Climate, trade and global governance in the midst of an economic crisis

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Briefing at a Public Hearing on Global Governance
Chaired by Wolf Klinz, Special Committee on the Financial, Economic and Social Crisis
European Parliament, Brussels, 25 March 2010

Thank you Chairman Klinz and distinguished members of the Special Committee on the Financial, Economic and Social Crisis (CRIS) for giving me the opportunity to participate in today's public hearing on global governance in the midst of an economic crisis.

I would like to address three questions in my brief presentation. First, how has the current crisis affected the response to climate change? Secondly, how has the crisis affected international trade and developing countries? Thirdly, what are the priorities for climate and trade governance beyond the crisis?

How has the crisis affected the response to climate change?

The impact of the economic crisis for climate change can be disaggregated into environmental, economic and political dimensions.

Environmental benefits short-lived

In the short run the crisis has had a negative impact on greenhouse gas (GHG) emissions. The International Energy Agency (IEA) estimates that the decline in economic output resulted in a fall of at least 3% in CO_2 emissions in 2009, the biggest fall in the past 40 years.[1] This would further translate to a 5% decline in emissions in 2020 compared to the earlier reference scenario. It is important to note that three-quarters of this fall is owed to the financial crisis; stimulus spending for low-carbon investments account for only a quarter of expected reductions.

We cannot be as sanguine about the medium- to long-term scenario. First, economic recovery could lead to a surge in emissions to offset any short-term reductions. Secondly, low fossil fuel energy prices will reduce incentives to invest in renewable or cleaner energy technologies. Thus, despite the current fall in emissions, aggregate energy-related emissions will still rise by 11Gt by 2030 (relative to 2007), with all of the increase coming from non-OECD countries. Power-generation will be responsible for half the increase, much of it from the coal-power sector.

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[1] IEA (2009) *World Energy Outlook*, November.

Mixed results on allocation of economic resources

From the point of view of the allocation of economic resources, the recession could have perverse consequences for the fight against climate change. Energy companies have cut back on new investments, either because of the lack of finance or because projects are no longer commercially viable. As a result, more efficient energy generation equipment are not being deployed and investments in R&D have also fallen. The IEA expects that if the recession persists and demand does not pick up, investments will flow into coal- and gas-fired generation away from more capital-intensive renewable energy sectors.[2]

Globally, there was a surge in investments for renewable-based energy from 2004 to 2007 (**figure 1**). Countries like Brazil, China and India experienced compound annual growth rates in renewable energy investments of 171%, 104% and 52%, respectively, during 2004-2008. The result is that renewable energy capacity in the world has increased: from 3.9% of global power capacity in 2002 to 6.2% in 2008 (see **figure 2** for installed capacity in key countries). More significantly, whereas only 8% of additional capacity in 2003 was in renewables, by 2008, this share had risen to 25%.[3]

This upward trend was halted thanks to the economic crisis. Although the crisis did not fully manifest itself until late 2008 and through 2009, quarterly investment data show that the slowdown in sustainable energy investments began early in 2008 (**figure 3**). By Q3'08, the four-quarter moving average was on a downward trend. We do not have up-to-date information yet on total investments in 2009, but estimates suggest that they have fallen by at least 20%.

One mitigating factor has been the role of government-backed stimulus spending. Globally, some $478 billion have been committed to what can be broadly classified as 'green' investments, including energy efficiency, renewables-based power and public transport systems. There is significant variation among the G-20 countries, ranging from $3.7 billion in the United Kingdom to about $9 billion in India to $216 billion for China (**figure 4**).[4] We should note that comparisons between countries are difficult, partly because the investments are expected to flow over several years. Actual spending levels are not available for all countries but some estimates suggest governments have struggled to spend the allocated sums so far.

[2] IEA (2009) 'The Impact of the Financial and Economic Crisis on Global Energy Investment,'*IEA Background Paper for the G8 Energy Ministers' Meeting*, 24-25 May. Power-sector demand has fallen 3.5% worldwide and 4.9% in OECD countries.

[3] UNEP, Sustainable Energy Finance Initiative, New Energy Finance (2009) *Global Trends in Sustainable Energy Investment 2009: Analysis of Trends and Issues in the Financing of Renewable Energy and Energy Efficiency*. Also, REN21 (2009) *Renewables Global Status Report: 2009 Update*, Paris: REN21 Secretariat.

[4] Nick Robins, Robert Clover, and Charanjit Singh (2009) *Building a green recovery*, HSBC Global Resesarch, 22 May.

Political trade-offs, nationally and globally

This presents a dilemma for policymakers. On one hand, 'green' investments are meant to be a key component of economic stimulus packages. On the other hand, there is a real danger that the inability to spend large sums will mean that they will be reallocated to other activities. The pressure of fiscal constraints (already a cause for withdrawing stimuli in many countries) could further draw resources away from clean energy investments. Aggregated at a global level, these pressures raise several questions for global governance and climate change.

Caution versus precaution: For rich and poor countries, alike, resuscitating economic growth and, more importantly, job creation has become a priority. Will it divert political attention away from environmental issues? But caution over fiscal spending or private investment needs to be balanced against the precautionary imperative to combat climate change. If the financial crisis has taught us anything it is that complex systems can collapse very suddenly. The question is whether political leaders, in fighting the economic crisis, will discount the future to an extent that precautionary steps against climate change, in particular a global deal, become less and less attractive.

Top-down versus bottom-up: The symptoms of such an eventuality are already there to observe. Although the Conference of Parties only took 'note of' it, the Copenhagen Accord could be read as a shift from a top-down approach to limiting and reducing emissions to an architecture that emphasises bottom-up, flexible commitments. A bottom-up approach is certainly attractive during a crisis, because parties can choose actions that are appropriate to their economic condition and maintain the flexibility to change according to circumstances. But will such a flexible approach sum up to the actions required to keep temperature increase below 2C? And how will we ensure that the promises are kept?[5]

Unilateral versus collective action: The third and related set of governance questions concern whether countries will choose to take unilateral steps vis-á-vis climate change. This might indeed be the consequence in the short-term. However, it would also increase concerns over leakage and threats to economic competitiveness. The problem with collective action is not that a party does not act, but that parties do not act if they believe that other parties are not acting *sufficiently*. Who is to determine what sufficient action will be? And if the major emitters strike bilateral and plurilateral bargains among each other, what incentives will they have to provide financing and technology to poorer countries?

[5] For a detailed discussion on potential shifts in the climate regime's architecture and governance, see Arunabha Ghosh (2010) 'Making climate look like trade? Questions on incentives, flexibility and credibility,' *Centre for Policy Research Policy Brief* 5, March, New Delhi.

How has the crisis affected trade and developing countries?

International trade and investment have suffered heavily during the current economic crisis. In 2009 merchandise trade volumes fell by 12% – the biggest fall since the Second World War – going down to 2006 levels. Foreign direct investment (FDI) flows fell 14% in 2008 and were estimated to have fallen by 30%-40% in 2009.[6]

Trade was adversely affected in all regions. When the crisis hit in Q4 of 2008, exports from Europe fell by 16% year-on-year, 7% in North America and 5% in Asia. Intra-regional trade declined more sharply.[7] The impact worsened in the first two quarters of 2009. The biggest dips were recorded for the Commonwealth of Independent States (CIS), Middle East and Africa regions, largely because of the fall in commodity prices (**figure 5**). Strong trade growth in the Asia-Pacific region has pulled up global trade and output levels in recent months.[8] But the brief recovery cannot disguise the adverse impact on other developing countries.

Widespread unemployment: More than 27 million people lost jobs in 2009 pushing up the global unemployment rate to its highest level ever. In total, 211 million people were jobless by end-2009 and the forecast for 2010 is worse. The sharpest increase in unemployment rates might have occurred in the rich countries but the rates continue to remain high for the Middle East and Africa as well (**figure 6**).[9]

Commodity prices and LDCs' exports: The small share of least developed countries (LDCs) in total world trade (0.9%) did not make them immune to the trade shock. During 2000-2008 LDC trade grew by 12% primarily because of a surge in commodity prices. Fuels and mining exports grew by 28% per annum in these countries. But with the onset of the crisis, commodity prices collapsed adversely affecting terms of trade. At least one in five low income countries suffered terms of trade losses of more than 3% of GDP.[10] For Africa as a whole, the value of exports fell by 32% in 2009, compared to world average of 23%.[11] The share of exports in GDP fell from 26.6% in 2007 to a projected 21.8% in 2009.[12]

Immigration restrictions and declining remittances: Remittances sent back home by international migrants are a significant source of household income and national foreign exchange reserves in many poor countries. The economic crisis has hit migrants hard. According to the International Organisation for Migration (IOM) unemployment rates among foreign-born workers is higher than for locals in many countries; remittances have dropped; there is a risk of more migrant workers having to look for irregular jobs in the informal

