee of Eminent Persons,[23] the Executive Board adopted in 2007 reforms that include the following three elements:

- A broadening of the investment mandate to enable the IMF to increase the average expected return and adapt its investment strategy over time. This step requires an amendment to the IMF's Articles.[24] The investment policies reflect the public nature of the funds to be invested and include safeguards to ensure that the broadened investment authority does not lead to actual or perceived conflicts of interest.
- Creation of an endowment with the profits from the limited sale of IMF's gold holdings. The gold sales have not yet been approved.
- To resume the long-standing practice of reimbursing the IMF's budget for the cost of administering the trust fund for concessional lending to low-income countries, the PRGF-ESF Trust, beginning in the financial year in which the IMF adopts a decision authorizing the gold sales. This cost recovery will not affect the IMF's ability to provide concessional lending to low-income countries.

These reforms attempt to diversify the IMF's income both in terms of contributing members and income sources. The investment of gold sale receipts in the market would generate income independent from the IMF's financing portfolio. The PRGF-ESF Trust would reimburse the GRA for the expenses in administering the trust resources.

It will take some time to implement the approved reforms through decisions at the level of both the IMF and the membership. First, an amendment to the IMF's Articles to expand the investment authority needs to enter into effect, following the acceptance of the IMF membership with the requisite number of acceptances. Second, gold sales require a decision of the Executive Board, which may for certain IMF members be subject to domestic legislative approvals. Third, only

[23]The Managing Director appointed a Committee of Eminent Persons, chaired by Andrew Crockett, to set the IMF's financing on a firmer footing. The Committee issued a report to the Executive Board on suggested reforms of the IMF's income model in January 2007. See: http://www.imf.org/external/np/sec/pr/2007/pr0718.htm.

[24]See Article XXXVIII of the IMF's Articles. The Board of Governors adopted a resolution (to Expand the IMF's Investment Authority) approving this amendment to the IMF's Articles, which is now open for acceptance to all IMF members. Once the IMF certifies that it has been accepted by at least three-fifths of IMF members representing 85% of the total voting power, it will enter into effective.

once the gold sales have been approved, will the decision to reimburse the GRA for administering the PRGF-ESF Trust become effective.

IMF Governance

This section discusses first possible reforms of the IMF's decision-making organs and second the "quota and voice reform" that is currently being implemented.

The IMF's Organs

The basic governance structure as set out in the IMF's Articles[25] has remained unchanged since 1944. Specifically, the IMF has the following organs:

The Board of Governors, the highest decision-making body of the IMF, consists of one governor and one alternate governor for each member country. The governor is appointed by the IMF member and is usually the Minister of Finance or the governor of the central bank. All powers of the IMF are vested in the Board of Governors. The Board of Governors may delegate to the Executive Board all except certain reserved powers.[26] The Board of Governors normally meets twice a year.

The Executive Board is responsible for conducting the day-to-day business of the IMF. It is composed of 24 Directors,[27] who are appointed or elected by members or groups of members, and the Managing Director, who serves as its Chairman.[28] The Executive Board usually meets several times per week. It carries out its work largely on the basis of papers prepared by IMF management and staff. In the Executive Board, Executive Directors elected by a multi-member constituency may not split their votes.

The staff of the IMF is led by a Managing Director,[29] who conducts, under the direction of the Executive Board, the ordinary business of the IMF. Subject to the general control of the Executive Board, he shall be responsible for the organization, appointment, and dismissal of the staff.

The Board of Governors has an advisory committee called the International Monetary and Financial Committee (the "IMFC"), which is not an IMF organ as such. The IMFC advises, and reports to, the Board of Governors on matters relating to the Board of Governors' functions in supervising the management and adaptation

[25] Compare: Article XII of the IMF's Articles.

[26] The Board of Governors delegated all the powers of the Board of Governors to the extent permitted under the IMF's Articles (Section 15 of the IMF's By-Laws).

[27] IMF members with the five largest quotas must appoint one Executive Director. The remaining Executive Directors are elected every two years.

[28] See: Article XII, Section 3(b) of the IMF's Articles.

[29] See: Article XII, Section 4 of the IMF's Articles.

of the international monetary and financial system, reviewing developments in global liquidity and the transfer of resources to developing countries; considering proposals by the Executive Board to amend the IMF's Articles of Agreement; and dealing with disturbances that might threaten the system. The IMFC has 24 members who are governors of the IMF, ministers, or others of comparable rank. The membership reflects the composition of the IMF's Executive Board.

Considering that the IMF's membership has increased significantly, the world in which the IMF operates has changed dramatically since 1944, and the IMF itself has changed from a largely regulatory institution to a comprehensive international financial institution, it was increasingly recognized that the IMF's governance structure needs reform. A recent report by the IMF's Independent Evaluations Office[30] prompted the IMF to review whether its governance structure at large is commensurate to the challenges of this millennium. The report underlined that the effectiveness of the IMF was strong albeit at the expense of accountability and voice. In particular, the report criticized, the lack of clarity in the roles between the different governance bodies, insufficient systematic "ministerial" involvement in the IMF's decision-making processes, the role of the Executive Board, and the need for mechanisms to ensure accountability for management.

The Managing Director has established an Eminent Persons' Committee[31] (headed by Minister of Finance Trevor Manuel of South Africa) to review the governance structure and to draft proposals for its reform. The Executive Board responded with the establishment of a committee to discuss these issues and draw conclusions. The process has just started and it is envisaged that reforms should be outlined in the course of 2009.

Two issues that could be further discussed are the criticism that the Executive Board excessively focuses on executive rather than supervisory functions and the perceived need of more systematic ministerial involvement. The IMF's Articles itself envisage an "executive" rather than a "supervisory" Board since it is responsible for conducting the business of the IMF. In this regard, historic records from the Bretton Woods conference[32] suggest that the drafters intended that the Board would exercise "political" control over management and staff's work by putting the Board in charge of conducting the business of the IMF. With respect to the systematic "ministerial" involvement, under the current Articles, by resolution of the Board of Governors, a "Council" could be established.[33] The Council would be a decision-making organ of the IMF between the Board of Governors and the Executive Board. It would counter the criticism that the Executive Board does not consist of the high-level representatives who are needed to conduct oversight over the IMF's operations and adopt high-level and directional decisions and that

[30]Independence Evaluation Office, Governance of the IMF: An Evaluation (May 2008), http://www.ieo-imf.org/eval/complete/eval_05212008.html.

[31]See: http://www.imf.org/external/np/sec/pr/2008/pr08200.htm.

[32]Horsefield, *The International Monetary Fund 1945–1965. Twenty Years of International Monetary Cooperation, Vol. I: Chronicle*, 1969, p. 132 (133).

[33]See Article XII, Section 1 and Schedule D of the IMF's Articles.

the Board of Governors is too large of a body (consisting of 185 governors) to efficiently discharge such a function. While the IMFC was created to assume this role, it is not a formal organ of the IMF. The Council, if established, would consist of high-level officials (central bank governors, or Ministers of Finance) and would mirror the Executive Board in terms of number of Councilors.

