# Journal Global Policy and Governance

## Papers

## Junior Research Working Papers

## Comments

PAPER

# China's Market Economy Status
# Adoption of Surrogate Country Methodology After 2016

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**Abstract**   After the expiration of paragraph 15(a) (ii) of the Accession Protocol of the People's Republic of China on 11 December 2016, it is still in doubt whether China's market economy status will be automatically recognized. On 12 May 2016, the European Parliament adopted a non-legislative resolution to deny China market economy status. Through the analysis of the criteria of market economy status and the application of surrogate country methodology, this article comes to the conclusion that , in any case, no definite connection exists between awarding a country non-market economy status and applying the surrogate country methodology to this country's products. Regardless of China's market status, Paragraph 15(a) of the Accession Protocol of the People's Republic of China cannot be cited as the legal basis for applying the surrogate country methodology after its expiration. Finally, this article explore the possible way for WTO importing members to apply the surrogate country methodology substituting Paragragh 15(a) of the Accession Protocol of People's Republic of China, which is through the term "particular market situation", as stipulated in Article 2.2 of the Anti-Dumping Agreement.

**Keywords**   Market Economy Status - Anti-dumping - Surrogate Country Methodology - Particular Market Situation

**JEL Classification**   K33

## Introduction

Market Economy is the economy where market decisions are based on supply and demand, and contains a free price system. [1] Paragraph 15(a) of the Accession Protocol of the People's Republic of China (hereinafter Accession Protocol of the PRC), which serves to provide rules regarding the accession of the PRC into the WTO and went into effect on November 2011, denied China market economy status. The provision states that investigating authorities of WTO importing members may determine the normal value of a product in an anti-dumping

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[1] *Gregory R. Stuart, Paul Robert: Comparing Economic Systems in the Twenty-First Century, Seventh Edition.( Boston: Houghton Mifflin ,2004), 538.*

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investigation by using the price of that product in a surrogate country. According to Paragraph 15(d) of the Accession Protocol of the PRC, paragraph 15(a) (ii), which provides that surrogate country methodology, shall expire 15 years after the date of accession, namely, 11 December 2016.

In the past decades, China's government has made significant progress in establishing a market economy. So far, more than 90 countries, including Australia, New Zealand and Singapore, have recognized China's full market economy status.[2] However, the United States, EU, Japan, Canada and India, among others, which are both major trading partners of China and countries that pursue an active approach in initiating anti-dumping investigations, still do not recognize China as a market economy country.

On May 12 2016, the European Parliament adopted a non-legislative resolution urging the European Commission not to recognize China's market economy status.[3] On July 2016, a United States government official claimed that the US would not automatically grant China market economy status after December 2016.[4] Therefore, it remains disputed questions that whether China may be automatically granted market economy status after 2016, and whether the surrogate country methodology can still be applied in the anti-dumping investigation after 2016..

## 2 The Criteria of Market Economy

It should be noted that there is no specific definition of "market economy" under the framework of the WTO. The criteria of "market economy" are based on the national laws of individual importing WTO members.[5] The national laws mentioned above include not only laws but also decrees, regulations and administrative rules.[6] Thus, WTO members have full autonomy over the determination of market economy status. For example, the United States (Hereinafter "the US") and European Union (hereinafter "the EU") both have their own criteria to establish whether a country qualifies as a market economy.

### 2.1 US's Criteria of Market Economy

According to Section 771 (18) of the Tariff Act 1930, The term "nonmarket economy country" means any foreign country that the administering authority determines does not operate on market principles of cost or pricing structures, so that sales of product in such country do not reflect the fair value. [7] When determining the market economy status of a country, the administering authority shall take into account, [8]

   1. the extent to which the currency of the foreign country is convertible into the currency of other countries;

2 "China Encounters Challenge of the normalization of Trade Conflict", China Daily, November 23 2015, accessed by May 15 2016, http://chinawto.mofcom.gov.cn/article/dh/janghua/201511/20151101197595.shtml.