[6] WTO, OECD, UNCTAD (2009) *Report on G20 Trade and Investment Measures*, 14 September.
[7] WTO (2009a) *International Trade Statistics 2009*.
[8] WTO, OECD, UNCTAD (2010) *Report on G20 Trade and Investment Measures*, 8 March.
[9] ILO (2010) *Global Employment Trends*, January.
[10] World Bank (2009) 'Protecting Progress: The Challenge Facing Low-Income Countries in the Global Recession,' *Background Paper for the G20 Leaders' Meeting*, Pittsburgh, 24-25 September.
[11] WTO, OECD, UNCTAD (2010)
[12] IMF (2009) *The Implications of the Global Financial Crisis for Low-Income Countries*, March.

economy; and many host countries have tightened immigration controls.[13] Remittance flows fell in all regions between 2008 and 2009, with an estimated 5%-8% decline in developing countries (**figure 7**). Remittance flows had enjoyed double-digit growth in recent years, so absolute declines in flows (even if nominally small) have a big impact on poor countries where remittances could account for a large share of national income. Thanks to exchange rate fluctuations, remittances in dollar terms from large developing countries like India and South Africa to their smaller neighbours are also expected to decline sharply.[14]

Restricted access to trade finance: In addition to falling demand, credit constraints increased the cost of trade finance during the crisis. Efforts by the World Bank and regional development banks have yielded $1 billion under the Global Trade Liquidity Programme (GTLP) and the G20 countries promised $250 billion to facilitate trade over the next two years. But in poorer countries trade finance remains severely impeded. Even large banks in Africa are charging more than double the rates for endorsing letters of credit compared to levels prevailing in China, India or Brazil. As long as trade finance has remains constrained, recovery in the poorer regions will prove difficult.

Adverse balance of payments: Falling commodity prices, decline in tourism revenues and in remittance flows have ensured that many low income countries now face adverse balance of payments (BoP) situations. Other channels of external finance are also affected, such as a 20% decline in FDI inflows in 2009.[15] In short, poor countries were estimated to face a BoP shock of $165 billion in 2009. There is also the risk of a worsening debt burden for the Heavily Indebted Poor Countries (HIPC). One study has calculated that growth prospects in HIPC countries are now lower by 0.5 to 2.6 percentage points during 2008-2011 compared to previous estimates.[16] Higher debt-GDP ratios and debt servicing obligations would lower public spending on physical and social infrastructure needs, further constraining growth and recovery.

Threat of protectionism has not abated

Pressures to impose trade restrictions are common during economic downturns. Despite being one of the worst crises ever, these pressures have not resulted in disproportionate use of protectionist measures.

According to the WTO, import-restricting measures affected only a small proportion of global and G20 imports in the first year of the crisis; a proportion that has further fallen in the past six months (**figure 8**).

[13] UN (2009) ‘Panel discussion on “Impact of the Financial Crisis on Employment, Migration, Trade and Debt”,’ Economic and Financial Second Committee, 64th General Assembly, 29 October.
[14] Dilip Ratha and Sanket Mohapatra (2009) ‘Revised Outlook for Remittance Flows 2009-2011: Remittances expected to fall by 5 to 8 percent in 2009,’ *Migration and Development Brief* 9, 23 March, World Bank. Also, Dilip Ratha, Sanket Mohapatra, and Zhimei Xu (2008) ‘Outlook for Remittance Flows 2008-2010: Growth expected to moderate significantly, but flows to remain resilient,’ *Migration and Development Brief* 8, 11 November, World Bank.
[15] IMF (2009).
[16] Andrea F. Presbitero (2009) ‘The 2008-2009 Financial Crisis and the HIPCs: Another Debt Crisis?’ *Money and Finance Research Group (MOFIR) Working Paper* 29, Università Politecnica delle Marche, September.

That said, the threat of protectionism has not abated completely. Support measures remain in place in many countries. Accusations of currency manipulation emerge regularly. Further, among G20 countries, while there has been a fall in new anti-dumping investigations, the past six months have seen a step increase in countervailing and safeguard investigations (**figure 9**). The implication is that as long as unemployment levels remain high, there is always the risk that countries will initiate investigations that incrementally increase the number of trade restrictions. If left unchecked, the complexity of identifying, analysing and removing such measures would mean that many might remain in place even after recovery resumes.

What are the priorities for climate and trade governance during and beyond the crisis?

Looking ahead, governance in both climate and trade will require immediate and longer-term measures. We cannot afford to fight the fire of the current crisis and neglect the underlying governance failures that could make future crises worse.

Facilitating actions during the crisis

- <u>Maintain a carbon price to stimulate investment</u>: Weak demand, low fossil fuel prices, regulatory uncertainty and the absence of an international agreement on climate change all have a negative impact on the price of carbon. It is important to ensure that trading schemes and tax systems maintain a price that is conducive to stimulating investment in renewable energy and energy efficiency activities.

- <u>Ensure that green stimulus allocations are not diverted</u>: Governments will need to overcome administrative barriers while local entrepreneurs, especially in developing countries, will need technical support to structure the finances needed to invest in projects.

- <u>Fulfil commitments on immediate climate funding</u>: It is important to ensure that the commitment to provide $30 billion to poor countries for mitigation and adaptation activities during 2010-2012 is met; if the economic crisis becomes an excuse to slow down disbursements, then future deals will become even less credible.

- <u>Increase trade finance to poor countries</u>: The Global Trade Liquidity Programme should be scaled up (until end-January 2010, only $1 billion had been disbursed). As larger banks are concerned about their risk exposure, there is a need to bolster the credit-worthiness of trading firms in poor countries so that they have access to new liquidity that might be injected into the markets.

- <u>Maintain flows of Aid-for-Trade (AFT)</u>: Despite growth in AFT in recent years ($25.4 billion in 2007), it is imperative that momentum is maintained during the economic crisis.[17] Donors must ensure that flows to the poorest countries do not drop as demand for their exports decline. Channelling funds through multilateral sources also helps to coordinate and monitor flows, ensure the additionality of commitments and improve the predictability of delivery. Needs assessments for AFT must be driven by recipient countries rather than by donor priorities.

Strengthening governance beyond the crisis

- Introduce flexibility in climate obligations with caution: As negotiations proceed on a multilateral climate agreement, it is possible the more and more bilateral and plurilateral deals might be struck. Such deals, while flexible, should be carefully scrutinised and monitored to ensure that parties comply with their commitments and their actions do not undermine agreements at the multilateral level.

- Build monitoring capacity for climate change: New reporting and review requirements under the Copenhagen Accord will significantly increase the financial and capacity burden for developing countries. It is not sufficient to increase multilateral monitoring if parties do not have the resources to measure emissions within their own jurisdictions or measure the impact of emissions from other countries. Further, monitoring must encompass not only emissions but also financial flows, improve assessments and verification of data, and facilitate the participation of poor countries in review procedures.[18]

- Create a more credible and transparent mechanism for climate finance: A large number of bilateral and multilateral initiatives are underway for climate finance. But they have either not delivered the sums at the scale required or are plagued by governance failures. As debates get underway about the design of a Copenhagen Green Climate Fund, key principles for climate financing must be kept in mind, namely institutional legitimacy, scale of funding, flexibility in financing modalities, ownership over project priorities, predictability of disbursements, transparency in decision-making, monitoring and evaluation, and equitable management of intellectual property.[19]

- Investigate trade and climate linkages across different dimensions: There is a tendency to discuss only border adjustment measures as a means to enforce climate rules through the trade system. Without pre-judging the legal and political consequences of such policies, policymakers need to explore linkages between trade and climate change across several other dimensions. These include: status of negotiations on environmental goods and services; barriers against exports of environmental goods from poor countries; the

[17] WTO and OECD (2009) *Aid For Trade at a Glance 2009: Maintaining Momentum*.
[18] Arunabha Ghosh and Ngaire Woods (2009) 'Governing Climate Change: Lessons from Other Governance Regimes,' in Dieter Helm and Cameron Hepburn (eds.), *The Economics and Politics of Climate Change*, Oxford: Oxford University Press.
[19] Arunabha Ghosh and Kevin Watkins (2009) 'Avoiding dangerous climate change – why financing for technology transfer matters,' *Global Economic Governance Working Paper* 2009/53, University of Oxford.

governability of private standards in international trade; intellectual property rules and access to technology; and coherence between rules governing energy trade, investments and climate change.[20]

- Focus on trade governance, not just negotiations: Even as negotiations continue on the Doha Round, there is an urgent need to focus more attention on the governance of the trade regime. Unequal agreements, failures to implement past commitments, new issues on the WTO agenda, capacity constraints within developing countries and the Secretariat are all reasons why the functioning of the organisation deserves to be on the top of the agenda.[21] Other issues that need to be addressed include the governance of bilateral and regional agreements, facilitating accessions, and issues specific to LDCs and small and vulnerable economies.[22]

- Improve transparency and monitoring in the WTO: The WTO's monitoring mechanisms need strengthening beyond the crisis-oriented reporting that has emerged in the past year. More robust monitoring will require paying attention to four imperatives: improving the timing of information for prompt notification of major shifts in trade policies; improving the quality of information to help poor countries understand flexibilities in the rules applicable to them and the impact of measures used by rich countries; improving the sources of information by creating up-to-date online databases and drawing on non-official agencies; and improving the uses of information by targeting members' reporting behaviour, facilitating developing countries' participation in review meetings and following up periodically about how countries have changed policies in response to other members' concerns.[23]

- Improve access to WTO dispute settlement provisions: The Dispute Settlement Mechanism (DSM) has been used effectively by rich countries and large developing countries. Efforts are needed to ensure that the poorest members receive adequate financial and technical support (such as through the Advisory Centre on WTO Law) to access the DSM. Moreover, in coming years the DSM could be put under further pressure with litigation on currency manipulation and environmental linkages.