Quota and Voice

Decisions in the Executive Board and resolutions in the Board of Governors are adopted on a quota-based system.[34] Based broadly on its relative size in the world economy,[35] each IMF member is assigned a quota, which largely determines a member's voting power in IMF decisions. Quotas also determine the size of a member's contribution to the IMF and the extent of its access to IMF financing. The IMF quota is thus an essential indicator of a member's influence and usefulness of the IMF.[36]

Given their strong growth relative to industrial members, some emerging market members perceive that their quota no longer adequately reflect their status in the world economy. To address this criticism, the IMF's quota and voice reform adjusts quotas to better reflect the relative weight of member countries in the world economy, particularly that of dynamic emerging countries. It also enhances the voice and representation of low-income countries within the IMF. The process was launched in 2006 and the reform occurred in various steps:

- First, an initial ad-hoc increase in quotas for the most underrepresented members, such as, China, Korea, Mexico, and Turkey.
- Second, a new quota formula to guide the assessment of the adequacy of members' quotas in the IMF.
- Third, a second round of ad hoc quota increases for 54 IMF member countries based on the new formula.
- Forth, an increase in the basic votes of each member to ensure adequate voice for low-income countries, as well as protection of the share of the basic votes in total voting power going forward. This step requires an amendment to the IMF's Articles.[37]

[34]Except as otherwise specifically provided ("special majorities"), all decisions of the IMF are made by a majority of the votes cast. See Article XII, Section 5(c) of the IMF's Articles.

[35]When a country joins the IMF, it is assigned an initial quota in the same range as the quotas of existing members that are broadly comparable in economic size and characteristics. The IMF uses a quota formula to guide the assessment of a member's relative position.

[36]Members' quotas are reviewed periodically at intervals of not more than five years. A general review of quotas allows the IMF to assess the adequacy of quotas in terms of its own ability to help meet the financing needs of members. A general review also allows for increases in members' quotas to reflect changes in their relative positions in the world economy. Ad hoc quota increases outside general reviews have been rare in recent decades.

[37]The reform in basic votes requires an amendment to the IMF's Articles. Basic votes reflect the principle of equality of states and give the smallest members of the IMF, many of which are low-

The quota reform has been agreed upon and finalized, but needs to be implemented. Given that it involves an amendment to the Articles, it may take some time. It was a major step into the direction of adequate representation of emerging IMF members, while continuing to ensure adequate representation of low-income members.

Conclusion

Challenges Ahead

The unprecedented effects of the global financial crisis on IMF members have also raised the question whether the IMF has sufficient financing resources to assist all its members if they were to request IMF assistance. While quotas of members are the main source of financing, the IMF can activate supplementary borrowing arrangements if it believes that resources might fall short of members' needs. Through the General Arrangements to Borrow and the New Arrangements to Borrow, a number of member countries and institutions stand ready to lend additional funds to the IMF. However, since the membership's financing needs cannot be precisely predicted in an uncertain climate – as is currently the case – it needs to be seen whether the IMF will need to supplement its financing resources through other means.[38] It should be noted that in February 2009, Japan and the IMF bilaterally concluded a borrowing agreement in the amount of up to US $100 billion.

Outlook

The IMF has recently successfully undertaken or started to undertake reforms in key areas some of which need to be implemented within the next few years. It should be recognized that in a dynamic world the IMF will need to continue to adapt its legal framework to the changing global environment to remain legitimate and relevant.

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income countries, a greater voice in the IMF. Each IMF member has 250 basic votes plus one additional vote for each SDR 100,000 of quota. Further, the proposed Amendment of the IMF's Articles will allocate additional resources for the two Executive Directors representing African members, as their constituencies comprise a fairly large number of countries. The proposed amendment will also add a provision to the IMF's Articles that the share of basic votes in total voting power should not decline in the event of future quota realignments. In order to avoid the erosion in voting share of low-income countries, the ad-hoc increases will not become effective until the proposed amendment to the IMF's Articles (on Quota and Voice) has become effective.

[38]Under Article VII, Section 1 of the IMF's Articles, the IMF may borrow currency from other sources within or outside of an IMF member on terms and conditions agreed between the IMF and the member. The IMF already used this authority to borrow for the General Arrangements to Borrow and the New Arrangements to Borrow.

The G8 and the Heiligendamm Process: A Group's Architecture in Flux

Katharina Gnath

Introduction

The strengthening of its relationship with emerging countries has been the central development of the G8 in 2007 and 2008. While the debate on how to better represent and integrate non-members into the Group of Eight is hardly new, it has gained new political momentum in the period under review: The 2007 summit in Heiligendamm established a topic-centred dialogue with the "Outreach 5" (O5) countries China, India, Brazil, South Africa and Mexico. The "Heiligendamm Process" was a response to the Group's perceived lack of representativeness and effectiveness; at the same time, it avoided a change in the G8's central structure through formal enlargement. In the context of the current debate of how global economic institutions and fora adapt to systemic change, the analysis touches on important issues of global governance that go beyond the G8's new initiative. Before examining the G8's recent adjustment, the chapter briefly summarises the Group's main characteristics and provides an outline of the thematic developments in the review period.

Background: The G8's Aims and Characteristics

The G8 is a high-level informal forum of governments that was founded in response to the global economic crises of the early 1970s. Its roots lie in the 1973 Library Group, a round-table for finance ministers of the G5 – France, Germany, the United Kingdom, the United States and Japan. Italy joined when the G6 met for their first summit of the heads of state and government in 1975. A year later, Canada

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became member at the request of the United States. Since 1977, the EC/EU is present at summits, but is not considered a full member. After a period as a guest, Russia officially became a member in 1998, although it was not invited to participate regularly in the G7 meetings of finance ministers and central bank governors.[1]

The G8 is an international forum to exchange views, clarify positions and support coordination on a non-binding basis on a wide range of global issues – it is not an international organisation. Having no "cafeteria or a pension plan",[2] it is characterised by the absence of formal procedures. As such, its influence is based on the capabilities and resources of its members to exert concerted ideational and material leadership domestically and within the network of international organisations of which they are major shareholders.[3]

The Group started out as a yearly personal get-together of the leaders of the world's most powerful economies. While it has maintained large parts of its conversationalist character with no formal rules or follow-up machinery, the summits of the heads of state and government depict only the "tip of the iceberg"[4] in a close-knit network of governments: The activities of the G8 now take place throughout the year at different levels and stages of the policy process. Yet, for the purpose of the present analysis, the yearly summits serve as useful signposts in tracing the Group's thematic and institutional developments. They bundle the work of the members' Sherpa teams in charge of the G8 preparations and attract most of the public attention.

Presidencies and Themes 2007/2008

The G8's agenda is set by the yearly-rotating presidency in consultation with the other members. Over the years, the thematic scope and depth of the G8 has expanded. While having traditionally been focused on international economic

[1]For an overview of G7/G8 participation see Bini Smaghi, Powerless Europe: Why is the Euro Area Still a Political Dwarf? International Finance 9 (2006) 2, p. 261 (265).