3 See European Parliament, Resolution of 12 May 2016 on China's market economy status (2016/2667(RSP)).

4 "the US refused to Award China Market Economy Status Automatically", July 14 2016, Accessed by August 7 2016, http://money.163.com/16/0714/23/BRVK9QER00253B0H.html.

5 Accession Protocol of the People's Republic of China, WT/L/432 (23 November 2001) [hereinafter Accession Protocol of PRC], paragraph 15(d).

6 Working Party on the Accession of China, Report of the Working Party on the Accession of China, 149, WT/ACC/CHN/49 (1 October 2001).

7 the Tariff Act of 1930, 19 U.S.C 1667n, Section 771 (18).

8 Id.

2. the extent to which wage rates in the foreign country are determined by free bargaining between labor and management;

3. the extent to which joint ventures or other investments by firms of other foreign countries are permitted in the foreign country;

4. the extent of government ownership or control of the means of production;

e. the extent of government control over the allocation of resources and over the price and output decisions of enterprises, and

6. such other factors as the administering authority considers appropriate.

When conducting anti-dumping investigations against transitional economy countries, the US utilizes a sector-based analysis method to monitor developments in the level of marketization in those countries. If a certain industry or enterprise in a non-market economy country is market-oriented and features virtually no government involvement, producers from this industry or enterprise may be treated as market economy producers, and the normal value of products from this industry or enterprise may be adopted for the purpose of the investigation. This is called the "market-oriented industry" test.

In the preliminary determination in the case regarding *Sebacic Acid from the People's Republic of China 1994*, the US Department of Commerce adopted the aforementioned "market-oriented industry" test. The test includes three conditions, namely,[9]

(a) There must be virtually no government involvement in setting prices or production quantities with regards to the merchandise under investigation. For example, state-mandated production of the merchandise, whether for export or domestic consumption in the non-market economy country, would be an almost insurmountable barrier to deciding that this industry qualifies as a market-oriented industry.

(b) The industry producing the merchandise under investigation should be characterized by private or collective ownership. There may be state-owned enterprises in the industry but substantial state ownership would weigh heavily against deciding that a certain industry qualifies as a market-oriented industry.

(c) Market-determined prices must be paid for all significant inputs, whether material or non-material, and for an all but insignificant proportion of all the inputs accounting for the total value of the merchandise under investigation. For example, an input price will not be considered market-determined if the producers of the merchandise under investigation pay a state-set price for the input or if the input is supplied to the producers at the direction of the government. Moreover, if there are any state-mandated production quantities in the industry producing the input, the share of such state-mandated production quantities must be insignificant.

### 2.2 EU's Criteria of Market Economy

Contrary to the US's practice, the EU's anti-dumping legislation offers no specific definition of "market economy country". Nonetheless, the EU included a list of nonmarket economy countries in its legislation, which includes Azerbaijan, Belarus, North Korea, Tajikistan, Turkmenistan and Uzbekistan.[10] Although China is not included in the list of non-market economy countries, EU

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9 Preliminary Determination of Sales at Less Than Fair Value and Postponement of Final Determination: Sebacic Acid From the People's Republic of China, FR Doc No: 94-160, (January 5, 1994).

10 Council Regulation on protection against dumped imports from countries not members of the European Community, (EC) No 1225/2009 of 13 November 2009, L343/51[Hereinafter Basic Anti-Dumping Regulation], Note of Article 2.7 (a).

does not fully recognize China as a market economy, rather treating China as an "economy in transition". Chinese export enterprises may only enjoy market economy treatment on an individual basis, after an application the exemption for the application of surrogate country methodology has been approved.[11] Article 2.7(c) of the Council Regulation on Protection against Dumped Imports from Countries Not Members of the European Community (hereafter the Basic Anti-Dumping Regulation) further set up five criteria for countries to be classified as "operating under market economy conditions", namely,[12]

- decisions of firms regarding prices, costs and inputs, including for instance raw materials, cost of technology and labour, output, sales and investment, are made in response to market signals reflecting supply and demand, and without significant State interference in this regard, and costs of major inputs substantially reflect market values,
- firms have one clear set of basic accounting records which are independently audited in line with international accounting standards and are applied for all purposes,
- the production costs and financial situation of firms are not subject to significant distortions carried over from the former non-market economy system, in particular in relation to depreciation of assets, other write-offs, barter trade and payment via compensation of debts,
- the firms concerned are subject to bankruptcy and property laws which guarantee legal certainty and stability for the operation of firms, and
- exchange rate conversions are carried out at the market rate.