[20] Arunabha Ghosh (2009) "Enforcing Climate Rules with Trade Measures: Five Recommendations for Trade Policy Monitoring" in *Climate Finance: Regulatory and Funding Strategies for Climate Change and Global Development*, edited by Richard B. Stewart, Benedict Kingsbury, and Bryce Rudyk. New York and London: New York University Press.
[21] WTO (2009b) 'Strengthening the WTO: Communication from Australia, Brazil, Canada, China, Hong Kong China, European Communities, India, Japan, Korea, Malaysia, Mauritius, Mexico, Norway, South Africa, Switzerland, Turkey, United States and Uruguay,' *Ministerial Conference Seventh Session* WT/MIN(09)/W/1, 16 October.
[22] WTO (2009c) 'Seventh Ministerial Conference – Chairman's Summary', WT/MIN(09)/18, 2 December.
[23] Arunabha Ghosh (2010) 'Strengthening WTO Surveillance: Making Transparency Work for Developing Countries,' in Carolyn Deere-Birkbeck (ed.), *Making Global Trade Governance Work for Development* (Forthcoming). Arunabha Ghosh (2010) 'Developing Countries in the WTO Trade Policy Review Mechanism', *World Trade Review* (Forthcoming).

- <u>Create safety nets for vulnerable economies</u>: Finally, a systemic response is needed to address the vulnerability of low income countries to trade and financial shocks. The G20 has called for more flexibility of the Debt Sustainability Framework of the Bretton Woods Institutions, UNCTAD has recommends a temporary debt moratorium, and the IMF has established new facilities for extending credit. But in many instances, promises of increased aid and assistance are not backed up by clear mechanisms for implementation. Multilateral institutions and forums like the G20 have to give more representation to the poorest countries to discuss their vulnerabilities and prepare institutional options for safety nets.

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The pursuit of global governance involves formal and informal mechanisms, processes and interactions among states, markets, intergovernmental and non-governmental organisations, and networks of individual specialists to define rights and obligations in an issue area of common global concern, implement agreed rules, and adjudicate and enforce disputes.

The challenge before us is that we are confronted by multiple crises, none of which can be solved by an individual country alone. Even as they affect us simultaneously, the full extent of the crises will enfold on different time scales. The economic crisis affects demand and economic growth today; the historic fall in trade volumes raises the spectre of protectionism tomorrow; yet climate change is expected to continue, posing severe hardships in coming years and decades. How do we respond to crises on different time scales? Are existing structures of global governance sufficient to deal with the multiplicity of crises and interdependence between them?

The world is experiencing a shift in power to new regions. New preferences and priorities will have to be accommodated. Credible incentives will have to be offered to secure collective action. The economic crisis is unprecedented in six decades. But it has given us an opportunity to begin discussing and resolving the political, institutional and normative dilemmas that confront global governance.