[2]Pentillä, The Role of the G8 in International Peace and Security, Adelphi Paper (2003) 355, The International Institute for Strategic Studies, p. 5.

[3]The G8's aims and defining characteristics are contested in the literature. The account above follows the "network school", see, e.g. Lesage, Globalisation, Multipolarity and the L20 as an Alternative to the G8, Global Society 21 (2007) 3, pp. 343 (347); Gstöhl, Governance through government networks: The G8 and international organization, The Review of International Organizations 2 (2007) 1, p. 1 (3); Slaughter, Government networks, World order, and the L20, in: English et al. (eds.), *Reforming from the Top. A Leaders' 20 Summit*, 2005, p. 280 (286).

[4]Gstöhl, Global Governance und die G8: Antwort auf globale Probleme [Global Governance and the G8: Answer to global problems], in: Gstöhl (ed.), *Global Governance und die G8. Gipfelimpulse für Weltwirtschaft und Weltpolitik* [Global Governance and the G8. Summit impulses for the world economy and world politics], 2003, p. 9 (16). German quotes are translated by the author. On the procedural character of the G8 see also Baker, *The Group of Seven. Finance ministries, central banks and global financial governance*, 2006.

policy and cooperation, the Group has increasingly addressed other major global challenges, including environmental and energy issues, and development and security policy. The thematic broadening has been reinforced by an increasing number of minister and expert meetings that take place in addition to the main summit of the heads of state and government throughout the year.[5]

The German presidency in 2007 had initially planned to take the G8 "back to the roots" by focusing on global economic issues. Yet international economic policy was sidelined during the leaders' summit. This was partly due to the members' inability to agree on a common stance towards stricter rules for more financial market transparency or a code of conduct for hedge funds. Over the course of review period, the global economic outlook worsened considerably, and the deteriorating state of the world economy grew to a leading topic in the run-up to the 2008 summit in Toyako: Spiralling food and oil prices and turbulences in the international housing, credit and financial markets became a major concern of the G8.

However, the single most important issue on the G8's agenda in 2007 and 2008 was the environmental challenge of climate change. The German presidency made it one of its foremost aims to come to an agreement on cutting greenhouse gas emissions among the G8 members. At the summit in Heiligendamm, the G8 leaders committed to "seriously consider" cutting emissions by half by 2050. The United States (together with Russia) blocked a common numerical emission target as recommended inter alia by the Intergovermental Panel on Climate Change (IPCC).[6] Yet, for the first time in international negotiations, president George W. Bush departed from his previous rejection of a UN-led initiative for the post-Kyoto negotiations. Climate change continued to be a main focus of the Japanese presidency in 2008: At the summit in Toyako, the leaders agreed to "share the common vision" to reduce emissions by at least 50%.[7] While the members could this time set on a common binding target, they left the base year for the cuts unspecified.

Development policy, with special emphasis on Africa, has traditionally featured high on the G8's agenda and was a key issue again in 2007 and 2008. Further discussions at the G8 included, among others, the situation in Afghanistan, North

[5]In addition to the set agenda, the G8 also deals with urgent international matters like security or humanitarian crises on a flexible basis. For an excellent overview of G8's past agendas see University of Toronto, *G8 Information Centre*, http://www.g7.utoronto.ca/ (last accessed 25/1/2009).

[6]All G8 members but the United States and Russia committed in fact to cut emissions. On the rift between the German presidency and the US-administration over climate change in the run-up to the summit see, e.g. Benoit/Williamson, Merkel to push Bush on climate change, Financial Times, 4/6/2007, p. 2.

[7]G8, *Chair's Summary*, 9/7/2008, http://www.mofa.go.jp/policy/economy/summit/2008/doc/doc080709_09_en.html (last accessed 14/1/2009).

Korea and non-proliferation, political developments Iran, and the deteriorating situation in Zimbabwe.

The G8 and Summitry Reform

The History of G8 Outreach

In its 34-year history, the Group has seen very few changes to its formal membership base. After the initial set-up phase was completed in 1977, it took more than 20 years for another country – Russia – to join the summits of the heads of state and governments. However, since the late 1990s, there has been an incremental loosening of the Group's hermetic character through a process of "Outreach" – a strengthened dialogue between the G8 and non-member countries.[8] In 1997, the Group's members met with leaders of APEC countries, and several G8 members convened with emerging countries on their way to the Okinawa summit in 2000. Since the Genoa summit in 2001, each G8 presidency has invited a selected number of third-country representatives to different parts of its deliberations: Several African leaders joined sections of the summit in 2002; the 2003 French presidency extended invitations beyond African countries to the governments of China, India, Brazil and Mexico; and leaders from the Middle East participated in parts of the US Sea Island summit in 2004. Tony Blair re-established the French Outreach to what was then termed the O5 – China, India, Brazil, Mexico and South Africa – at the Gleneagles summit in 2005 on issues pertaining to energy and climate policy. Despite Russia's initial reluctance, the dialogue with the O5 was continued at the 2006 St. Petersburg summit. While there has been a steady increase in outreach initiatives between the G8 and non-member countries over the past decade, the pattern of dialogue remained diffuse and ad hoc and depended on the priorities of the respective presidency in its choice of invited countries and the format for discussions.[9]

[8]The paper focuses on Outreach as intensified dialogue with non-member countries. The term can also refer to increased participation of international organisations and civil society actors in the G8's proceedings. On the G8's relationship with international organisations see Gstöhl, Governance through government networks: The G8 and international organizations, The Review of International Organizations 2 (2007) 1, p. 1; on the engagement with civil society see Hajnal, The role of civil society, in: Hajnal (ed.), *The G8 System and the G20. Evolution, Role and Documentation*, 2007, p. 103.

[9]For a chronology of Outreach initiatives until 2005 see G8 Research Group, G8 Reform: Expanding the Dialogue. An Overview of the G8's Ongoing Relationship with the Emerging Economic Countries and Prospects for G8 Reform, University of Toronto, 2005, p. 14, http://www.g8.utoronto.ca/evaluations/csed/ed_050707.pdf (last accessed 25/1/2009).

The Heiligendamm Process 2007–2009

Although summitry reform of the G8 has long been debated,[10] it gathered momentum in the review period. One of the cornerstones of the 2007 German presidency was the establishment of a formalised and structured Outreach mechanism between the G8 and the O5. The Heiligendamm summit launched a topic-driven dialogue on key global issues, which was set around four thematic pillars: (1) promoting and protecting innovation; (2) enhancing freedom of investment through an open investment environment including strengthening corporate social responsibility principles; (3) defining common responsibilities for development with special regard to Africa; and (4) sharing knowledge for improving energy efficiency and technology cooperation, especially with view to climate change. The "Heiligendamm Process" was set to be reviewed after two years at the 2009 summit in Italy. Rather than incorporating the dialogue in the G8's central structure of the national Sherpa teams preparing the summits, the OECD was invited to assist the work of the Process with its broad organisational and technical expertise in form of a newly-established support unit.[11] A high-level steering group (at Sherpa level) and official-level working groups on the four topics were established in the second half of 2007, with representatives of the G8 and the O5 co-chairing the sessions.