Concluding from the above criteria for Market Economy shows that , while the US's criteria for countries' classification as market economies mainly focus on "government involvement" and "state ownership", the EU's criteria emphasize the soundness of the markets in question. Regardless of the difference in criteria, awarding market economy status under both sets of criteria is subjective and uncertain. The recognition of market economy status will depend on investigate authorities' interpretation of the terms "government involvement", "state interference" and "government ownership".

In recent years, the EU has been considering granting China market economy status, with attitudes divided into two groups. A group of supporters consists of economically competitive northern European countries, such as the United Kingdom, the Netherlands, Norway, Sweden and Denmark. Another group of opponents is made up of economically less competitive countries, headed by Italy. The economies of the opposing countries mainly consist of struggling traditional industries, such as steel, ceramics and textiles. Due to intense debates between the two aforementioned factions, the European Commission had to postpone the publication of a proposal to determine China's market economy status in January 2016.[13] The difficulties of European countries to reach a decision on the one hand reflect the European Commission's willingness to recognize China's market economy status; on the other hand show that impediments against the awarding of market economy status exist, hailing from both inside and outside the EU. For example, the US has warned the EU that recognizing China's market economy status would be equivalent to unilaterally disarming Europe's trade defenses against China.[14] Moreover, United

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11 Basic Anti-Dumping Regulation. Article 2.7 (b
12 Id. Article 2.7 (c).
13 See "EU Postponed Resolution on China's Market Economy Status", Economic Information Daily, 15 January 2016, http://finance.sina.com.cn/roll/2016-01-15/doc-ifxnqriy2917057.shtml, accessed by May 15, 2016.
14 See Christian Oliver, US warns Europe over granting market economy status to China, accessed by 15 May 2016http://www.ft.com/cms/s/0/a7d12aea-a715-11e5-955c-1e1d6de94879.html#axzz48gVMLouj,.

Steel Workers (USW) wrote a letter to US trade representative Frohman on the subject of the Transatlantic Trade and Investment Partnership (TTIP), stating that the US's manufacturing industry would be adversely affected if the EU would recognize China's market economy status.[15] This amounts to an admission that opposition against China's market economy status is not based mainly on legal principles and legal reasoning. Rather, it is based for a large part on policy considerations related to saving declining traditional industries.[16]

In conclusion, it is still doubtful whether China's major trade partners, headed by the US and the EU, will recognize China as a market economy country. Although paragraph 15(a) (ii) expires after 11 December 2016, the text of paragraph 15(a) does not require WTO members to automatically award China market economy status. Instead, the granting of such status depends on subjective and certain criteria, the interpretation of which is liable to be influenced by policy considerations rather than purely legal arguments.

Regardless, the absence of the granting of "market economy status" in itself does not lead to adverse effects on China's trade exports. Instead, it is the surrogate country methodology, applied to countries under a non-market economy status, that significantly influences China's cross-border trade.

## 3 The Adoption of Surrogate Country Methodology

The *surrogate country methodology* may be defined as a method in which the normal value of a product in a certain non-market economy country is determined not by examining the actual price or cost of such product in that country's domestic market, but instead by looking at the price or cost of such product in a third country. Under the current WTO framework, the surrogate country methodology may be applied on the basis of the note of Article 6.1 GATT, Article 2.2 of Anti-Dumping Agreement and Paragraph 15(a) (ii) of the Accession Protocol of PRC.

