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Global Governance Challenges:
Climate Change and the Financial Crisis

Daniel M. Price*

Thank you, Mr. Verill, for your very kind introduction, and I thank the Surrey family and friends for inviting me here today. I am indeed honored to deliver this talk in commemoration of the legacy of Walter Surrey. His many accomplishments as lawyer and statesman are both humbling and inspirational.

Today I would like to address two pressing global problems – climate change and the financial crisis. The challenges these problems present are daunting and their solutions will require an unprecedented degree of international cooperation and consensus.

This is because greenhouse gas emissions anywhere contribute to harmful atmospheric concentrations that affect the climate everywhere.

Financial markets are similarly global and interconnected. The result is that a build up of persistent surpluses or deficits by any major economy, a bank failure in a small economy such as Iceland, or the proliferation of credit derivatives by a UK subsidiary of a US insurance company, can have serious adverse economic consequences even for those not directly involved in the underlying economic activity.

Given the integration of the global economy and today's distribution of economic power and industrial activity, the relatively small group of countries who together fashioned the Bretton Woods agreements and institutions cannot by themselves solve these problems. New forms of cooperation are necessary. And how the global community addresses these issues will shape global governance for decades to come.

While at first climate change and the financial crisis might seem like completely disparate problems that require very different solutions, I would like to advance the thesis that

* Daniel M. Price is Senior Partner for Global Issues at the law firm of Sidley Austin LLP.

they have a number of features in common and that our success in meeting these challenge turns on how we answer three fundamental questions:

- First, will countries work cooperatively together or will each country or regional grouping seek to fashion its own solution? In other words, can we break out of the developed-developing country divide and adopt a more refined view of global responsibilities.
- Second, will governments seek constructive engagement with the private sector in a way that encourages innovation and entrepreneurship, or will their actions and policies stifle these essential components of economic growth?
- And third, will nations renew their support for open markets and liberalized trade and investment flows, or will they look inward and give in to the false promise of protectionism?

We as international lawyers have a special obligation in respect of these challenges. We must seek answers to these questions with the customary rigor and discipline of our training. But we must do so in a fashion that channels political energy along constructive lines and that contributes to the progressive development of the rule of law in international relations.

From July 2007 to January 2009 I was privileged to work on both climate change and the financial crisis as President Bush's international economic advisor. I'd like to share with you some lessons learned as well as some thoughts on possible ways forward.

Let me begin with climate change. I arrived at the White House shortly after the G8 Summit that was held in Heillingendam, Germany. There the G8 embarked on a new course on climate change. Prior to this Summit, the discussion among the G8 was largely centered on whether the United States, Canada, Japan and Russia would agree to the emissions reduction targets adopted by the EU. The assumption was that the major developing countries would simply fall into line – and agreement would quickly be reached – once the G8 had a united position on cuts to greenhouse gas emissions.

At the G8 Summit in Germany, the United States suggested a different approach – one that reached beyond the G8 and conceived of the major emerging economies as partners rather than wards. President Bush proposed to convene the 17 nations that together constituted 80% of greenhouse gas emissions and 80% of energy consumption.

The purpose of convening this group, first called the “major emitters,” and later more euphemistically “major economies,” was to discuss the key issues that would need to be

addressed in ongoing negotiations under the UN Framework Convention on Climate Change. These countries included the G8 plus China, India, Brazil, Mexico, South Africa, Indonesia, South Korea, and Australia.

This was quite a novel approach. Recall that under the Kyoto Protocol, which had been unanimously rejected by the United States Senate, the world was divided into developed and developing countries. The developed countries were to undertake binding commitments to reduce greenhouse gas emissions, whereas the developing countries, large and small, were not required to cut emissions.

The idea behind the Major Economies Forum was to look at the world through a different prism. Not as developed and developing, but as major economies, major emitters and major energy consumers, which, by virtue of their size and carbon footprint, had a special responsibility to find common ground for an international climate agreement that would replace the Kyoto Protocol when it expired in 2012. Indeed, the meeting in Copenhagen this December is supposed to produce that successor agreement.

