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The International Rules-Based Architecture: Identifying Indian Priorities

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The Observer Research Foundation (ORF), in partnership with the Foreign and Commonwealth Office of the United Kingdom, organised a multi-stakeholder workshop on the 'International Rules-Based Governance' on March 15, 2013. The objective of the workshop was to arrive at a better understanding of the order of priorities for India within the international rules-based architecture.

Three areas of focus were identified, namely: Corporate governance benchmarks and regulations, International trade and Global financial governance. This Issue Brief highlights the main issues and ideas that were discussed and debated by participants from the Indian policy-making sphere, the private sector and civil society.

Background

The global political and economic landscape has undergone significant shifts over the past few decades. Rapid economic growth in the global 'South' has led to some degree of convergence with advanced economies of the 'North'. As a result, developing economies, such as those within BRICS, account for a large proportionate share of global growth. While the balance of global economic power has shifted towards the East and South, commensurate shifts in the global governance architecture have not taken place as yet. There is a general agreement that the present international rules-based architecture is still largely representative of the post-World War II power structure dominated by advanced countries. The workshop participants noted that while the new structure of global governance must continue to evolve, it must simultaneously provide greater representation to the leading emerging economies, including China and India, in order to reflect the shift in the balance of economic power that has taken place in last two decades and that is likely to take shape in the coming years.

The international rules-based architecture lies at the heart of the globalisation process. However, it is also true that the present architecture is neither universally accepted, nor are the rules set by it fully observed in reality. Developing countries, such as those constituting the Group of 77 (G77), have long felt excluded from the process of global rule-making. It is important to recall the context within which the prevailing architecture and the institutions that support it were first created. The Bretton Woods Institutions (The International Monetary Fund and the World Bank) were created in the post-World War II era. The priorities of developing nations were not at the forefront and largely ignored. The world today bears little resemblance to its past. While institutions and rules of global governance have evolved, there is significant room for improvement in the pace and pattern of change through appropriate representation of the new emerging economic powers as stated above.

Improvement implies a greater inclusiveness in the rule-making process. As a member of both the G77 and G20, in many ways, India is representative of the growth narrative of the South. With a large population and low income base, India has been able to harness fundamental growth drivers and become a more visible player on the global stage. The country believes in the centrality of the United Nations framework, and simultaneously, actively engages as a member in informal and formal plurilateral groupings, including organisations like the BRICS, IBSA, BIMSTEC, East Asia Summit and SAARC. The country's veritable emergence has taken place over a short span of two decades—reflective of the pace of change brought about by globalisation, among other drivers. India represents over a seventh of the global population and is the third largest economy in purchasing power parity terms. Its role in this evolutionary process of global governance is critical.

This Issue Brief focuses on issues around the perceived effectiveness and credibility of international instruments as well as the perceived legitimacy of the existing international rules-based framework and the way forward.

1. Global Financial Governance: Basel III Norms

1.1. Financial risks in a globally more closely interconnected economy are multiplicative in nature. Hence, a robust international regulatory environment is necessary for creating buffers against systemically transferrable risks in the global economy. In this regard, the international Basel regulations on capital adequacy were discussed by the stakeholders at the workshop.

1.2. International regulations are meant to create a level-playing field across geographies, apart from addressing systemic global risks. However, owing to different regulatory environments in sectors such as banking, an environment of regulatory arbitrage is created by overlaying voluntary international rules on varying domestic frameworks. Market participants often use such opportunities (for instance, lightly regulated countries) for short term gains. Therefore oversight capacity at the global level becomes an important consideration, without which speculative capital flows (hot money) will continue to create worrisome imbalances in the global economy.

1.3. Though there are a limited number of foreign banks with more than 40 branches located in urban agglomerations in India, stakeholders agreed that even domestic Indian banks are globally integrated; therefore, the need for international regulations cannot be understated. Whether such regulations can be 'one size fits all' or tailored to each domestic context is debatable. Both scenarios present difficulties, including the aforementioned regulatory arbitrage.

1.4. While the international Basel regulations provide a credible framework of reference in terms of capital management in the banking sector to the domestic regulator (the Reserve Bank of India), satisfactory frameworks of reference for operational implementation of rules do not exist.

1.5. Some regulations in the global sphere often help to reinforce the policies (not necessarily market friendly) of the domestic regulator. For capital adequacy, commercial banks operating in India are required to maintain a proportionate amount of net demand and time liabilities, known as the Statutory Liquidity Ratio (SLR), in the form of gold or government approved securities. This constricts available resources of the bank for lending and credit growth. Stakeholders were of the view that this is also a way for the government to create a captive market for government securities; indeed, public sector banks in particular are heavily subscribed to government securities. The Reserve Bank of India has indicated that the Basel III liquidity norms would be incorporated within the SLR format.