The German presidency was the palpable initiator – and the main financier – of the Process,[12] and some G8 members have remained ambivalent about it. During its presidency in 2008, Japan downplayed the role of the Process for fear of acknowledging the power of China: It diluted the accentuated role of the O5 by inviting further non-members such as Australia, South Korea, Indonesia and leaders from several African countries to parts of the G8 summit. Yet not only G8 members remained ambiguous: Some of the O5 countries complained that they had only been granted a limited role at the launch summit in Heiligendamm and pressed for

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[10] For a concise review of reform proposals see Hajnal, Summitry from G5 to L20: A Review of Reform Initiatives, Working Paper (2007) 20, The Centre for International Governance Innovation (CIGI), http://www.igloo.org/community.igloo?r0=community&r0_script=/scripts/folder/view.script&r0_pathinfo=%2F%7B7caf3d23-023d-494b-865b-4d143de9968%7D%2FPublications%2Fworkingp%2Fsummitry&r0_output=xml (last accessed 15/1/2009).

[11] G8 Summit, Growth and Responsibility in the World Economy, Summit Declaration, 7/6/2007, p. 37, http://www.g-8.de/Content/EN/Artikel/__g8-summit/anlagen/2007-06-07-gipfeldokument-wirtschaft-eng,templateId=raw,property=publicationFile.pdf/2007-06-07-gipfeldokument-wirtschaft-eng (last accessed 24/1/2009); see also Joint Statement by the German G8 Presidency and the Heads of State and/or Government of Brazil, China, India, Mexico and South Africa on the occasion of the G8 Summit, 8/6/2007, http://www.g-8.de/nsc_true/Content/EN/Artikel/__g8-summit/anlagen/o5-erklaerung-en,templateId=raw,property=publicationFile.pdf/o5-erklaerung-en (last accessed 13/1/2009).

[12] In fact, the declaration launching the Heiligendamm Process was issued by the O5 and the German presidency – and not by all G8 members. See also Fues/Leininger, Germany and the Heiligendamm Process, in: Cooper/Antkiewicz (eds.), *Emerging Powers in Global Governance: Lessons from the Heiligendamm Process*, 2008, p. 235 (245 and 252).

greater involvement in the choice of items on the Process' agenda.[13] Furthermore, some feared that the great proximity to what was essentially an exclusive club of rich nations might damage their reputation as anchor countries for the developing world. This cautiousness was fuelled by locating the Process at the OECD, a Western-dominated organisation.

Despite initial difficulties in setting up the Process, the steering group and working groups subsequently look up their work. According to commentators closely observing the Process, trust has risen among the participants.[14] Furthermore, the O5 – or "G5", as they have named themselves – have gradually developed an identity vis-à-vis the G8 in spite of diverging interests and foreign policy identities.[15]After the initial two-year period ended in July 2009, the G8 and O5 agreed to continue the dialogue as "Heiligendamm L'Aquila Process" until mid-2011.[16]

Accounting for Change at the G8

Responding to the Dual Crisis of Representativeness and Effectiveness

The establishment of the Heiligendamm Process was an attempt to solve the G8's persisting problems of inadequate representativeness and lacking

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[13]The G8 had published the statement to launch the Heiligendamm Process before the O5 had joined the Heiligendamm summit. See, e.g. Singh, *PM's on board interaction with media on flight from Berlin to New Delhi*, 9/6/2008, http://meaindia.nic.in/mediainteraction/2007/06/09mi01.htm (last accessed 13/1/2009); Lourdes Aranda, deputy foreign minister of Mexico, quoted in Williamson, Rich nations stall dialogue with emerging powers, Financial Times, 3/7/2009, p. 6.

[14]See, e.g. Cooper, The Heiligendamm Process, in: Cooper/Antkiewicz (eds.), Emerging Powers in Global Governance: Lessons from the Heiligendamm Process, 2008, p. 1. Steering Committee of the Heiligendamm Process, Interim Report on the Heiligendamm Process at the G8 Summit in Hokkaido Toyako, 7-9/7/2008, http://www.mofa.go.jp/policy/economy/summit/2008/doc/pdf/0709_01_en.pdf (last accessed 26/1/2009).

[15]E.g. G5, Statement Issued by Brazil, China, India, Mexico and South Africa on the occasion of the 2008 Hokkaido Toyako Summit, 8/7/2008, http://www.g8.utoronto.ca/summit/2008hokkaido/2008-g5.html (last accessed 14/1/2008); Secretaría de Relaciones Exteriores [Mexican Ministry of Foreign Affairs], Se Reúnen los Cancilleres del Grupo de los Cinco en Nueva York [The Chancellors of the G5 meet in New York], 27/9/2007, http://www.sre.gob.mx/csocial/contenido/comunicados/2007/sep/cp_253.html (last accessed 14/1/2009).

[16]G8, The Agenda of the Heiligendamm-L'Aquila Process, http://www.g8.italia2009.it/static/G8_Allegato/O6_Annex_2_concept_Note_on_HAP.pdf (last accessed 5/10/2009).

effectiveness.[17] Due to the phenomenal shifts in the global balance of economic powers in recent years, the G8 did not adequately reflect the prevalent power structures in the world economy anymore. Even if the G8 members still occupy the world's top positions in economic terms, others – especially big emerging countries such as China and India – are quickly catching up.[18]

There has been a growing recognition in the scholarly and policy community that the G8 members alone cannot effectively solve many of today's most pressing global problems. The agendas 2007 and 2008 show many examples for the G8's collective ineffectiveness: Without countries like China – by far the largest holder of foreign reserves and one of the main CO_2-emitters –, or India and Brazil – both key players in the multilateral trade negotiations – global solutions on climate change, international trade or global imbalances are hardly feasible. Other G8 issues that require broader cooperation include intellectual property and investment rules, energy security, commodity prices and development policy. Bringing together those countries that are politically and economically important was meant to increase effectiveness of commonly agreed global solutions.

In addition, the G8 has continuously faced heavy criticism for its unelected and self-selected status and its lack of accessibility for non-members – a criticism that finds its vocal outlet in the large crowds of protestors who have become an integral part of all G8 summits. The G8 has long been accused of promoting a policy agenda that has global effects beyond its members' realm without giving the affected a voice. Integrating countries from a varied geographical provenance into the G8's work more closely through the Heiligendamm Process aimed to ameliorate the G8's representativeness.

The G8's Reluctance to Enlarge

Nevertheless, while a broad agreement on the need to enhance dialogue and cooperation with non-members has long existed among the G8 members, countries have differed as to how far, how fast and in what form non-members should be integrated.[19] Two main arguments have generally been advanced by the opponents

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[17]Cooper/Jackson, Regaining Legitimacy: The G8 and the "Heiligendamm Process", International Insights 4 (2007) 10, p. 1; on comparable reasons for establishing the G20 see Kirton, The G20: Representativeness, Effectiveness, and Leadership in Global governance, in: Kirton et al. (eds.), *Guiding Global Order: G8 Governance in the twenty-first Century*, 2001, p. 143.