The first meeting of the major economies was held in Washington, in September of 2007. Thereafter it met on three other occasions in Paris, Hawaii and Seoul, Korea all leading up to a meeting of the leaders of the major economies in conjunction with the G8 Summit in Hokkaido, Japan, held in July of 2008. I served as the moderator of these meetings.

Among the issues discussed were mid-term and long term emission reduction goals, technology development and deployment, cooperative sectoral approaches in energy intensive industries to reduce emissions, financing mechanisms for both mitigation and adaptation efforts, measurement and verification mechanisms, and deforestation.

This cooperative format proved to be a breakthrough not only in relations between developed and developing countries, but also in relations among the developed countries themselves. If one looks at the G8 declaration of 2008, one sees for the first time that the G8, while recognizing its continuing leadership role, underscored the importance of two other points.

First, that developed country efforts to curb greenhouse gas emissions will, alone, be ineffective in addressing climate change unless the major emerging markets also undertake commitments to curb their emissions.

Second, the G8 leaders recognized that the solution to climate change lies principally in the development and diffusion of technology. So the G8 leaders embraced a U.S. initiative called the Clean Technology Fund and committed \$6 billion to assist developing countries who

came forward with credible national plans to mitigate greenhouse gas emissions. The G8 also committed \$10 billion a year in research and development for climate-friendly technologies. By no means sufficient, but a start.

The other breakthrough, and perhaps the more significant one, can be seen in the declaration of the Leaders of the Major Economies issued on the same day. In this Declaration, the old divisions between developed and developing were in a sense set aside. The leaders of the Major Economies acknowledged that they, as a group, had a leadership role to play and must do more. While the developed countries would need to achieve absolute reductions and take deeper cuts in emissions than developing countries, for the first time the emerging markets acknowledged the necessity themselves to undertake emissions reduction actions that would slow the growth of greenhouse gasses and mark a substantial deviation from business as usual.

The Major Economies Leaders also recognized the centrality of technology development rather than regulation to achieve this goal. The leaders affirmed “the critical role of technology and the need for technological breakthroughs in meeting the interlinked global challenges of energy security and climate change” and declared that “our ability ultimately to achieve a long-term global goal will depend on affordable, new, more advanced, and innovative technologies, infrastructure and practices that transform the way we live, produce and use energy, and manage land.”

So what we see in the major economies process, is a degree of cooperation that crosses the development line, that acknowledges that China, India, Brazil and the other major emerging markets are differently situated than the other developing countries. That they, as significant energy consumers and significant contributors to emissions, have responsibilities that are differentiated from other developing countries and that they must play a role in this solution consistent with their carbon footprint and economic circumstances.

The Obama Administration has continued the Major Economies process and leaders’ representatives will be meeting in Mexico next week to prepare for a leaders’ meeting that again will be held in conjunction with the July G8 Summit, this year in Italy.

As I mentioned, the G8 and Major Economies Leaders’ declarations recognized the importance of technology development in moving towards a lower carbon society. It was recognized that regulation alone would not do it. Regulation could help by putting a price on carbon but it was market mechanisms that would be needed to stimulate development of technologies. Ultimately it will be a technology-enabled shift to lower carbon fuels, a shift to more energy-efficient buildings and transportation that will permit the achievement of emissions reductions on the scale necessary to avert the harmful consequences of climate change.

And here we come to the second of the questions: the role of the private sector. Clearly the technology solutions will be provided by the private sector, not by governments. This necessarily means that there must be incentives for innovation, both in the form of financing but also importantly in the form of protection of intellectual property. If the centerpiece of deployment of technology is not market-based, but is for example, a compulsory license, or if governments conceive of clean technology as a public good to be purchased in bulk at low rates, there is a very real risk that the private sector will not respond to produce the solutions necessary. So we have a global problem that is going to require the active participation of the private sector to solve.