1.6. A major point of contention regarding the Basel framework for global financial governance relates to the definitional aspect of various stages of growth. For instance, while the US recently recorded between 2.0 and 3.0 per cent (annual) GDP growth, India recorded between 6 and 7.5 percent growth in the period immediately following the recent global financial crisis. India's growth rate has unfortunately sharply declined during 2011-12 and 2012-13 but is likely to grow higher again in the coming years. According to the Basel framework, a counter-cyclical buffer within a range of 0-2.5 per cent of common equity or other fully loss-absorbing capital can be maintained in periods of 'high growth'. It is clear that 'high growth' for the US is not equivalent to 'high growth' for India. Therefore, there is a risk of depriving credit to increasing production linked demand in economies such as India even in periods of low to moderate growth, when credit is most required.

1.7. Financial inclusion is a necessity for developing countries like India where only a small proportion of the population is formally engaged in transactions with financial institutions. Financial inclusion covering all sections of the society—rich and poor, urban and rural—would be helpful in deepening India's capital markets and channelling savings towards long term capital formation. However, this imperative of promoting financial inclusion in developing countries like India is at odds with the Basel III type norms which require reduction in lending for capital formation. By automatic extension of the Basel norms for developing countries like India—where credit extension to all sectors of the economy is a priority for promoting long term economic development—a divergent risk management system would be thrust on the capital market that would be in conflict with the objective of promoting sustainable higher growth in the long run. The reconciliation of such contradictions poses enormous challenges. This would require balancing the twin objectives of ensuring adherence to prudential norms in more developed segments of the financial sector and the provision of liberal norms for further extension of credit to the proportionately larger segments of the under-banked or unbanked sections of the society for ensuring financial inclusion.

1.8. India is a part of the 27-member Basel Committee and therefore the question of the appropriateness of the international norms for its banking sector would have been taken into account when it agreed to the Basel framework. This view may need re-thinking. It should be noted that several large developing countries were not part of the committee that drafted and agreed to the final text of the Basel norms. The more nuanced legitimacy issue is that the construct under which the Basel III norms were created had already been formed before India was invited to join as a member of the committee in 2009.

Following the global financial crisis, the Basel committee in its wisdom had opined that there was a problem in the global banking system that originated from the banking system in the advanced countries; this had to be addressed through shoring up capital adequacy requirements.

1.9. In continuation of the aforementioned inputs on legitimacy of the Basel system, the point was raised by stakeholders that India does not have adequate capacity to represent itself (for a country of its size) at many of the global discussions on financial governance. Since there is a lack of inputs and insufficient institutional capacity to absorb changes in the global system to enable India to negotiate its priorities, the country continues to be a passive participant, (particularly in many technical discussions).

2. Corporate Governance: International Norms and Standards

2.1. Without doubt, the global financial crises have resulted in the institution of international and domestic norms on corporate governance. While the recent financial crisis provoked an array of new voluntary and involuntary regulations globally, traditional environmental and social issues that are important in the context of responsible governance of corporations, have not been sufficiently addressed through existing frameworks.

2.2. The reason for the international rules-based framework being largely ineffective in addressing environmental and social fragilities in India is the lack of adequate transparency in the business operations of the corporate sector. It was argued that broad non-sector specific transparency requirements need to be framed both within the international and domestic contexts. Without a high level of transparency, compliance to rules-based frameworks is likely to continue to be fundamentally non-substantive in nature. There is a need to focus on transparency in business operations (such as human resources policies, sector specific best practices, etc.) within the prevalent international norms and benchmarks for best global practices.

2.3. Further to the discussions on the substance of compliance itself, the stakeholders suggested that domestic regulations such as the Listing Agreements between stock exchanges and listing of corporate entities tend to emphasise formulaic aspects of corporate governance owing to the deficiency in oversight capacity. Domestic corporate governance norms have focussed on issues such as the number of independent directors on company Boards etc, without commensurate emphasis on addressing high levels of opacity and discretionary decision-making practices within corporate structures. This applies particularly to Board level functioning of corporations. These issues are relevant in the context of international norms and how systemic failures can be addressed through a more engaging comprehensive normative framework, with complementary institutional capacity for monitoring and oversight combined with optimal regulation and effective enforcement in the public interest.

2.4. In the Indian context, adherence to global norms on corporate governance is largely driven by perceived reputational benefits by firm-level stakeholders. As a result, adherence to such frameworks is largely superficial, without emphasis on integrating responsible governance practices into the risk management calculus of everyday business. Therefore, since compliance to local nodal regulatory bodies also has embedded elements of oversight and monitoring, international norms are likely to be more successful if there is uptake of such norms at the level of the local regulator.