### 3.1 Note of Article 6.1 GATT

According to the note of Article 6.1 GATT,[17]

> In the case of imports from a country which has a complete or substantially complete monopoly of its trade and where all domestic prices are fixed by the State, importing contracting parties may find it necessary to take into account the possibility that a strict comparison with domestic prices in such a country may not always be appropriate.

This note opens up the possibility to apply the surrogate country methodology. However, compared to the EU's and the US's criteria towards determining whether a country qualifies as a market economy, the criteria under Article 6.1 GATT, namely, "substantially complete monopoly" and "prices […] fixed by the State", are stricter and much harder to satisfy. Thus, WTO members are not likely to adopt the surrogate country methodology based on the note of Article 6.1 GATT.

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15 "USW: EU's Decision on China's Market Economy Status must the negotiation of TTIP" 29 October 2015, accessed by 15 May 2016 http://chinawto.mofcom.gov.cn/article/e/t/201511/20151101160413.shtml
16 " EU opposition to China's MES may be less about legal doctrines than industrial policies to revive fading industries." See Dan Steinbock, The EU Division Over China's Market Economy Status, accessed on May 15, 2016, http://www.economonitor.com/blog/2016/03/the-eu-division-over-chinas-market-economy-status/,
17 General Agreement on Tariffs and Trade, Oct.30 1947, [hereinafter GATT],Note of Article 6.1 GATT 1947.

## 3.2 Article 2.2 of Anti-Dumping Agreement

The procedure to determine the normal value of a product under Article 2.2 of the Anti-Dumping Agreement is as follows. In general, the domestic price of the product should be used. Only under special circumstances, a comparable price of the product in question when exported to an appropriate third country should be used as a basis for the determination.[18] These special circumstances only exist where there are no sales of the product in question in the ordinary course of trade in the domestic market or where the domestic price should not be used due to other particular market situations or due to the low volume of the sales in the domestic market.[19]

## 3.3 Paragraph 15(a) (ii) of the Accession Protocol of PRC

Under Paragraph 15(a) (ii) of the Accession Protocol of the PRC, importing WTO Members may use a methodology that is not based on a strict comparison with domestic prices or costs in China, if the producers under investigation cannot clearly show that market economy conditions prevail in the industry.[20] However, in any event, Paragraph 15(a) (ii) shall expire 15 years after the date of accession.[21] Thus, even if China is not awarded market economy status by the EU and the US after 2016, Paragraph 15(a) (ii) cannot be the legal basis for adopting the surrogate country methodology.

However, as early as 2011, a European scholar opined that the expiration of Paragraph 15(a) (ii) does not give rise to the expiration of the preamble of Paragraph 15(a) and Paragraph 15(a) (i). According to this line of reasoning, the surrogate country methodology could still be applied.[22] Nontheles, It should be noted that the methodology described under Paragraph 15(a) (i) and the preamble of Paragraph 15 is grounded on the effectiveness of Paragraph 15(a)(ii). In fact, the Summary of the U.S.-China Bilateral WTO Agreement specifies that,[23]

> The U.S. and China have agreed that we will be able to maintain our current antidumping methodology (treating China as a non-market economy) in future anti-dumping cases without risk of legal challenge. This provision will remain in force for 15 years after China's accession to the WTO.

Furthermore, in the *EC- Iron or Steel Fasteners* case, the appellate board held that,[24]

> Paragraph 15(d) of China's Accession Protocol establishes that the provisions of paragraph 15(a) expire 15 years after the date of China's accession (that is, 11 December 2016). [...] In other words, paragraph 15(a) contains special rules for the determination of normal value in antidumping investigations involving China. Paragraph 15(d) in turn establishes that these special rules will expire in 2016 and sets out certain conditions that may lead to the early termination of these special rules before 2016.

Moreover, the spokesperson of China's Ministry of Commerce, Danyang Shen, has emphasized

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18 Agreement on Implementation Of Article VI of the General Agreement On Tariffs And Trade 1994, [Hereinafter Anti-Dumping Agreement], Article 2.2.