This leads me to the last of our three questions, that having to do with protectionism. We have seen in proposed legislation in the United States and in proposals from Europe, that some nations think the way to induce participation in a new climate accord by the major emerging markets is to tax their products at the border or otherwise adopt measures that will equalize carbon prices. The idea behind these measures is that, as the price of energy rises in a particular jurisdiction as a result of mitigation commitments, there is a risk that energy intensive jobs will migrate to jurisdictions where there is a lower energy price or that have not similarly bound themselves to undertake mitigation commitments.

While some might see this as a necessary step either to protect industry or to induce participation by the major emerging markets in a climate deal, I think this course risks a descent into carbon based protectionism. If one goes down the path of looking at production processes and methods in the manufacturing state as the basis for border measures or, worse, if we decide to dissect the carbon pedigree of products, we will run in to significant problems. If differential energy costs are a basis for border adjustment, why not different regulatory or compliance costs in all other areas?

Another potential front in a carbon trade war are the subsidies being given by governments to encourage investment in less carbon-intensive technologies. For example, the U.S. Department of Energy recently announced a funding initiative to develop high-impact products to facilitate the transition to a less carbon-intensive economy. However, the funds available under this program are only available to companies owned by U.S. citizens. This means that the U.S. subsidiaries of foreign-headquartered companies – that is, companies that are incorporated in the U.S. and have substantial operations here – are not eligible to participate. Not only is this reducing the effectiveness of the program, but it is discriminating between U.S. companies and U.S. workers on an irrational basis.

Adding to the concern, these restrictions are not required by law. In fact, when DOE staff members were asked why they implemented these restrictions, they explained that they were merely acting “in the spirit” of the Buy American provisions.

Our trading partners have taken notice and are retaliating. In Canada, the province of Ontario is considering imposing a local content requirement on the purchase of certain renewable energy technologies. Under one proposal, the program could require domestic (i.e., Ontario) content of 40 percent initially, rising to 60 percent within five years.

Similarly, just this week, China adopted an explicit “Buy Chinese” policy for procurement pursuant to its economic stimulus plan. Under the edict, the government must use only Chinese products and services unless they are not available or are unreasonably priced. But the Chinese measures go further. Not only are there affirmative regulations requiring purchase of Chinese goods but, in an effort to root out foreign participation, Beijing is launching an investigation into local government purchases of goods and services from foreign suppliers.

This xenophobic spirit in procurement and technology development can only serve to undermine the effectiveness of individual government programs and global recovery efforts. Those with the greatest stake in the global trading system, including, most especially, the United States, should think twice before letting loose the forces of protectionism, however nuanced the presentation or politically popular the justification.

We must reject an approach to climate change and technology development that depends on discrimination, trade barriers or the threat of trade sanctions.

There is another way forward that relies more on the carrot than the stick. I have already explained the idea behind the Clean Technology Fund and the linkage between financing infrastructure using clean technologies and the willingness of developing countries to undertake meaningful mitigation commitments. There is also an approach to technology diffusion that relies on trade liberation rather than coercion. That is an agreement to lower tariffs on clean energy goods and remove barriers to the provision of clean energy services.

It is doubtful that Copenhagen will produce a fully developed agreement. One has only to read the reports coming out of the preparatory meetings in Bonn to learn of the negotiating gaps that remain among the parties. But a template or negotiating roadmap that ensures cooperation and mitigation commitments by all major economies, that encourages private sector involvement and safeguards intellectual property, and that affirms the importance of commitment to open markets – this is an approach that can help chart a path for a successful conclusion.

I’d now like to shift gears and talk about financial system reform. The global effort to coordinate a response to the financial crisis is in some respects further along than global efforts to address climate change. Despite some setbacks along the way – and some looming threats on the horizon – the cooperation achieved to date in efforts to address the financial and economic crises has been quite promising.

This is in large part due to the work being done through the G20. And the progress made through the G20 provides important lessons for how we might attack the development divide in the climate context.