2.5. The financial sector has a large role to play in India, as it has in countries where stakeholders are engaged and protected by corporations. In India, despite a host of international voluntary frameworks and principles, such as the London Principles on financial investments, systemic drivers within the financial sector are missing. Thus, in practice, neither the financial sector nor businesses themselves are the primary drivers of responsible governance. The government, with all its capacity limitations and capability gaps, is still by default or by compulsion effectively the primary driver of responsible corporate governance through mandatory legislations and enforcement.

2.6. It was noted that listed companies which adhere to most international norms and regulations tend to comprise of only a sliver of the total number of large companies in India. In this context, commensurate emphasis on governance or business responsibility (by international standards) of unlisted corporations (forming the vast majority of companies) is missing.

2.7. On the question of legitimacy, the normative rules-based frameworks and benchmarks on corporate governance, and the various disclosure regimes, both international and domestic, have been formed without sufficient inclusion of all stakeholders. In the Indian context, norms relating to Corporate Social Responsibility (CSR) have been formed without adequate consultation with the concerned stakeholders. This is a two-way problem in India: the corporate sector has not developed sufficient engagement capacity; consequently, the feedback loop is generally limited to a few corporate leaders. In the international context, norms are inevitably formed by nations with the capacity and the funds to lead global rulemaking initiatives.

2.8. On public disclosures, such as the Global Reporting Initiative (GRI), the role of the consultancy agencies must be carefully scrutinised. While international frameworks on disclosure may aim to create transparent corporate regimes, stakeholders noted that many times, the benchmarks, rating methodologies and systems are manipulated by large consultancy companies themselves.

2.9. Finally, stakeholders suggested that better alignment with the relevant regulations in the domestic context would improve the adoption of the existing international frameworks. For instance, the OECD guidelines for multinational corporations focus on issues around supply chain etc. In India, corporate entities are highly input price sensitive (owing to other externalities including consumer choice) and the supply chain many times is informal and unregulated. Therefore, supply chain capacity building and consumer awareness should be a higher priority rather than elimination of suppliers who are not adhering to supply chain based international benchmarks. Similarly, other relevant domestic contexts must be embedded while formulating the normative frameworks, to be considered both credible and viable.

3. International Trade: Free Trade Agreements (FTAs) and the WTO Framework

3.1. The stakeholders agreed that the reasons for the proliferation of FTAs around the world, including those involving India, were not limited to economic logic. The recent Regional Comprehensive Economic Partnership Agreement (RCEP), which falls within the ASEAN framework and includes India, and the prominent Trans Pacific Partnership (TPP) are examples of agreements signed between diverse stakeholders in the Asia Pacific with an underlying geopolitical emphasis. Trade liberalisation is perceived to be a secondary theme in both the agreements.

3.2. There was broad agreement that the various regional FTAs which India has entered into in the recent past have not yet yielded any measurable trade benefits. At the same time, there was an admission that palpable benefits of such agreements can only be measured over a long time period of five to ten years. Moreover, such FTAs are ideally signed between countries which see some trade complementarities, which can be further leveraged for spurring economic growth.

3.3. It was noted that the purpose of FTAs as well as the multilateral World Trade Organization (WTO) framework of international trade, focused on trade liberalisation, should be to look beyond traditionally defined non-tariff barriers to trade such as licensing requirements, procurement policies etc. As such, countries including India must focus on harnessing and cross leveraging structural competitive advantages by adopting a sector-wise approach to promoting trade. This would also help in assessments of domestic preparedness prior to negotiating with regional or global stakeholders. In addition, common harmonised standards for commodities proposed under regional agreements such as the South Asian Association for Regional Cooperation (SAARC) can help to set contextual product benchmarks. FTA networks are starting to create minimum standards, but there is also a great deal of inconsistency which could undermine uptake for new arrangements such as the Global Value Chains discourse emanating from the OECD countries.

3.4. The reason why there has been a steady uptake of FTAs by India, as suggested by workshop stakeholders, is that FTAs tend to have a narrow strategic focus. It was noted that one of the key problems with the Doha negotiations was that their ambit has been too broad, and the probability of resolution on a host of contentious issues is slim. Issues like those related to triggers for Special Safeguard Mechanisms (SSMs), which have caused a deadlock in the Doha negotiations, are not mirrored in India's FTAs. In this vein, it was suggested that unless a reasonable timeline for resolving issues on the Doha round is agreed upon (at the next meeting in Bali), the process will most likely remain paralysed.