[18]For a summary of the shift of global economic weight see, e.g. Gnath, Beyond Heiligendamm: The G8 and its dialogue with emerging countries, Internationale Politik Global Edition (2007) 3, p. 36 (37).

[19]Due to the informality, the G8 does not have formal membership criteria. On the choice of participating non-member countries see Cooper, The Logic of the B(R)ICSAM Model for G8 Reform, *Policy Brief in International Governance* (2007) 1, The Centre for International Governance Innovation (CIGI), http://www.cigionline.org/community.igloo?r0=community&r0_script=/scripts/folder/view.script&r0_pathinfo=/%7B7caf3d23-023d-494b-865b-84d143de9968%7D/Publications/policybr/thelogic&r0_output=xml (last accessed 15/1/2009).

of formal enlargement. First, the G8's small size and the informality of its meetings have been seen as a necessary precondition for a direct and frank exchange of views.[20] It has been feared that admitting further countries would reduce the G8's capacity to react flexibly and quickly.

Second, the members have considered themselves as a homogenous group. The continued commitment to share a common set of values as reflected in the founding declaration[21] has been perceived as vital for the Group's robustness. Russia's accession in 1998, which marked a departure from the value-based membership principle, has been judged a mistake by many, thus reinforcing the centrality of common core political and economic values. Among the potential candidates for membership, China ranks highest due to its exceptional position in the world economy. Yet despite gradual rapprochement over time, China's political system has so far made full integration difficult to accept for some group members.[22] Other big emerging countries such as India and Brazil, whose political values might conform better to those of the G8, will most likely not be accepted before China.

The literature has suggested that the G8's informal character made regeneration and adaptation to changing circumstances comparably easy.[23] There is no doubt that the absence of legal constraints and the limited number of veto players reduces the hurdles for adjustment. Still, the Group has been marked by a high degree of institutional stability, showing great reluctance to transform or to open up.[24] Hence, the G8 faced a dilemma: On the one hand, the pressures to reform its architecture and incorporate new actors had multiplied over time and "business as usual" was not considered a viable option anymore; on the other hand, the stability of the set-up was seen as a crucial precondition for the Group's success, and outright enlargement did not find the support of all members in the review period.

[20]See, e.g. Fratianni et al., Introduction, in: Fratianni et al. (eds.), *New Perspectives on Global Governance: Why America Needs the G8*, 2005, p. 3 (4).

[21]"We came together because of shared beliefs and shared responsibility. We are each responsible for the government of an open, democratic society, dedicated to individual liberty and social advancement". G6, Communiqué Declaration of Rambouillet, 17/11/1975, http://www.g8.utoronto.ca/summit/1975rambouillet/communique.html (last accessed 13/1/2009).

[22]On the changing relationship between the G8 and China see, e.g. Kirton, The G7/8 and China: Toward a Closer Association, in: Kirton et al. (eds.), *Guiding Global Order: G8 Governance in the Twenty-First Century*, 2001, p. 189; see also Chin, China's Evolving G8 Engagement: Complex Interests and Multiple Identity in Global Governance Reform, in: Cooper/Antkiewicz (eds.), *Emerging Powers in Global Governance: Lessons from the Heiligendamm Process*, 2008, p. 83 (104).

[23]Rode, *Weltregieren durch internationale Wirtschaftsorganisationen* [Global Governance through international economic organisations], 2001, p. 26.

[24]Lesage, Globalisation, Multipolarity and the L20 as an Alternative to the G8, Global Society 21 (2007) 3, p. 343 (345).

The Heiligendamm Process: Incremental Adjustment Outside the G8's Central Structures

The establishment of a body outside an institution's central structures that includes both members and non-members provides an alternative adjustment mechanism to outright enlargement: It allows an institution to respond to a set of external and internal factors that has led to a crisis in decision-making and creates "voice" for outsiders. At the same time, it provides an "exit" strategy for the existing members: It by-passes internal constraints and minimises the risk to destroy the central system's stability.

The Heiligendamm Process opened up such an outside option for incremental change.[25] The establishment of a new dialogue format that used the OECD – rather than the preparatory system of the G8 presidency – shifted the adjustment process to a non-central venue. The Process' steering group and workings groups can be conceived as outside bodies that created both exit and voice for the G8 members and some selected non-members. For the G8 countries, the set-up depicted an opportunity to adjust in the face of the double crisis of lacking representativeness and effectiveness while maintaining the exclusivity and homogeneity of the summit system. Contrary to one-off negotiations, a longer-term perspective of interaction increases the sustainability of compromises and potentially furthers cooperation on key global issues beyond the G8. The Process departed from the ad hoc approach of former Outreach initiatives by formalising the relationship between the G8 and the O5, which enhances the Group's overall effectiveness and legiticuacy.

At the time of its creation, the non-central character was not only in the G8 members' interest, but also served the O5's preferences: It raise the O5 countries' profile in the G8's system and gave them the opportunity to actively participate in the G8 deliberations. At the same time, too close a relationship with what has traditionally been conceived as a "Western club" endangered the non-members' status as developing countries and as representatives of the global South.[26] The Heiligendamm Process thus offered an opportunity to the O5 to have more voice according to the increased role in the global economy without having to decide whether or not to actively pursue formal membership and risking to incur an image loss vis-à-vis their regional partners.

[25]Prantl, Informal Groups of States and the UN Security Council, International Organization 59 (2005) 3, p. 559 (pp. 561–568). Although Prantl developed the theoretical framework within the context of the UN-system, it provides a useful analytical starting point to the G8's recent Outreach initiative and its distinction between the core summit structure and the external set-up of the dialogue.

[26]In addition to the joint statement with the G8 that established the Heiligendamm Process, the O5 issued a separate position paper stressing their common allegiance to the global South. Joint Position Paper of Brazil, China, India, Mexico and South Africa participating in the G8 Summit, 8/7/2007, http://pmindia.nic.in/GermanyG-8_visit.htm (last accessed 26/1/2009).

The Future of the G8

Variable Geometry in a Multi-layered Network

The permanent accession of Russia to the political G8 but not the G7 of finance ministers in the late 1990s depicted an important departure from the concept of unitary Group membership. The increasing number of flanking ministerial meetings and topic-related task forces have further added additional layers to the G8's architecture. The 2008 Toyako summit can be conceived as effectively three overlapping summits, with "Africa on day one, the G8 on the second day and the big developing carbon emitters on the third".[27] Similarly, only the first day of the 2009 summit in L'Aquila was reserved for the G8; discussions on the second and third day were organised in a range of formats and included participants from the O5, Egypt, and several African countries. The Heiligendamm Process has reinforced this multi-level network character over the review period, and the G8's further differentation through over lapping contituencies "with a flexible plus"[28] will continue to be an important feature of the G8's future architecture.