I served as President Bush's "sherpa" to the first G20 leaders' meeting held last November here in Washington. As the financial crisis unfolded in the fall of 2008, President Bush recognized that a coordinated and cooperative global response was necessary and decided to move quickly to convene a meeting of leaders. To make this happen, he asked his economic team to pull together a summit in just 24 days.

Some in Europe claim that they foisted the Summit on an unwilling United States. That is not the case. Recognizing the global scope of the crisis, President Bush decided that a summit must include both major developed and developing countries. This was done over the initial objections of some European countries, who wanted to limit attendance.

Participation by the major emerging markets was essential for three reasons. The first two reflect the same logic that led President Bush to convene the Major Economies Forum on Climate. First, the crisis would significantly affect major emerging markets. Second, any agreement on principles and specific actions, in order to have broad legitimacy, required the support of developing countries. And third, because a critical piece of the puzzle related to reforming international institutions such as the International Monetary Fund (IMF) to enhance the voice of emerging markets in their governance, such countries had to be at the table. In short, as with the Major Economies Forum, President Bush recognized that a global crisis required a global solution and that it was no longer acceptable, effective or even possible for a relatively small group of developed countries to dictate outcomes to the developing world.

It was important to the President that the G20 summit in Washington produce both a meaningful declaration of principles and a concrete plan for further progress. As a result, two documents were produced at the summit. The first was the Leaders' Declaration – a statement of principles to guide reform and recovery efforts. The second was an action plan that set forth specific steps to be taken in the near and medium terms. The core principles included strengthening transparency and accountability, enhancing sound regulation, promoting integrity in financial markets, reinforcing international co-operation, and reforming international financial institutions.

In the run-up to the Washington Summit, there was much inflated language about the end of capitalism. Indeed, France's president Nicolas Sarkozy declared that capitalism must be "refounded" because "Laissez-faire is finished. The all-powerful market that is always right is finished." This reflected largely a rhetorical bidding war within Europe over leadership in the crisis. President Bush filtered out the noise and concentrated on achieving concrete results.

Considering the diversity of countries involved, and some of the statements made ahead of the Summit, the Leaders Statement that resulted is quite significant. The G20 recognized that their reform efforts would only be successful if grounded in “a commitment to free market principles, including the rule of law, respect for private property, open trade and investment, competitive markets, and efficient, effectively regulated financial markets.”

Further, the leaders recognized that “our financial markets are global in scope, therefore, intensified international cooperation among regulators and strengthening of international standards, where necessary, and their consistent implementation is necessary to protect against adverse cross-border, regional and global developments affecting international financial stability.”

The G20 were conscious of the need for regulatory reform, but at the same time, they were concerned that regulators not stifle innovation.

Striking the right balance is admittedly difficult. At the Washington Summit, the G20 recognized that “efficient, effectively regulated financial systems . . . are essential to economic growth and prosperity and have lifted millions out of poverty, and have significantly raised the global standard of living.” However, they warned that, despite the need for new regulation, that they “must avoid over-regulation that would hamper economic growth and exacerbate the contraction of capital flows, including to developing countries.” They also warned that “[r]egulators must ensure that their actions support market discipline, avoid potentially adverse impacts on other countries, including regulatory arbitrage, and support competition, dynamism and innovation in the marketplace.”

In addition to embracing these important principles, the Washington Summit set forth a 47-point action plan that laid the groundwork for further progress. Once the summit wrapped up, the four working groups were established, each built on the four core principles. The work of these four groups established a strong foundation for further progress to be made at the G20 London Summit in April.

The London Summit was an opportunity to harvest some of the progress made over the previous six months, but also to reaffirm the core principles, even in the face of increased protectionism and economic stress. Before the Summit, press reports contributed to a sense of conflict between countries that wished further stimulus and those that wanted to focus the Summit on financial regulation reform.