Figure 1

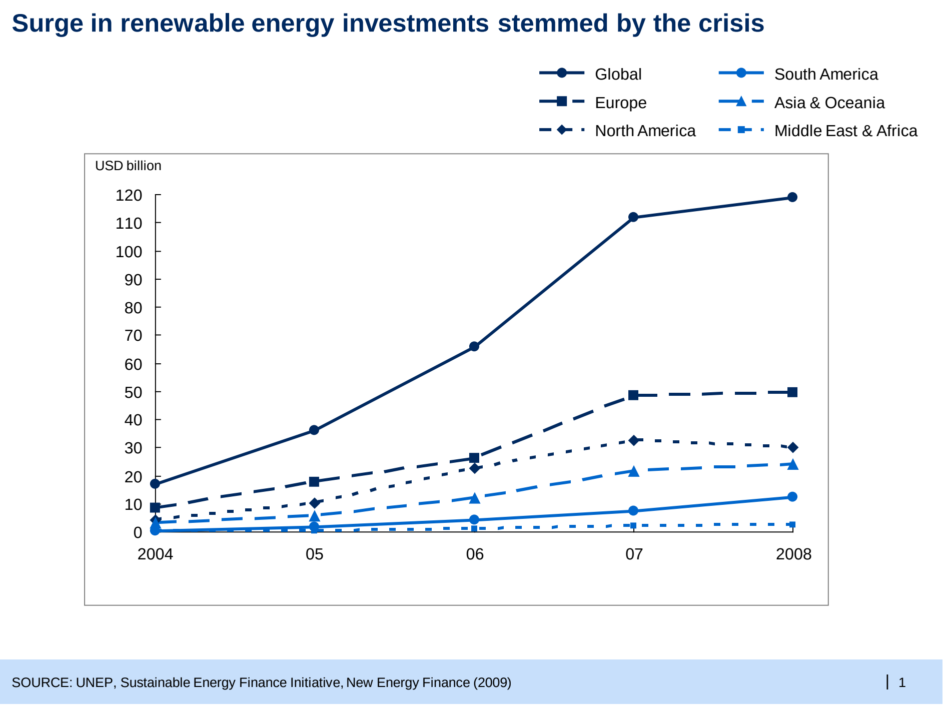


Figure 2

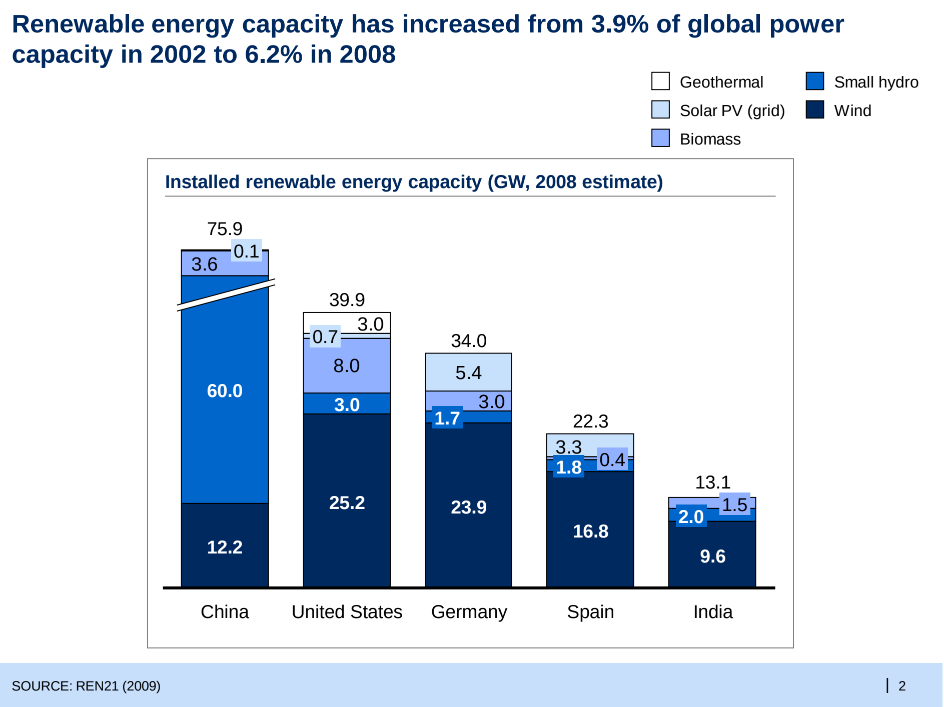


Figure 3

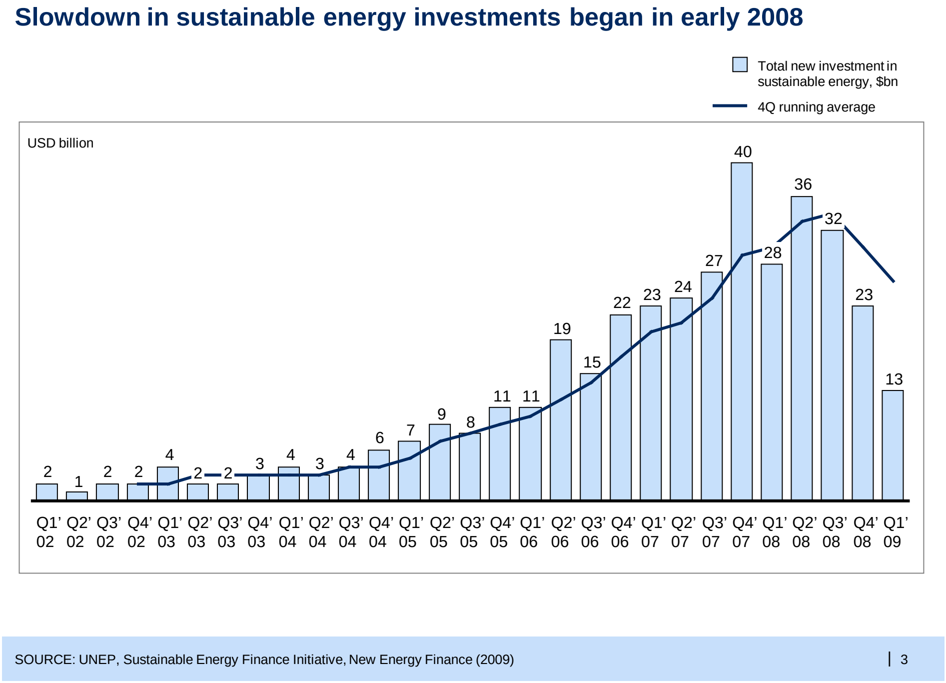


Figure 4

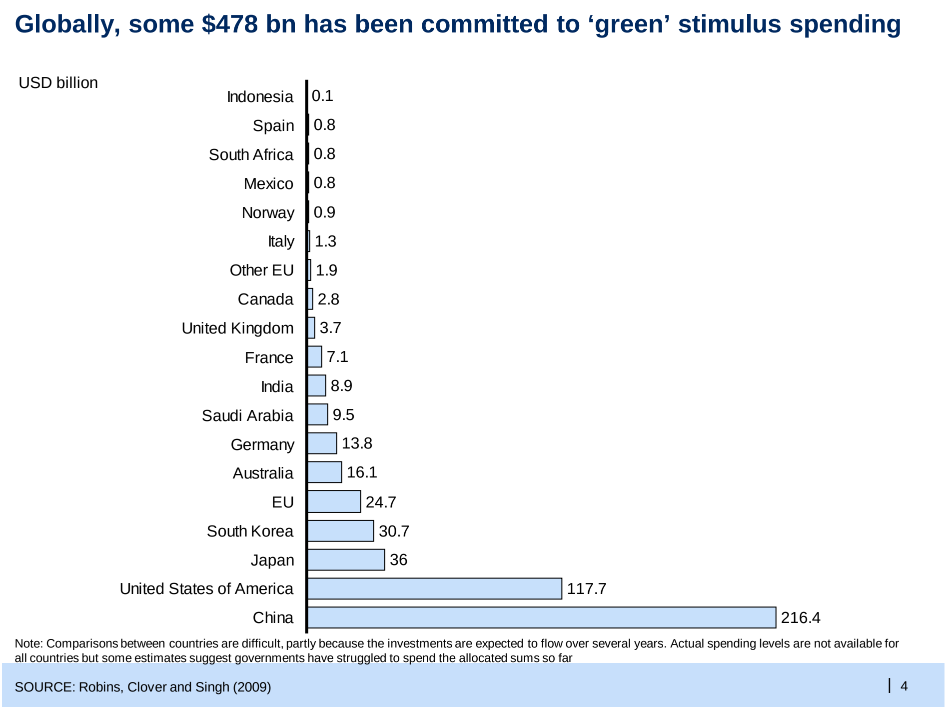


Figure 5

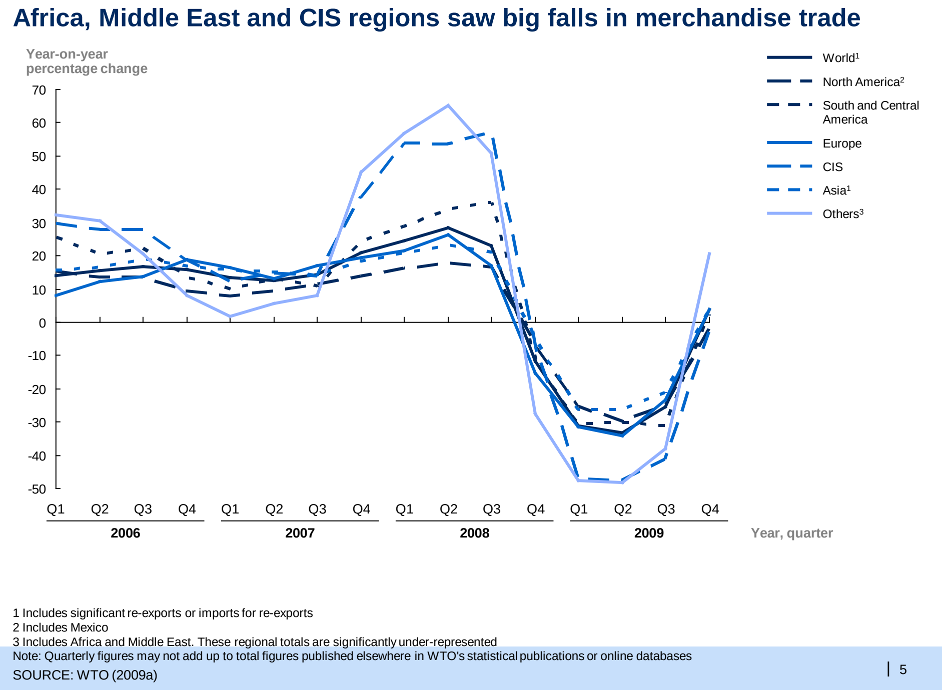


Figure 6

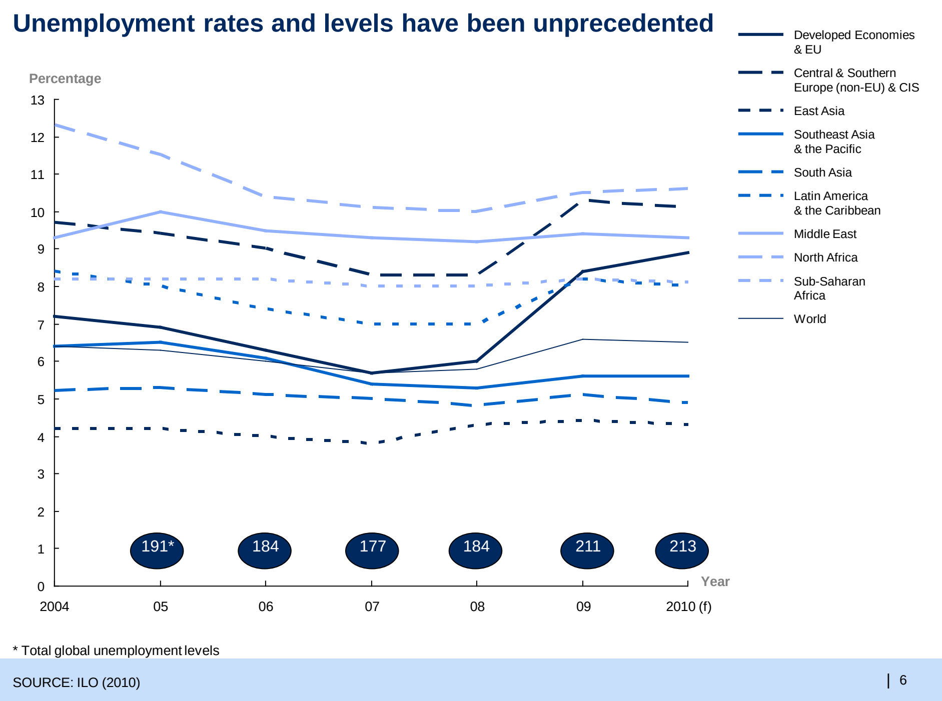
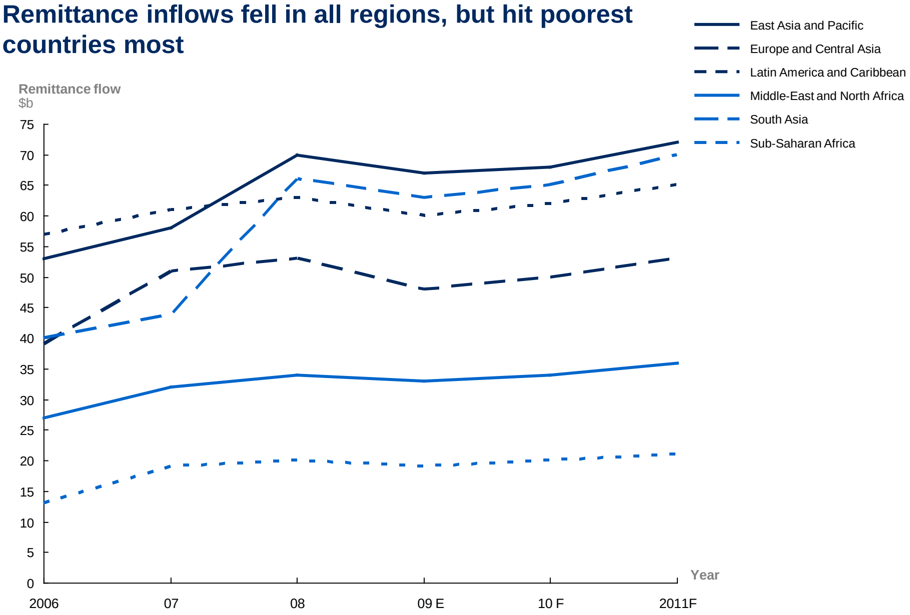