The process beyond Heiligendamm

The Heiligendamm Process was agreed for an initial period of 2 years. A final report was issued at the summit in L'Aquila in July 2009 where it was decided to continue the process for at least another 2 years – albeit in a more flexible format than before.[29]

Nevertheless, calls for alternative reform paths did not cease and even gained momentum: In July 2008, Nicholas Sarkozy proposed yet again to expand the G8 to a G13 on a permanent basis. He posited that it was "not reasonable to continue to meet as eight to solve the big questions of the world, forgetting China – 1.3 billion people – and not inviting India – 1 billion people".[30] Gordon Brown – echoing calls

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[27] Brown quoted in Pilling, Club under pressure to expand, Financial Times, 10/7/2008, p. 2, http://www.ft.com/cms/s/0/c7454f2a-4dde-11dd-820e-000077b07658,dwp_uuid=af522be6-4c8c-11da-89df-0000779e2340.html (last accessed 28/1/2009).

[28] Neidhart, Der exklusive Club öffnet sich [The exclusive club opens up], Süddeutsche Zeitung, 10/7/2009, p. 8; BBC Monitoring European, Italy to bring "flexible format" to G8, 2/1/2009, http://g8live.org/2009/01/02/italy-to-bring-flexible-format-to-g8/ (last accessed 15/1/2009); see also Lesage, Globalisation, Multipolarity and the L20 as an Alternative to the G8, Global Society 21 (2007) 3, p. 343 (359).

[29] G8 Presidency 2009, Details: The Dialogue Process with Emerging Countries, http://www.g8italia2009.it/G8/Home/IlContesto/G8-G8_Layout_locale-1199882116809_VersoAllargamento.htm (last accessed 21/1/2009).

[30] Quoted in Wendtland, France's Sarkozy says "not reasonable" to meet as G8, Reuters.com, 5/7/2008, http://www.reuters.com/article/newsMaps/idUSPAC00963220080705 (last accessed 23/1/2008).

made by his predecessor Tony Blair – continued to demand a greater role of the O5 in the G8's central proceedings. Hence, while the Heiligendamm process has been accepted by its participants as a useful step towards adjusting the G8, it has not been successful in putting an end to the debate on the reform of the Group's architecture.[31]

A Regular Leader's G20?

A direct competitor to the incremental reform that the Heiligendamm Process epit omises is the permanent expansion of the G18 to a G20 – a, "big bang."[32] Given the strong reservations by several G8 members, the feasibility of reform through large scale enlargement has previously been judged low.[33]

However, the current financial crisis has created political mometum for broad-based governance reforms that has not failed to affect the G8.[34] For the first time in November 2008, the G20 met in the leaders' composition to discuss the implications of the financial crisis on the world economy and to consider possible ways to reform the global economic order. The new format was initially restricted to the ongoing economic crisis. Yet after having convened three times over the course of

[31] The Italian and the French government have called for the participation of an Arab or Muslim country such as Egypt beyond the O5. E.g. Reuters, Italy aims to expand G8 in include China, India, Brazil, 28/9/2008, http://in.reuters.com/article/topNews/idINIndia-35695220080928 (last accessed 4/1/2009).

[32] The original G20 is a forum for discussion among finance ministers and central banks that includes the G8, the O5, as well as Argentina, Australia, Saudi Arabia, South Korea and Turkey. The new form has been labelled G20 or "Leaders' 20" in the literature to distinguish it from the lower-ranking G20 of finance ministers. On the L20 see, e.g. Cooper/English, Introduction: Reforming the international system from the top – a Leaders' 20 Summit, in: English et al. (eds.), *Reforming From the Top. A Leaders' 20 Summit*, 2005, p. 1; Linn/Bradford, Pragmatic Reform of Global Governance: Creating an L20 Summit Forum, Policy Brief (2006) 152, The Brookings Institution, http://www.brookings.edu/papers/2006/04globalgovernance_linn.aspx (last accessed 22/1/2009).

[33] See Fues, Global Governance Beyond the G8: Reform Prospect for the Summit Architecture, Internationale Politik und Gesellschaft (2007) 2, p. 11 (17). For an overview of different G8 reform paths and their estimated likeliness see Bradford, The United States and Summit Reform, in: Cooper/Antkiewicz (eds.), *Emerging Powers in Global Governance: Lessons from the Heiligendamm Process*, 2008, p. 307 (323 et seq.).

[34] Payne, The G8 in a changing global economic order, International Affairs 84 (2008) 3, p. 519 (529); for the recent revival of the L20 approach see Bradford/Linn/Martin, Global Governance Breakthrough: The G20 Summit and the Future Agenda, Policy Brief (2008) 168, The Brookings Institution, http://www.brookings.edu/papers/2008/12_g20_summit_bradford_linn.aspx (last accessed 15/1/2009).

twelve months, it was decided at the Pittsburgh summit in September 2009 that the newly-upgraded G20 would take on a permanent coordinating role.[35]

Concluding Remarks

With the establishment of a regular G20 at leaders' level, the G8 finds itself at a critical juncture – with its future being more uncertain than ever. It is very likely that the G7/8 will lose influence to the G20 at least in matters of global finance. In how far the recent developments constitute the G8's "death certificate"[36] or whether it will be successful in working along side the new G20 will crucially depend on the G8's response beyond the Heiligendamm Process.

[35]See leaders' statement: The Pittsburgh Summit, 24-25/9/09, http://www.pittsburghsummit.gov/mediacenter/129639.htm (last accessed 6/10/09).

[36]Crook, Expectations come down to earth, FT.com, 16/11/2008, http://www.ft.com/cms/s/0/c4f4539c-b3ff-11dd-8e35-0000779fd18c.html (last accessed 15/1/2009); for a similar assessment see also The Economist, Global Governance. Goodbye G7, hello G20, 20/11/2008, http://www.economist.com/finance/displaystory.cfm?story_id=12652239 (last accessed 1/12/2008).

Part IV
Book Reviews

Jens-Christian Gaedtke, Politische Auftragsvergabe und Welthandelsrecht

Duncker & Humblot, Berlin, 2006, ISBN 978-3428117581

Oliver Dörr

This dissertation, written under the supervision of Martin Nettesheim at the University of Tübingen, brings together two issues that count among the most debated ones in international economic law. First, there is the longstanding debate to what extent the rules of world trade allow the WTO member states to pursue non-economic objectives in their trade relations with one another: that debate has culminated in well-known trade disputes, such as those on import restrictions on shrimps in order to protect the dolphins, import restrictions against genetically manipulated food, or the violation of immaterial property rights in order to provide free AIDS medicine to the population. Yet, the underlying tension between economic goals of international trade law and non-economic goals of national policies goes far beyond those particular disputes; it seems to be inherent in the universal trade system built upon WTO law. Secondly, the law of public procurement has been, for quite some time now, seized with the question whether national procurement authorities may pursue political objectives when awarding public contracts, such as to require contractors to respect certain social, environmental or human rights standards. The discussion on those "secondary" objectives has so far been mainly focussed on the procurement rules of the European Community, and seems to have neglected the impact of WTO law. Gaedtke's opus goes about to change that, and asks what are the limits to political objectives in public procurement, in short to "political procurement," under WTO law.