19 Id.

20 Accession Protocol of PRC, Paragraph 15(a) (ii) .

21 Accession Protocol of PRC, Paragraph 15 d.

22 Bernard O'Connor, The Myth of China and Market Economy Status in 2016, pp.3-4, available at http://worldtradelaw.typepad.com/files/oconnorresponse.pdf .See also Bernard O' Connor, Market- economy status or China is not automatic, in Yale Global Online, 8 December 2011.

23 Summary of U.S.-China Bilateral WTO Agreement, 2 February 2000, accessed by May 15 2016, http://chinawto.com/wto/index-e.asp?sel=info&info=summary.

24 Appellate Board Report, European Communities – Definitive Anti-Dumping Measures On Certain Iron Or Steel Fasteners From China, WT/DS397/AB/R, 15 July 2011, para. 289.

in a recent regular news conference that, regardless of China's market economy status, according to the Accession Protocol of the PRC, application of the surrogate country methodology in anti-dumping investigations will lose its multilateral legal basis after 11 December 2016.[25] Therefore, after the expiration of Paragraph 15(a) (ii), Paragraph 15(a) may no longer be cited as the legal basis of the surrogate country methodology.

In conclusion, Paragraph 15(a) of the Accession Protocol of the PRC is not the only legal foundation on which WTO importing members may base to apply the surrogate country methodology to Chinese products. Rather, the note of Article 6.1 GATT and Article 2.2 of the Anti-Dumping Agreement also contain grounds for the application of such methodology. After 11 December 2016, Paragraph 15(a) of the Accession Protocol of the PRC may no longer be cited as the legal basis for applying the surrogate country methodology. Meanwhile, the criteria under the note of Article 6.1 GATT are too high for WTO members to adopt the said methodology. Therefore, the term "particular market situation" under Article 2.2 of Anti-Dumping Agreement will soon replace Paragraph 15(a) of Accession protocol of PRC as the legal basis of WTO importing members for applying the surrogate country methodology.

The use of the term "particular market situation" as ground for applying the surrogate country methodology is precedent through WTO importing members' treatment of Russia. Although Russia has been recognized as a full market economy country, its domestic product prices are still not used to determine the normal value of Russian products in some sectors, since investigative authorities have determined that a "particular market situation" exists in these sectors. Further precedent may be found in Australia's treatment of Chinese products. Australia has recognized China as a market economy country, but has also found that a "particular market situation" exists in some of China's economic sectors.

As a result of the abovementioned considerations, it is necessary to explore the definition and application of the term "particular market situation" on the basis of WTO laws, WTO members' national laws and anti-dumping practice.

## 4 The determination of particular market situation

### 4.1 GATT/WTO's Determination of Particular Market Situation

The Anti-Dumping Agreement provides neither a specific definition of the term "particular market situation" nor an illustrative list of countries that feature particular market situations. The British scholar Francis Snyder believes the term "particular market situation" originated from the term "non-market economy".[26] Meanwhile, Chinese scholars Sibao Shen and Tong Liu hold the view that the determination of a "particular market situation" must involve an analysis of elements such as the level of government interference, the soundness of the internal market and the method of market circulation.[27] Recent cases under the WTO dispute settlement mechanism exist concerning cost adjustment methodologies, such as the surrogate country methodology.[28]

25 "China Encounters Challenge of the normalization of Trade Conflict", China Daily, November 23 2015, accessed by May 15 2016, http://chinawto.mofcom.gov.cn/article/dh/janghua/201511/20151101197595.shtml.

26 Francis Snyder .2001. "The Origins of the 'Nonmarket Economy': Ideas, Pluralism and Power in EC Antidumping Law about China", European Law Journal, pp. 369-424.

27 Shen, Sibao and Liu, Tong. 2006. Interpretation of WTO Anti-dumping Agreement. Hunan: Hunan Science and Technology Press. p33.