Figure 7

Remittance inflows fell in all regions, but hit poorest countries most



E = Estimate; F= Forecast

SOURCE: Ratha and Mohapatra (2009); Ratha, Mohapatra and Xu (2008)

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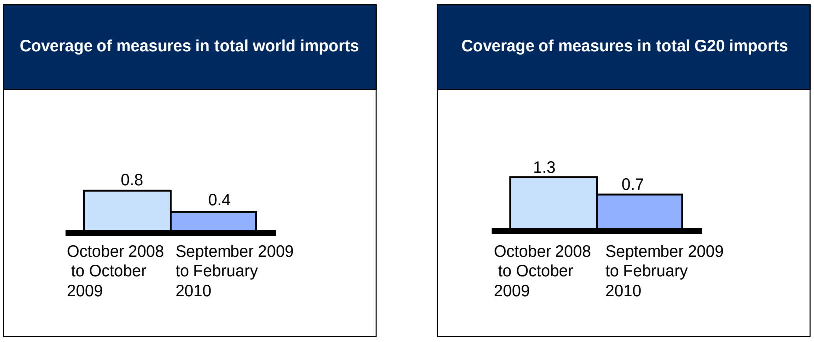
Figure 8

So far, G20 import-restricting measures have been restrained



SOURCE: WTO, OECD, UNCTAD (2010)

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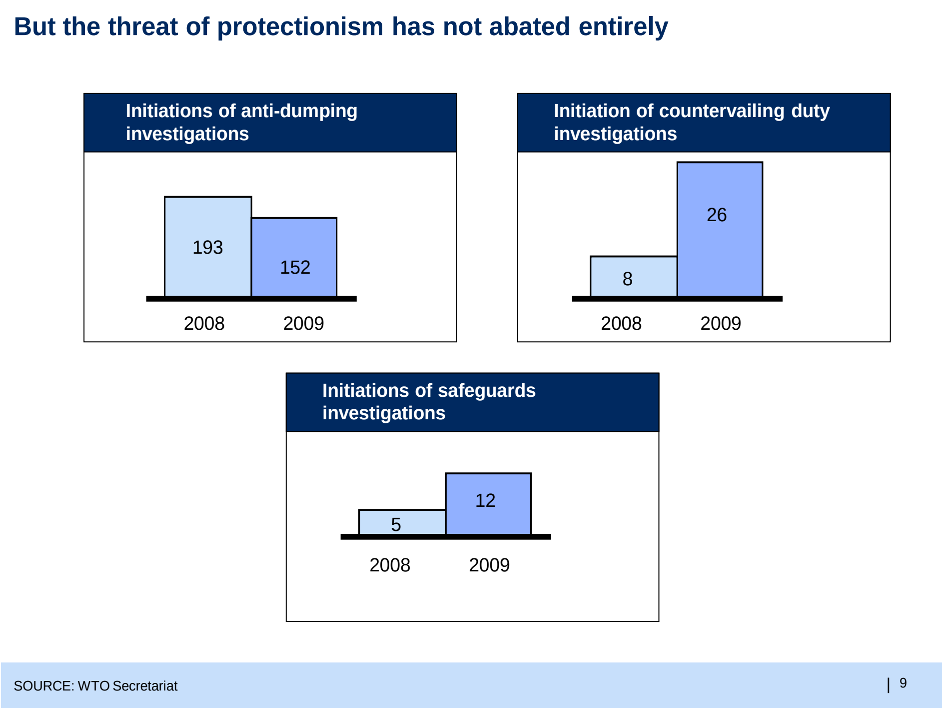
Figure 9



But the threat of protectionism has not abated entirely
Initiations of anti-dumping investigations
193
152
2008
2009
Initiation of countervailing duty investigations
8
26
2008
2009
Initiations of safeguards investigations
5
12
2008
2009
SOURCE: WTO Secretariat
| 9

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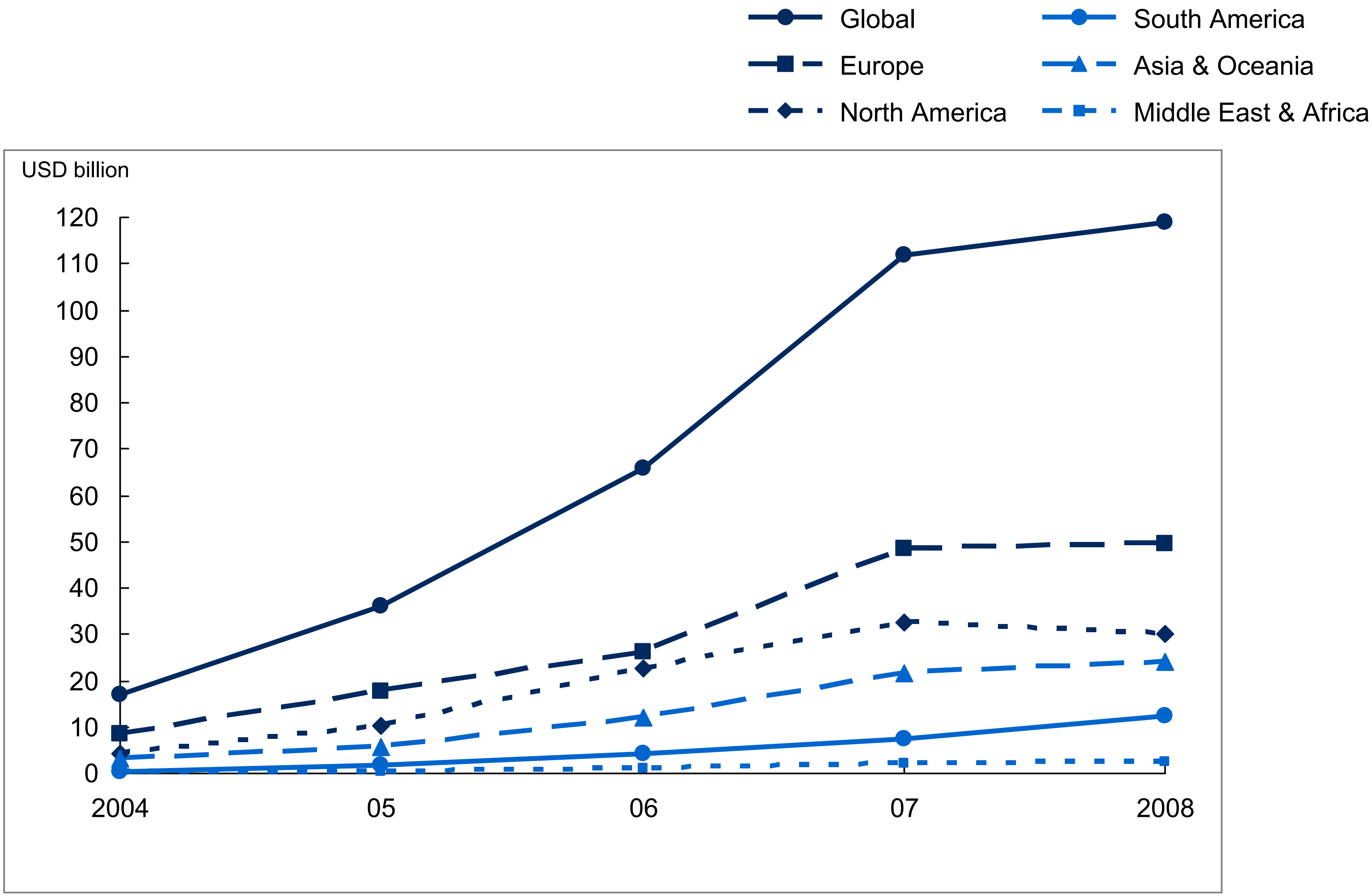
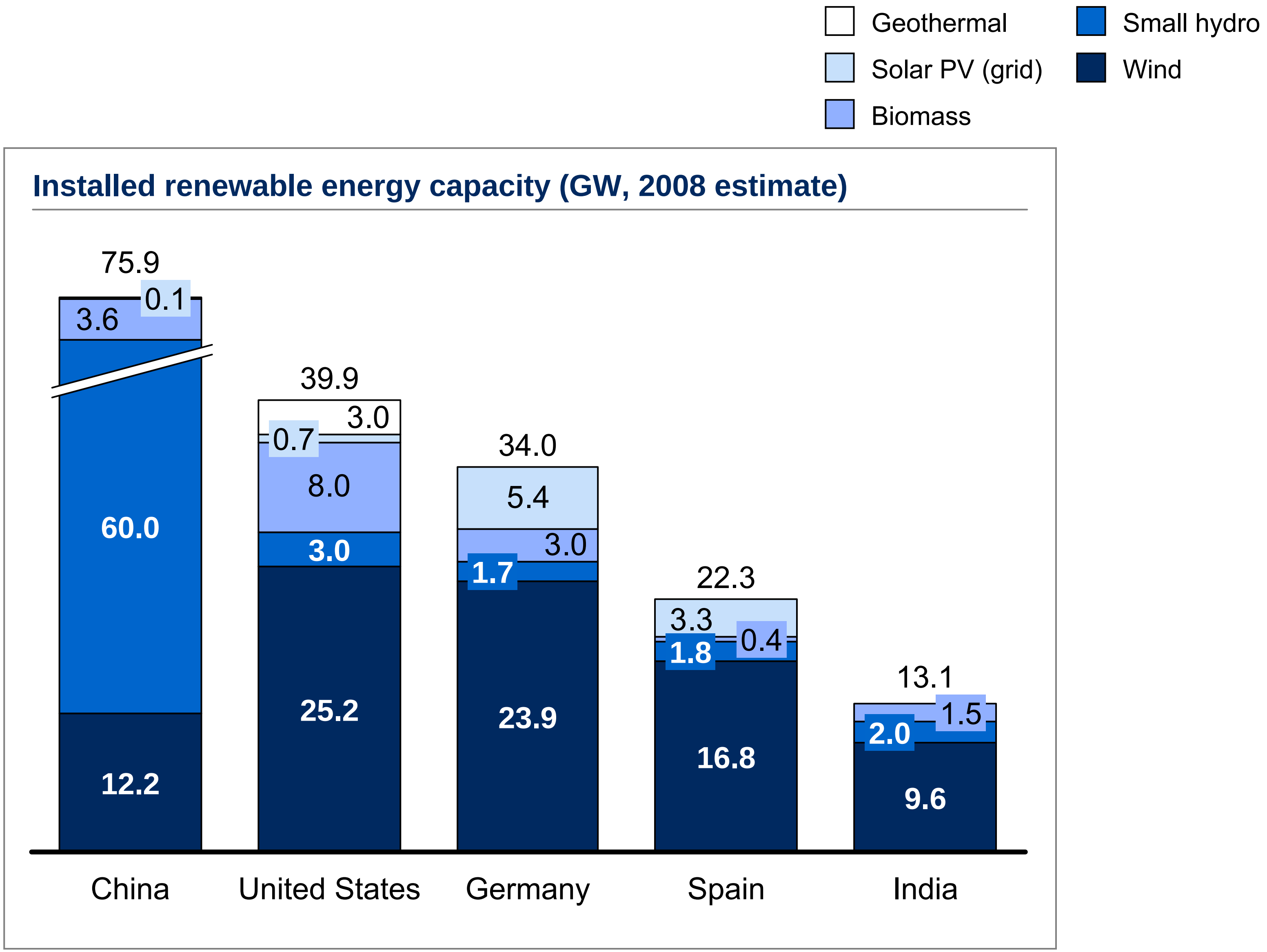
Surge in renewable energy investments stemmed by the crisis