The book is divided into three parts, the first of which describes in rather general terms those features of the current world trade system which could predetermine the conflict between the universal objective to reduce trade-barriers and the various non-trade-related policy objectives of the WTO member states. Gaedtke collects elements of the WTO system that argue in favour of an increased member state autonomy with respect to non-economic objectives, such as the limited functions of

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C. Herrmann and J.P. Terhechte (eds.), *European Yearbook of International Economic Law 2010*, European Yearbook of International Economic Law,
DOI 10.1007/978-3-540-78883-6_19,

the WTO and the deregulatory effects of its legal order, its in some aspects insufficient legitimacy, and the role of non-economic policy goals pursued by other treaty regimes within the international system of which he sees the WTO as an integral part. All this leads the author to conclude that the WTO organs ought to a greater extent respect the autonomy of member states by modifying their proportionality test: for the purposes of that test, the national policy objectives should in principle be attributed the same weight as the general objective of unrestricted world trade.

In his second part, the main part of his thesis, Gaedtke applies these general observations to the admissibility of "political procurement" under the WTO rules, above all under the plurilateral Government Procurement Agreement (GPA). He begins by explaining how procurement is all over the world being used by public authorities for political objectives that are not contract-related; he describes different forms of "political procurement," and points out to what extent they are admissible in Germany and the United States, the rules in the former being, of course, implemented Community law. Gaedtke only very briefly points to the important rulings of the European Court of Justice that determine the admissibility of political criteria for the member states of the Community. His account of the case law is, however, too scant to really give an idea on what the state of Community law in this matter is. The new European rules contained in the unified Procurement Directive of 2004 are mentioned, but the author was not able to analyze their practical effects in some detail, because he finished his work apparently some months before the Directive entered into force. The author uses much more space for describing the practice of "political procurement" in Germany and the US and how it is being used in order to pursue a variety of regional, social, environmental, human rights or foreign policy objectives than he does concerning the admissibility of the practice.

Following a somewhat puzzling systematic order, this second part continues by applying the rules of the GPA to those forms of "political procurement." Gaedtke begins with the scope of the Agreement, which follows, as does the entire WTO legal system, the principles of self-commitment and reciprocity. This makes the GPA for some look more like a collection of bilateral treaties, and makes determination of the scope in any given case a rather complicated matter. And it allows parties to exempt certain procurement objectives from the binding effect of the Agreement, which makes things even more complicated. The heart of the matter lies, of course, in the question as to which norms of the GPA "political procurement" could possibly violate. The author turns to the procedural rules of Art. VII et seq., the rules of non-discrimination, and those on technical specifications. He finds that the former give the parties considerable room for applying supplier-related and product-related political criteria, as long as they are from the outset made an explicit part of the conditions of contract and thus their use conforms to the principle of transparency. However, "political procurement" must also be in accordance with the principles of national treatment and most-favoured treatment, the two non-discrimination rules of Art. III GPA. Gaedtke demonstrates appropriately how the use of political criteria can under certain circumstances run counter to the general obligation of national treatment, whereas the rule of most-favoured treatment is of far lesser importance in this respect. Also the rules on technical specifications laid down in Art. VI GPA are in the view of the author only relevant with regard to ecological procurement criteria.

The essential test for the compatibility of "political procurement" with the GPA is, of course, the question whether an infringement, for example against the rule of national treatment, can be justified under the exception clauses of Art. XXIII of the Agreement. The author examines both paragraphs of that Article for their relevance in respect of political criteria. Para. 1, which concerns essential security interests of the parties, has not been relevant in GPA practice so far, but the provision entails the risk of lending itself all too easily to political abuse: in times of the international fight against terrorism, almost every procurement measure of a certain scale could be tagged as being important for national security. This is why Gaedtke proposes a moderate abuse control in applying the norm: parties should only be allowed to rely on it if they can present a plausible connection with the need to safeguard their external security. Thus, the German ban of bidders with any relationships to the Scientology organization very clearly does not fall under the exception. Of much greater relevance for the justification of "political procurement" is the general exception clause in Art. XXIII para. 2 GPA. Gaedtke interprets the norm in analogy to the much better-known Art. XX GATT, and gives quite a few examples to which it could be applied in practice. He rightly warns against giving the Parties too much discretion in defining and applying political objectives, and thus argues against a general ordre public exception. Moreover, the author advocates an interpretation that would take into account that WTO law is today part of an international order, with the consequence that those objectives of public order must be admissible which conform to treaty rules accepted by the Parties in other international contexts. Policy objectives that are protected, or even determined by the international legal order can also be treated as privileged measures for the purposes of the necessity test required by Art. XXIII:2 GPA, and thus be more easily justified than measures without an "international background." In this way, WTO procurement law would in view of the author fulfil an international coordinating function and set an incentive for increasing international cooperation.

In his third part, Gaedtke reviews the various initiatives for a reform of the WTO procurement rules, and proposes amendments to the procedural rules and Art. XXIII:2 GPA. Since he essentially finished his book in 2004, however, he could not know that the drive for reform culminated in December 2006 in a draft GPA 2007 which does indeed contain in its Art. X:9 an express provision on a secondary objective, allowing the environmental characteristics of a product to be included in the evaluation criteria.

Gaedtke's dissertation is an important work because he deals with an extremely pertinent issue of current international trade law in a very prudent and thoughtful way. He covers the subject thoroughly, puts it in a general perspective and offers his own view of things, which might, if heard, improve the coordination of international procurement law with the whole of the international treaty system. The book is written in an elegant language which makes it easy to read and allows everyone interested in the subject to benefit from it enormously. It is a very good piece of German legal science at its best.

Markus Gehring, Nachhaltigkeit durch Verfahren im Welthandelsrecht. Umwelt- und Nachhaltigkeitsprüfungen und die WTO

Duncker & Humblot, Berlin, 2007, ISBN 978-3428122691

Erich Vranes

Environmental assessments of international and national trade measures have come to be increasingly employed in international and domestic decision-making in recent years. Such assessments, which are known under various names such as "environmental (impact) assessments", "strategic environmental assessments", "sustainability impact assessments" and the like, have tended to evolve in their coverage, and today sometimes comprise examinations not only of the environmental, but also of the possible social and economic impacts of trade measures.[1] The relevance of such review mechanisms for unilateral, bilateral and multilateral trade policy-making seems to have been more removed from the limelight than other aspects of the "trade and environment" debate. A book which is intended to help fill this gap is Markus Gehring's doctoral thesis, which is organised into four parts. Part 1 addresses legal principles relevant for sustainability assessments of trade measures, Part 2 examines various types of assessment mechanisms used in national and international contexts, Part 3 deals with the possibility of incorporating assessment mechanisms of this sort into WTO law, and Part 4 contains some very brief concluding remarks.