Some developed and developing country leaders played the “who caused the crisis” blame-game or demonized certain institutions or products, like securitization and credit default swaps, that in fact perform useful functions by enabling companies to manage complex risk. For

example, President Lula of Brazil blamed the “irrational behavior of white people with blue eyes” and President Sarkozy called for a “new world order for capitalism.” Prime Minister Berlusconi pledged to stop the use of securitization and derivatives.

Despite the rhetoric in the run-up to the London Summit, the G20 leaders were able to build on the goodwill that was forged in Washington to develop a coordinated approach to global economic stimulus, financial market stabilization and regulatory reform. The G20 leaders, recognizing the deteriorating economic situation, took important steps to increase the resources of the IMF, broaden its mandate and reform its governance. The G20 also provided greater support for developing countries and encouraged trade flows through commitments for an additional \$250 billion in trade financing.

In addition, the G20 renewed its commitment to resist protectionism, and vowed that its members “will not repeat the historic mistakes of protectionism of previous eras.” To ensure that this commitment was honored, the G20 charged the World Trade Organization (WTO) with monitoring and reporting on the protectionist impact of recovery efforts.

And in order to facilitate better cooperation and coordination on the regulatory front, the G20 transformed the Financial Stability Forum into the Financial Stability Board (FSB) by expanding its membership to include all of the G20. The leaders charged the FSB with coordinating regulatory reform efforts, developing international best practices and monitoring financial protectionism.

There are important lessons to be drawn from the financial reform context. First, the diversity of the group involved is critically important. Without major emerging economies fully engaged in the process, a coordinated approach simply would not have been possible or effective. Second, having regular meetings, and more importantly an action plan, has helped to propel progress and keep leaders and their representatives engaged in the difficult process of reform. Third, involving international organizations – of a more broadly representative character – to both monitor progress and facilitate coordination can help to defuse protectionist impulses and encourage more effective solutions through cooperation, both among member countries, and between regulators and the private sector.

This leads into the second of my questions – the role of the private sector. As governments embark on the important work of regulatory reform, they must take care to avoid the dangers identified by the G20 in Washington and London. They must not demagogue particular products or services nor stifle innovation or appropriate risk-taking. Political leaders must always bear in mind what Teddy Roosevelt called the distinction between public opinion and the public interest.

Here the Financial Stability Board can play an important institutional role. The G20 charged the Financial Stability Board with facilitating cooperation and coordination of regulatory efforts. The Board will meet for the first time next week. I am hopeful that they will take on the task of avoiding fragmentation and financial protectionism.

But there are worrying signs on the horizon. One has only to read today's press on the dispute between the UK and Brussels over who will regulate financial services in the City of London to get a flavor of the difficulty – and that is only within Europe.

As the crisis drags on, some of the principles that were so energetically embraced in Washington are starting to be watered down. In London, for example, the G20 Leaders did not renew their commitment to “free market principles” or seek explicitly to balance the need for regulation against the need for continued dynamism and risk-taking.

More recently, the G8 Finance Ministers' Statement, which came out last weekend, includes what can best be described as a tepid commitment to open markets. In London, the G20 declared that “the only sure foundation for sustainable globalization and rising prosperity for all is an open world economy.” The G8 Ministers merely note that “growth is underpinned by stable financial markets and strong fundamentals.”

Also gone are the robust condemnations of protectionism found in the November and April G20 Declarations. Replacing them is a single line stating that finance ministers “reaffirm our commitment to refrain from protectionism and we commit to continue to working towards and ambitious conclusion of the Doha Round.”

These worrying trends are found not only in diluted rhetoric. They may be seen as well in the financial protectionism that characterizes early reform efforts. Here the most common protectionist barrier is the application of territorial restrictions on the provision of services. For instance, the EU has promulgated regulations on credit default swaps, credit rating agencies, and private pools of capital. In all three instances, the proposed regulations include territorial restrictions.