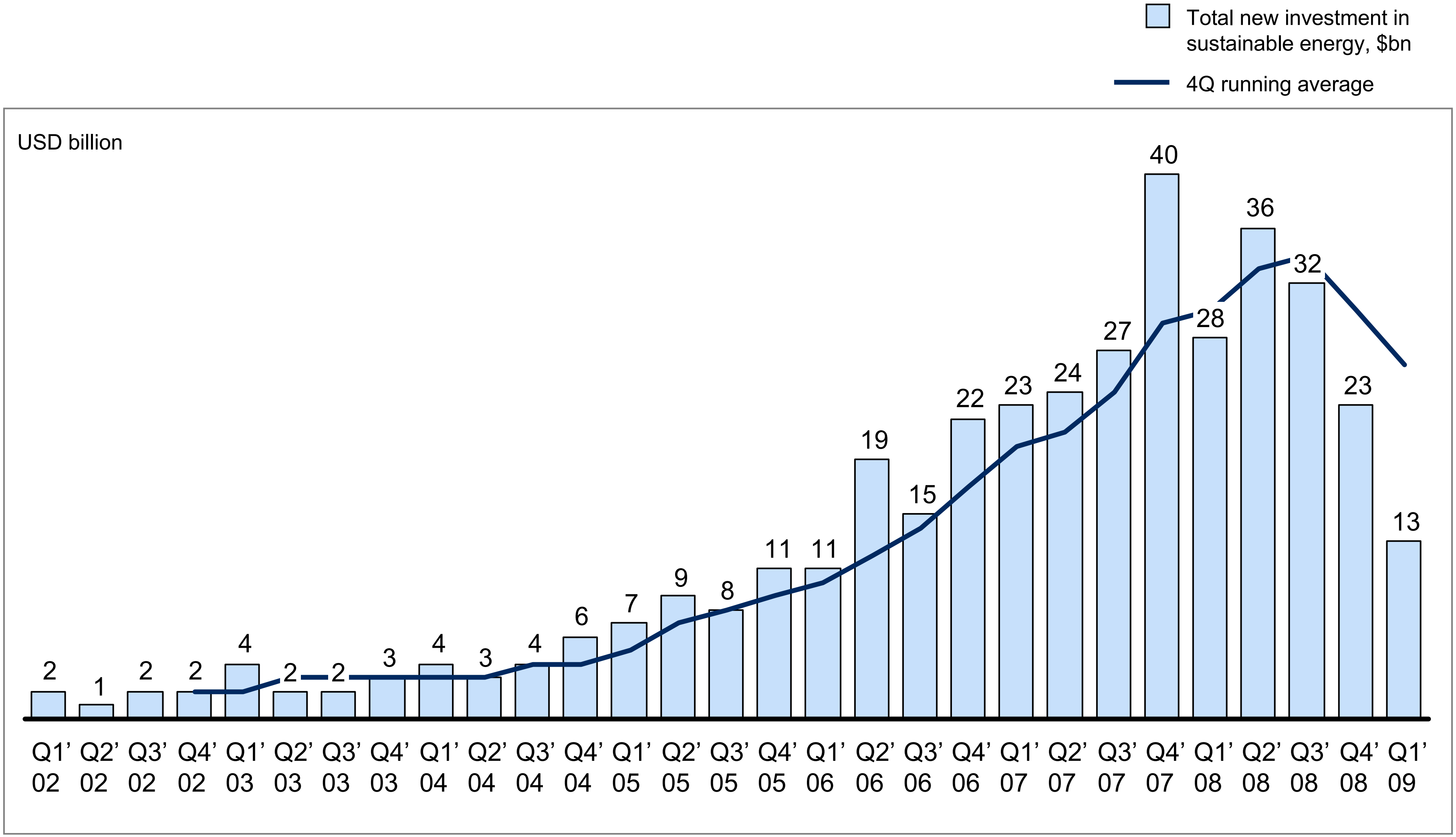


SOURCE: UNEP, Sustainable Energy Finance Initiative, New Energy Finance (2009)

Renewable energy capacity has increased from 3.9% of global power capacity in 2002 to 6.2% in 2008