28 See European Union-Cost Adjustment Methodologies and Certain Anti-Dumping Measures on Imports from Russia, DS 474, https://www.wto.org/english/tratop_e/dispu_e/cases_e/ds494_e.htm; see also European Union -Cost Adjustment Methodologies and Certain Anti-Dumping Measures on Imports from

However, only in the case regarding *European Economic Community-Imposition of Anti-Dumping Duties on Imports of Cotton Yarn from Brazil* (hereinafter *EC-Cotton Yarn*)[29] in the era of GATT, did the GATT panel explain the application of the term "particular market situation". In the *EC-cotton Yarn* Case, Brazil claimed that the EC had failed to properly consider the particular market situation prevailing in Brazil and had therefore acted in breach of Article 2.2.[30] Due to the very high level of inflation in Brazil in early 1989, the Brazilian government froze the exchange rate in an attempt to decrease the available money supply and to control inflation. The exchange rate freeze continued for three months, during which period domestic inflation continued. Following the unfreezing of the exchange rate, the currency depreciated.[31] Brazil argued that this combination of a fixed exchange rate and domestic inflation had led to a gross distortion in the comparison between domestic prices (used as the basis for determining the normal value of products) and export prices, which distortion in turn had resulted in an inflated dumping margin.[32]

The GATT panel noted that Article 2.2 of the Anti-Dumping Agreement specifies two situations under which the normal value of a country's products may be determined through the use of cost adjustment methodologies, such as adopting a constructed normal value of products or using third country sales as a basis for applying the surrogate country methodology. The first situation occurs where no sales of the product in question in the ordinary course of trade exist in the domestic market. The second situation occurs where a particular market situation exists, due to which the use of domestic sales would not permit a proper comparison.[33] With regard to the second situation, the panel noted that the wording of Article 2.2 makes it clear that the test to determine whether cost adjustment methodologies may be applied is not whether or not a "particular market situation" exists *per se*.[34] Rather, a "particular market situation" is only relevant insofar as it has the effect of rendering domestic sales unfit to permit a proper comparison.[35] Although Brazil claimed that the exchange rate was affecting internal trade and product prices, it failed to demonstrate that the cost of raw cotton materials was affected.[36] Brazil also failed to specify whether domestic sales were affected to such an extent by the combination of high domestic inflation and a fixed exchange rate, that those sales did not permit a proper comparison.[37] Consequently, the GATT panel concluded that Brazil's arguments had not demonstrated that the EC had acted inconsistently with the requirements of Article 2.2.

To conclude, although the panel did not explore the specific definition of the term "particular market situation", the panel did make an effort to explain the application of the term. Namely, a particular market situation may be found to exist where a particular situation has the effect of rendering domestic sales unfit to permit a proper comparison.

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Russia (Second complaint) , DS 494, https://www.wto.org/english/tratop_e/dispu_e/cases_e/ds474_e.htm.
29 GATT Commission on Anti-Dumping Practices, European Economic Community- Imposition of Anti-Dumping Duties on Imports of Cotton Yarn from Brazil (hereinafter "EEC-Cotton Yarn"), ADP/137, 4 July 1995.
30 Panel Report, EC-Cotton Yarn, para.467.
31 Id.
32 Id. Para. 468.
33 Id. Para. 477.
34 Id. Para. 478.
35 Id.
36 Panel Report, ECC-Cotton Yarn, para.479.
37 Id.