The EU's proposed new rules for Credit Rating Agencies (“CRAs”) require that non-EU domiciled CRAs must obtain the “endorsement” of their ratings from CRAs located in the EU or must be “certified” by the European Commission as subject to “equivalent” regulation. Without such endorsement or certification, rated products cannot be used for regulatory capital purposes by European investment firms.

In the effort to regulate credit default swaps, there are indications that a worrying fragmentation is underway. The EU is requiring that all credit default swap transactions with an EU-based reference entity be cleared through EU-based central clearing parties.

Similarly, recently proposed EU regulations require that the managers of non-EU domiciled hedge funds be regulated in the EU in order to freely market products to institutional investors in Europe.

These territorial restrictions inhibit the cross-border flow of capital and result in fragmented markets. Fragmentation can lead to the very regulatory arbitrage that reform efforts were meant to address.

More importantly, regulation that embraces a territorial principle risks the dis-integration of the global economy that we have spent decades integrating, that has lifted millions out of poverty, and that has brought about unparalleled economic growth and prosperity.

In addition to the territorial measures, there are two recent regulatory initiatives that also cause concern. These barriers are embedded in banking law reform. The first, enacted by Switzerland last year, requires that certain banks maintain a leverage ratio that exceeds a minimum threshold. On its face that is not discriminatory. However, the way that a bank is directed to calculate its ratio requires a number of “adjustments” to the bank’s balance sheet, including the deduction of the entire domestic loan book. This effectively places limits on international lending (which is counted in the leverage ratio calculation) without imposing similar restrictions on domestic lending (which is not counted in the leverage ratio calculation).

The second such initiative was recently proposed by the UK Financial Services Authority. This would require banks to conduct assessments of their liquidity management based solely on in-country capitalization. As drafted, the proposal would prevent banks and investment firms with non-UK parents from relying on their parent and wider group in their liquidity risk management. A nationally segmented approach to liquidity would make it more difficult for cross-border groups to manage risk effectively or efficiently.

Finally, I must mention an especially pernicious restriction found in the U.S. TARP Program: financial institutions that receive government assistance are barred from hiring foreigners. This is America. We cannot forget who we are.

So in the face of these growing threats, what can be done? The G20 built in mechanisms to address resurgent protectionism and to improve the effectiveness and quality of regulation through cooperation and coordination.

Both governments and the private sector must engage with each other and with international organizations. They should be working together to develop regulatory frameworks that are robust, non-discriminatory, mutually reinforcing, transparent and that encourage innovation, with appropriate constraints on the buildup of systemic risk.

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Let me conclude. Efforts to address climate change and the financial crisis will necessarily require both international rules and national legislation. To be successful, these efforts must be based on international cooperation, engagement with the private sector and must avoid the pitfalls of protectionism.

The issues of climate change and the financial crisis place us at a fascinating juncture in the evolution of international institutions and the development of new international rules. The mandates and governance of international institutions such as the IMF and the Financial Stability Board are being made broader and more inclusive. The major emerging economies are poised to take their rightful place as full partners in addressing global problems.

International rules are being fashioned that will reach deeply into domestic financial systems and energy grids. The tensions between national sovereignty and the need for global governance are manifest. The outcome of the climate negotiations will directly effect all energy producers and energy consumers.

If the development of international law can be marked by its progression from the border inwards – the move from territorial delimitation and tariffs to the very content of domestic regulation – then we are indeed in a progressive era. Everyone who has a mortgage, drives a car, who turns on a light switch or who purchases a share of stock will be touched by these new rules.

And these new arrangements will require the diligence and creativity of international lawyers. Climate change is not only an issue for those in your firms or offices who deal with energy and environmental matters. Financial system reform is not the sole province of banking and securities lawyers.

We as international lawyers have a special role to play in ensuring that our international agreements and institutions meet current global challenges and do so in a way that channels political energy along positive not populist lines and serves the long-term interest of the international rule of law.

Thank you very much for the opportunity to share these thoughts with you and the honor to do so in memory of Walter Surrey. I'd be pleased to take any questions.