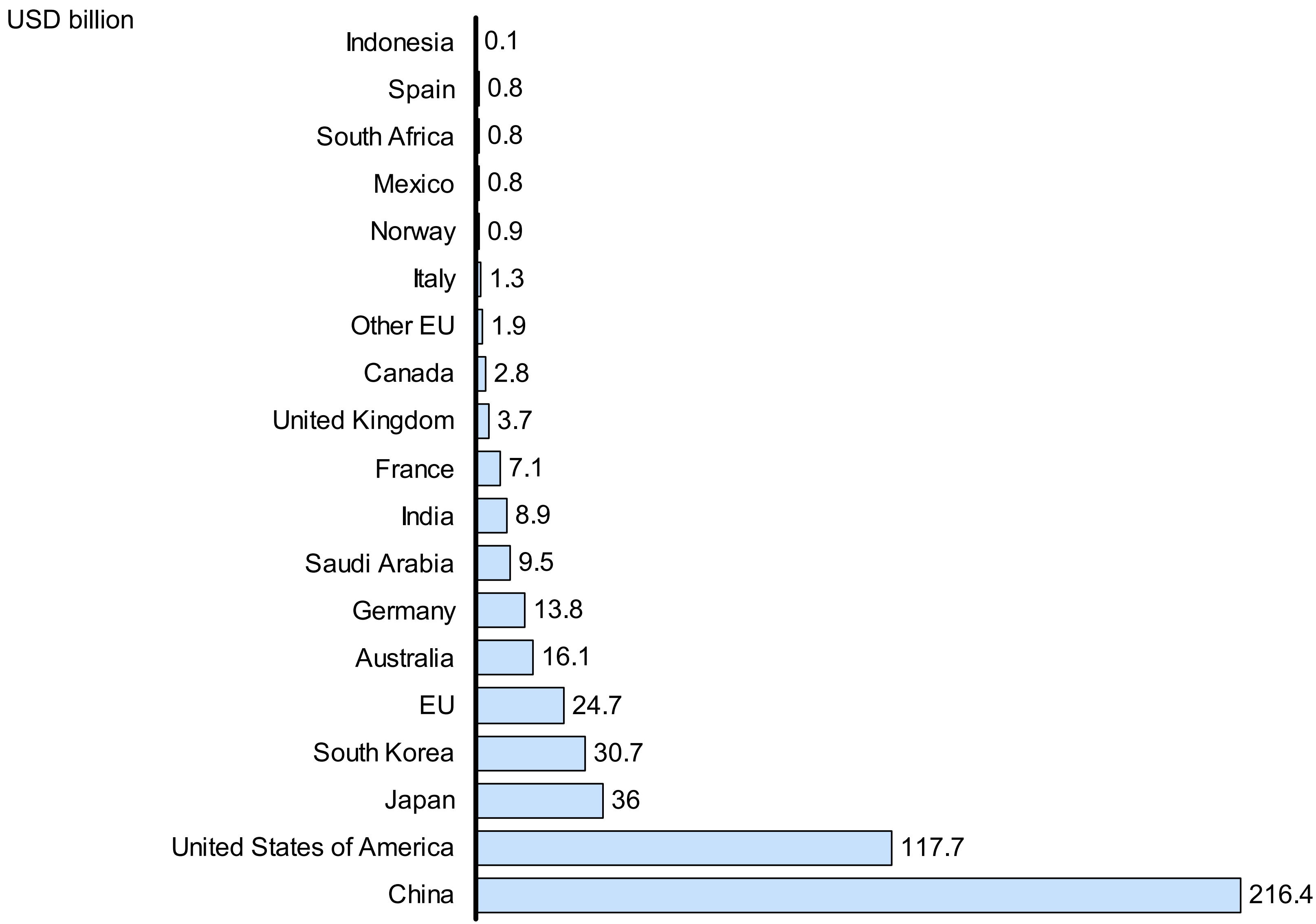


Slowdown in sustainable energy investments began in early 2008



SOURCE: UNEP, Sustainable Energy Finance Initiative, New Energy Finance (2009)

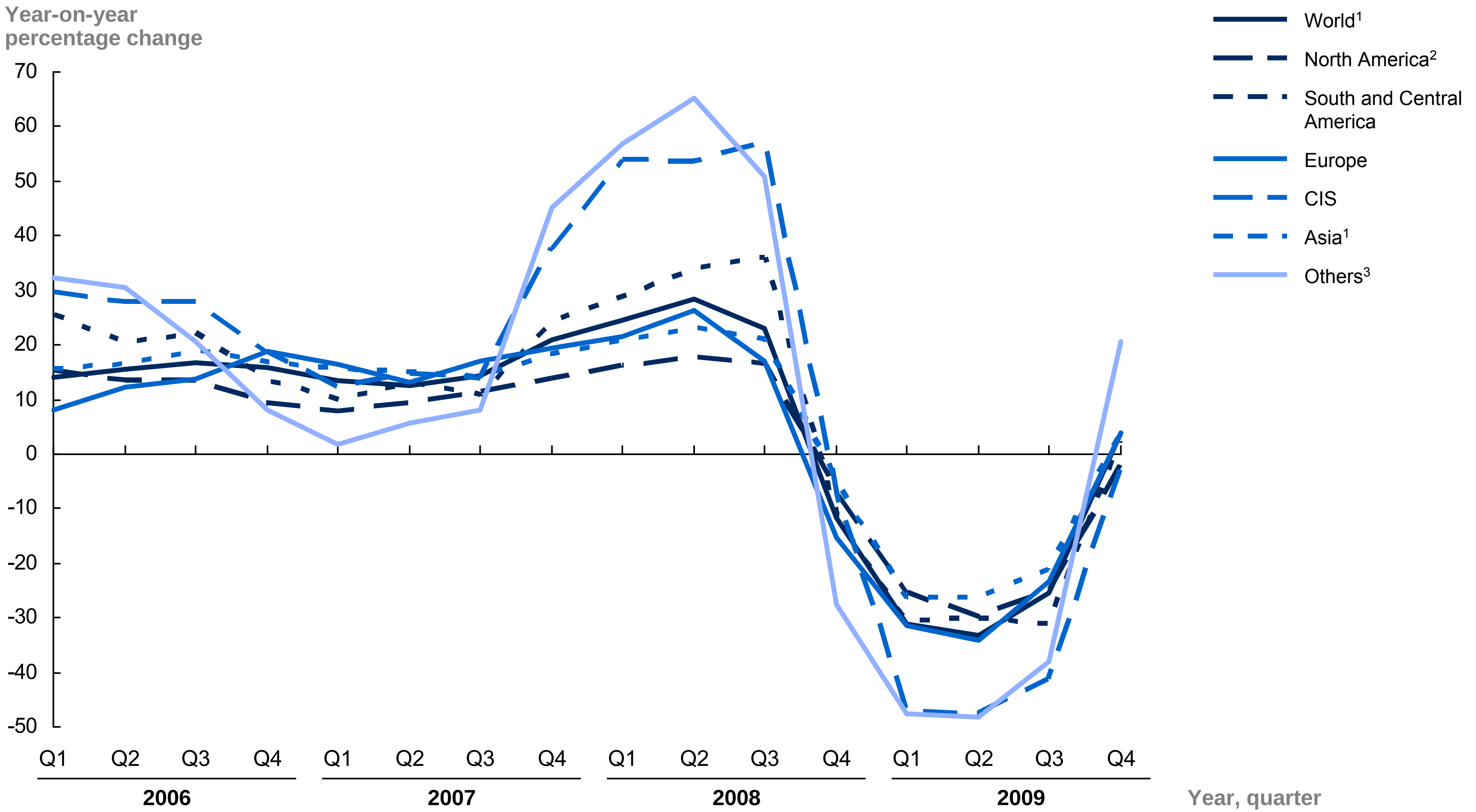
Globally, some $478 bn has been committed to 'green' stimulus spending



Note: Comparisons between countries are difficult, partly because the investments are expected to flow over several years. Actual spending levels are not available for all countries but some estimates suggest governments have struggled to spend the allocated sums so far

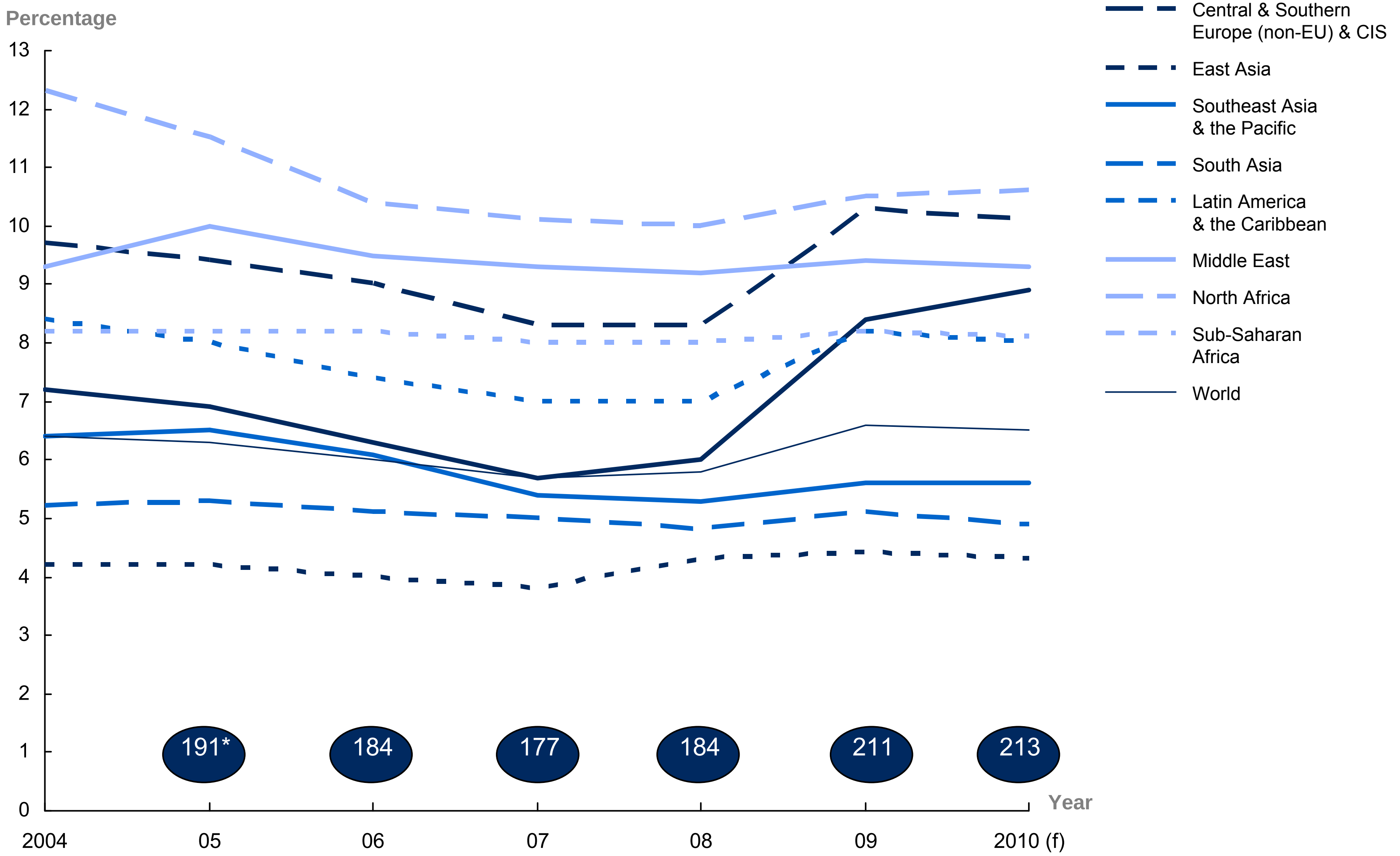
SOURCE: Robins, Clover and Singh (2009)