Part 1 first analyses the contents of the precautionary principle. While it posits (tersely and surprisingly) that the diverging views on its contents hardly matter in terms of material law (p. 35), it puts considerable emphasis on the proposition — to be found also in a 2002 Declaration of the ILA[2] — that the precautionary principle comprises both a procedural element, which indicates how to proceed in cases of

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[1]For a recent example, cf., for example, the sustainability impact assessment of the EU–African–Caribbean–Pacific trade relations of the Economic Partnership Agreements at http://ec.europa.eu/trade/issues/global/sia/studies_geo.htm#acp (last visited on 12 December 2008).

[2]ILA Resolution 3/2002, New Delhi Declaration of Principles of International Law Relating to Sustainable Development, available, for example, at http://www.cisdl.org/pdf/ILAdeclaration.pdf (last visited 28 November 2008).

C. Herrmann and J.P. Terhechte (eds.), *European Yearbook of International Economic Law 2010*, European Yearbook of International Economic Law,
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scientific uncertainty, and a material element, which contains a "value judgment" (*Wertung*) requiring environmental protection in cases of doubt. According to the author, the procedural element in particular requires that environmental impact assessments be carried out in the context of relevant projects (pp. 35–36). Gehring describes how environmental assessments have developed, in international law, from traditional environmental impact assessments, into: (1) instruments that increasingly take account also of the social impacts of individual projects, (2) strategic assessments that are not project-based any more, but attempt to apply the principles of (environmental) impact assessments to programmes and policies more generally, and (3) integrated sustainability assessments of economic, social and environmental factors. The final chapter of Part 1 analyses the relevance of the aforementioned procedural element of the precautionary principle in WTO law. Although the precautionary principle is not explicitly laid down in WTO law, Gehring holds that one can find traces of it inter alia in the preamble of the WTO Agreement, in the SPS and TBT Agreements, and in WTO dispute settlement decisions. The book further emphasises that environmental and sustainability assessments serve to increase transparency and participation, and claims that these principles find points of contact ("Anknüfungspunkte") in clauses like Article X of the GATT and Article 10 of the TBT Agreement. While the consequence of this argument remains rather unclear, the purported link between transparency and participatory requirements under environmental or sustainability reviews and the aforementioned GATT and TBT transparency clauses does not seem very convincing, given that the latter appear to merely address trade-specific transparency concerns such as the publication of domestic regulations "pertaining to the classification or the valuation of products for customs purposes, or to rates of duty, taxes or other charges" and the like (Article X of the GATT), and information about technical norms and standards (Article 10 of the TBT Agreement). Unfortunately, Part 1 does not summarise the conclusions that are relevant for the rest of the study.

Part 2 provides an overview over various instruments that are used on the planes of domestic, regional and international law, to assess the environmental and sustainability impacts of trade measures. Part 2 first turns to legally binding instruments, namely the Canadian environmental assessment of trade negotiations (under which, for example, the Uruguay Round was reviewed), the US environmental review of trade agreements, and environmental assessments in NAFTA, and then deals with the EU's legally non-binding sustainability impact assessment. Markus Gehring criticises inter alia the fact that instruments of this type sometimes seem to be designed, or at least used, to persuade a critical public rather than to conduct a transparent environmental review, and that no coherent methodology for carrying out complex assessments has yet been developed. With respect to the EU sustainability impact assessment, Gehring criticises in particular the fact that this type of instrument constitutes an expert review not offering sufficient possibilities for public participation. This critique is repeated in the next chapter, dealing with assessment models developed by international organisations and NGOs, with respect to the methodology for environmental and trade reviews proposed by the OECD. Gehring argues that the OECD proposals in particular may have increased the pressure on its member states to resort to environmental assessments, although he admits that so far only one OECD Member has implemented these guidelines (pp. 178, 190). The remainder of this chapter is consecrated to a description of similar efforts of the UN Environmental Programme (UNEP), the UN Commission on Sustainable Development, and the World Wide Fund for Nature (WWF), and to a short reference to a WWF case-study of NAFTA-related effects on the Mexican production of maize. In view of the brevity of this reference (pp. 207–208) and the author's repeated earlier critique of the methodological insufficiencies of various types of assessment mechanisms, it is somewhat surprising that the author submits without a more detailed explanation that this case-study shows that there indeed exists a methodology which suffices for analysing the effects of trade measures and proposing concrete political measures (p. 210). On the whole, although this second part of the study, which amounts to 120 pages (i.e. one-half of the book), is informative, it unfortunately remains largely descriptive, the overviews of the various assessment mechanisms being arranged into a rather loose sequential order. As in Part 1, there is no section summarising the conclusions which the author draws from Part 2, which seems problematic insofar as the synthesis in Part 3 is based on the analysis of the first two parts.

Part 3 addresses the question of how one could transfer environmental or sustainability assessments to the WTO. The introduction to this part bears witness to the aforementioned problem of a lack of clear conclusions in the preceding analysis: it remains unclear which type(s) of assessment — among the many varying models discussed before in this book — might be transposed, in the view of the author, to the level of WTO law: the book merely speaks of the question as to whether "the instrument" could be transposed to WTO law ("Übertragbarkeit des Instruments", p. 211). It becomes clearer in the then following parts that the author confines himself to pointing out some characteristics that he deems important in a possible future design of environmental and/or sustainability reviews in the WTO context. According to the author, two approaches to the introduction of an environmental or sustainability assessment into WTO law seem conceivable, namely incorporating such assessments into world trade negotiations or into the Trade Policy Review Mechanism (TPRM). With regard to the first approach, Markus Gehring proposes that assessments should take place in parallel to trade negotiations, so as to ensure a possibility for the first to have a bearing on the latter. In his view, reviews should preferably be carried out in the WTO Committee on Trade and Environment and the WTO Committee on Trade and Development, which should cooperate with international environmental and development organisations such as UNEP; moreover, such reviews should ensure sufficient transparency and participation by civil society, and should restrict themselves to international environmental effects, as local effects are best addressed on a national level. Much remains vague in this brief account (described in particular at pp. 223–225). This holds true even more with respect to the second approach proposed by the author, i.e. the alternative solution of introducing environmental or sustainability reviews into the TPRM: after a long description of this mechanism, merely one page is devoted to the issue of how such an incorporation could be effected. It almost goes without saying that the relevant legal issues can be, and are, hardly referred to, let alone be analysed within less than 30 lines.

In summary, in view of the book's title "Sustainability through Procedural Devices *in WTO Law*" ("Nachhaltigkeit durch Verfahren im Welthandelsrecht"), the brief and cursory treatment of these issues in Part 3 of the treatise, which one would expect to be a main focus of the book, is somewhat disappointing. Also, it seems questionable whether some sections of the book (dealing with issues such as the division of competences for external economic relations in the EU, or US external trade law) are really relevant for the topic of the book. In an overall evaluation, it probably seems fair to say that while the synthesis in Part 3 of the study does not appear wholly convincing, readers interested in environmental assessments of trade measures will profit most from the relevant descriptive sections in Part 2 of the book.