3.5. It was noted that the failure of the Doha round is also linked to the cyclicality of the global economy and the growth of protectionism. Moreover, while at the end of the first world trade talks in 1947, 23 countries were involved; 155 countries participated at the start of the Doha round, making the rulemaking process much more complex. What the WTO gains in credibility from its broad membership, it loses on effectiveness. Participants agreed that the window for successful resolution of the Doha negotiations has passed, and that there is an urgent need for a 'Plan B', to agree to what is both credible and viable.

3.6. Participants agreed that the WTO Dispute Settlement Mechanism has been highly effective, and is perhaps the single biggest reason for improving its credibility. While the efficacy of the rule-making function of the WTO currently seems to be under cloud, its other two pillars of executive and judicial functioning remain robust. The absence of dispute settlement mechanisms in the context of the FTAs was highlighted by the stakeholders as one of the drawback of remaining outside the WTO framework.

3.7. For India (and other developing countries with comparative advantage for exporting skilled labour services), unlocking value from Mode 4 (under the WTO rules defined as "temporary movement of natural persons: when independent service providers or employees of a multinational firm temporarily move to another country") presents huge opportunities vis-a-vis liberalisation of global trade. Taking advantage of the gains from Mode 4 will remain a strategic priority for India (and other similar countries endowed with skilled labour force). The Indian template of FTAs also makes this a priority issue. The stakeholders acknowledged that the increase in protectionism owing to the overall global economic slowdown implies that rapid progress on Mode 4 will remain elusive in both regional and multilateral negotiations. The WTO's success in increasing free movement of goods and capital is not being matched by free movement of people.

3.8. Regarding the WTO agreement on Trade Related Aspects of Intellectual Property Rights (TRIPS), India's priorities are centred on three aspects—affordability, access and treatment of traditional knowledge. Participants felt that India is comfortable with the TRIPS mandate, with which its relevant domestic legislation is fully compliant. However, it is concerned about the TRIPS+frameworks that are being driven by developed countries through the FTA route.

3.9. The stakeholders noted that under the Doha negotiations, issues of concern related to TRIPS are mainly centred on compulsory licensing and ever-greening (whereby incremental innovation helps to protect product patents). Without progress on improving the international rules, these areas are becoming increasingly problematic in practice. There have been multiple instances of Indian companies being denied compulsory licenses in the recent past, as well as issues around ever-greening.

The Priority Matrix

The following priority matrix has been tabulated, in order to capture some of the most prominent issues covered in the multi-stakeholder workshop discussions. The table presents a concise outline of what Indian stakeholders see as some of the most important issues within each of the pre-identified themes and, concomitantly, reflects the priorities for engagement with and within the existing international rules-based architecture.

Financial Governance	Corporate Governance	International Trade
Credit availability to all, particularly MSMEs	Transparency across sectors	Leveraging sector specific competitive advantages
Financial inclusion of those at the bottom of the pyramid	Alignment with local context, and benchmarks	Leveraging geopolitical ties through FTAs
Regulatory certainty/long term capital accumulation	Proactive financial sector, investor awareness	Timeline at Bali/ alternate plan with narrower focus
Capacity building/oversight (international and domestic)	Capacity building/oversight (domestic)	Greater access under Mode 4, Navigating TRIPS+

Other areas where it might be appropriate to consider the benefits of developing more effective international rules are e-commerce, private standards and tax policies and procedures.

Conclusion

The complexities of international rule-making are self-evident even in local level stakeholder consultations, such as the one carried out for the purpose of this report. Multiple stakeholders organically offer different permutations of their priorities. Such discussions serve to highlight that concerns centred on legitimacy of the rules architecture can only be addressed through enhanced inclusion and participation by all stakeholders. In fact, legitimacy of the international rules-based architecture must flow from a dynamic and sustained effort at interfacing with a diverse range of stakeholders within all member countries. It is useful to observe common strands of inputs across the three thematic areas of focus presented in tabular form in this report. While the priority matrix has captured the subject specific nuances articulated by stakeholders, the discussions revealed that the following fundamental points must be considered thoroughly in any international rule-making process or framework:

- **Consensus building on the accepted point of departure:** The accepted point of departure, or the formulation of the problem statement itself, must necessarily result from an inclusive and transparent process. Particular emphasis must be maintained on transparency of engagements and consultations with all external stakeholders identified in such processes, such as international bodies, trade associations etc.

- **Focus on domestic contexts:** Disparate domestic contexts, including prevailing regulations, stakeholder responses etc., must be considered within rule-making matrices. A number of stakeholder concerns centre on the lack of context building to identify priorities and gaps in domestic rule-based systems.

- **Capacity enhancement of international supervisory/regulatory bodies:** Without requisite capacity building of existing and proposed international supervisory or regulatory institutions (such as the Financial Stability Board), the efficacy and legitimacy of the rules-based frameworks cannot be maintained in practice.

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