## 4.2 EU's Determination of Particular Market Situation

The current effective EU legislation on anti-dumping is the Basic Anti-Dumping Regulation, which has been amended via Regulation No 765/2012 and Regulation No 1168/2012. Under Article 2.3 of the Basic Anti-Dumping Regulation, a "particular market situation" exists (a) when prices are artificially low, (b) when there is significant barter trade, or (c) when there are non-commercial processing arrangements.[38]

The *Russian potassium chloride* case was the first case to apply the term "particular market situation" in anti-dumping investigations after the EU had recognized Russia's market economy status.[39] It was also the first case to apply the term "particular market situation" after the publication of Council Regulation No 1972/2002, which provides an interpretation of the term "particular market situation" and enumerates a number of examples.[40] Therefore, this case forms a significant precedent for the EU investigative authority in its application of the term "particular market situation". In the *Russian potassium chloride* case, the EU investigative authority stated that the situations enumerated under Article 2.3 of the Basic Anti-Dumping Regulations are not exhaustive. Moreover, the investigative authority held that any decision on whether a "particular market situation" exists must include an evaluation of price variations and price trends, rather than be solely based on the absolute level of prices.[41]

## 4.3 Australia's Determination of Particular Market Situation

Article 269TAC 2 (II) of the Australian Custom Act 1901 also refers to the term "particular market situation".[42] More specifically, where the situation in the market of an exporting country is such that sales are not suitable to be used to determine the price of a product, the price of the same product in an appropriate third country may be adopted instead.[43] The Dumping and Subsidy Manual published by Australian Customs and Border Protection explores the issue in further detail, stating that whether a "particular market situation" exists depends on (a) whether the prices are artificially low; or (b) whether there are other conditions in the market which render sales in that market not suitable for use in determining prices under s.269TAC(1).[44] With regard to "government influence", which is regarded as a specific form of particular market situation, the manual defines it as influence from any level of government. When investigating whether a particular market situation exists due to government influence, the Commission will seek to determine whether the impact of the government's involvement in the domestic market has materially distorted competitive conditions.[45] Any finding that competitive conditions have been materially distorted may give rise to a finding that domestic prices are artificially low or not substantially the same as they would be if they were determined in a competitive market.[46]

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38 Basic Anti-Dumping Regulation, Article 2.3.

39 See Council Regulation (EC) No 1972/2002, Amending Regulation (EC) No 384/96 on the protection against dumped imports from countries not members of the European Community, L 305/1, p1.

40 See Id.

41 Council Regulation (EC) No 1891/2005, Amending Regulation (EEC) No 3068/92 imposing a definitive anti-dumping duty on imports of potassium chloride originating in Belarus, Russia or Ukraine, L 302/14, 19.11.2005, p3.

42 Custom Act 1901, Compilation No. 137(Austl), section 269TAC 2 (II).

43 Custom Act 1901, Compilation No. 137(Austl), section 269TAC 2 (II)(d).

44 Australia Customs and Border Protection, Dumping and Subsidy Manual, June 2015, p35.

45 Australia Customs and Border Protection, Dumping and Subsidy Manual June 2015, p35.

46 Id.

On 19 Sept 2011, Australian Customs and Border Protection initiated a dumping and countervailing investigation against a certain type of steel products named "hollow structural sections" exported from China, Korea, Malaysia, Taiwan and Thailand.[47] In the *Hollow Structural Sections* case, Customs and Border Protection considered that a particular market situation existed in China's relevant industry, since the government of China influences the Chinese iron and steel industry through (a) provision of the raw materials of steel at less than adequate remuneration; (b) the prevalence of SOEs (SIEs) in the manufacture of hollow structural section components, resulting in artificially low prices of hollow structural sections; (c) reduced or subsidized energy input prices in the manufacture of hollow structural section components; (d) Chinese government benefits received by manufactures of hollow structural sections, including reductions in tax, exemptions of duty and VAT, as well as the provision of grants.[48]

## 5 Conclusion

Whether China's major trade partner will recognize China as market economy is still at doubt. The recent resolution adopted by the European Parliament to deny China market economy status is non-legislative. To grant China market economy status, the EU must go through a three-step procedure. Firstly, the European Commission must make a proposal regarding China's market status, which means a consensus must previously have been reached inside the Commission. Secondly, the European Council, consisting of representatives of the 28 member states, must vote for the proposal, which means that at least 16 member states, representing at least 65% of the EU population, must vote in favor. Thirdly, the proposal must be adopted by a majority vote in the European Parliament.[49] The three-step procedure is expected to be initiated in the latter half of 2016. Regardless, expectations with regards to the outcome of the procedure are not particularly high.