Africa, Middle East and CIS regions saw big falls in merchandise trade



1 Includes significant re-exports or imports for re-exports
2 Includes Mexico
3 Includes Africa and Middle East. These regional totals are significantly under-represented
Note: Quarterly figures may not add up to total figures published elsewhere in WTO's statistical publications or online databases
SOURCE: WTO (2009a)

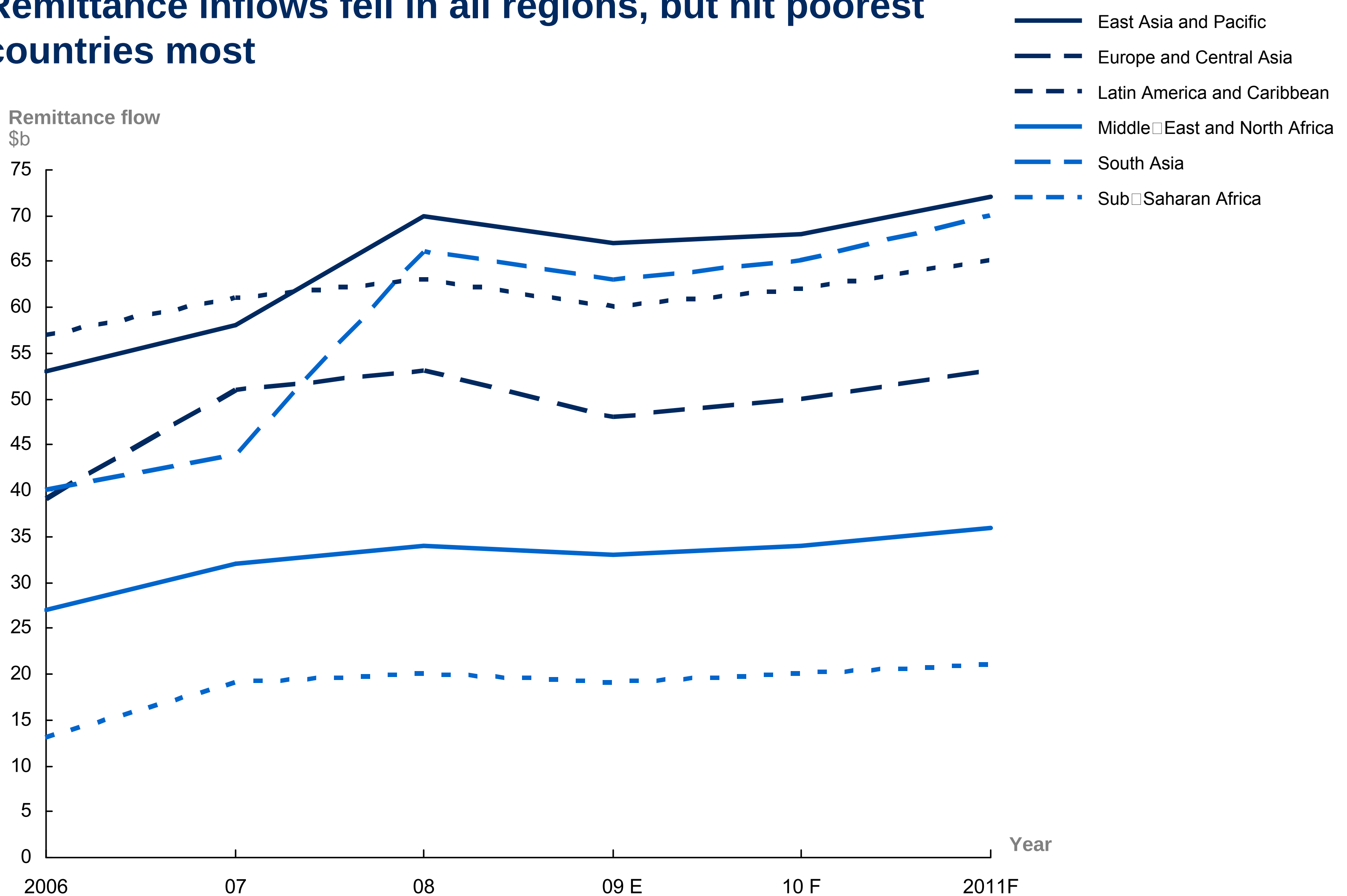
Unemployment rates and levels have been unprecedented



* Total global unemployment levels

SOURCE: ILO (2010)

Remittance inflows fell in all regions, but hit poorest countries most

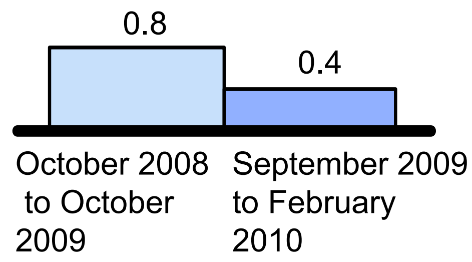


E = Estimate; F= Forecast

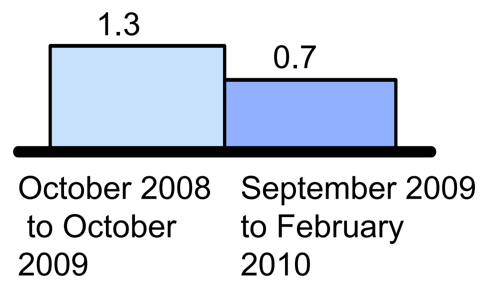
SOURCE: Ratha and Mohapatra (2009); Ratha, Mohapatra and Xu (2008)

So far, G20 import-restricting measures have been restrained

Coverage of measures in total world imports



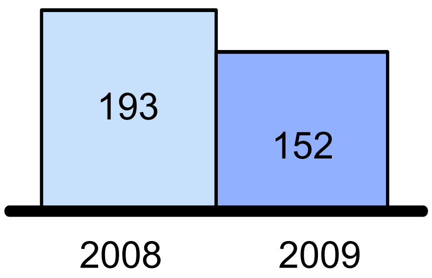
Coverage of measures in total G20 imports



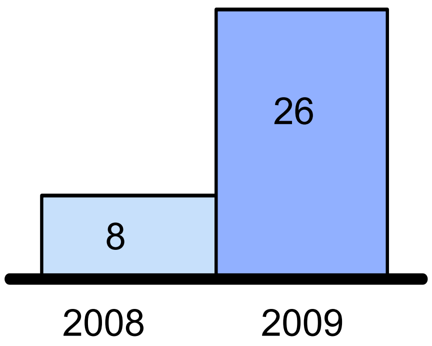
SOURCE: WTO, OECD, UNCTAD (2010)

But the threat of protectionism has not abated entirely

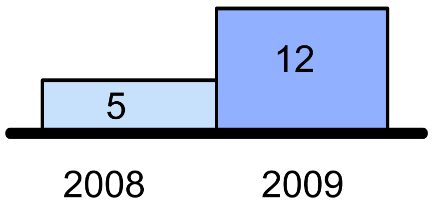
Initiations of anti-dumping investigations



Initiation of countervailing duty investigations



Initiations of safeguards investigations



SOURCE: WTO Secretariat