The Chinese government maintains that China deserves to be awarded market economy status 15 years after China's accession to the WTO and Chinese government officials reiterated this position in the WTO meeting on July 14 2016.[50] Simultaneously, we note that, despite the expiration of Paragraph 15(a) of the Accession Protocol of the PRC, WTO importing members may still not be willing to grant China market economy status. Instead, they might raise the standard for being awarded "market economy status" through a stricter interpretation of the criteria for being classified as a "market economy". Such an approach would constitute a disguised form of trade protection, since it would stem mainly from policy considerations and would be less convincing as to its legal merits.

The current focus for China should be on how to approach and deal with future possible investigations. It should be noted that, regardless of whether China will be recognized as a market economy country, paragraph 15(a) of the Accession Protocol of the PRC will soon no longer be cited as the legal basis for adopting the surrogate country methodology. In this light,

47 Australian Government Anti-dumping Commission, Certain Hollow Structural Sections Exported from the People's Republic of China, the Republic of Korea, Malaysia, Taiwan and the Kingdom of Thailan Case No. IRT 177[Hereinafter Hollow Structural Sections ]. accessed by 15 May 2016, http://www.adcommission.gov.au/cases/ITR177.asp.

48 Australian Customs and Border Protection Service, Report To The Minister No.177, 7 June 2012, (REP 177), p 110.

49 French Foreign Minister Speaks about China's Market Economy Status: Supporting Talks between China and EU, 13 May 2016, accessed by 15 May 2016, http://international.caixin.com/2016-05-13/100943490.html.

50 "China Advocates for the Abandon of Surrogate Country Methodology Against China", 15 July 2016, accessed by 15 May 2016, http://news.xinhuanet.com/world/2016-07/15/c_1119228189.htm.

it is worth noting that the EU is considering modifying its trade defense legislation. The EU Trade Commission is currently involved in an attempt to delete the list of nonmarket economy countries and transitional economy countries from the EU Basic Anti-Dumping Regulation, while advocating for the application of new anti-dumping methodology to all WTO members equally, including the non-standard methodology against government interference which leads to price distortions.[51] Another possible reform direction would be to base the application of the surrogate country methodology on the determination of "particular market status" under Article 2.2 of the Anti-Dumping Agreement.

Differences do exist between classifying a country as a market economy and determination whether or not a particular market situation exists. Firstly, the criteria regarding the term "market economy" are exclusive, while the list of "particular market situations" is non-exhaustive. Secondly and more importantly, while awarding non-market economy status to a country directly leads to the application of the surrogate country methodology to that country's products, the determination that a "particular market situation" exists *per se* does not lead to application of the surrogate country methodology. Only where the particular market situation leads to a gross distortion in the comparison between domestic prices, may the surrogate country methodology be applied. In other words, the application of the surrogate country methodology under Article 2.2 of the Anti-Dumping Agreement is stricter and tougher than that under Paragraph 15(a) of the Accession Protocol of PRC.

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PAPER

# Foreign Exchange Regulation in Armenia: Current Status and the Need for Revision in the Context of Eurasian Integration Initiatives[1]

## Sandoyan E.M. • Voskanyan M.A. • Mnatsakanyan L.A. • Okhikyan L.A.

**Abstract**  With the acceleration of economic globalization more and more countries begin to look for effective ways of deepening of integration processes with the regional neighbors. At the same time, each country, depending on the specific structural features of the domestic economy, in addition to the expected positive effects of trade and economic relations and increase of the level of welfare, has to deal also with the impact of certain negative effects, which in some cases are able to nullify all the favorable expectations.

Recent developments in the integration processes in the Eurasian space point to the inevitability of sophistication of integration levels between countries. Despite the fact that it is in the short term the currency or financial integration, however, clear that this possibility is not far off. And, given the seriousness of such a step, the preparation of the financial integration should start long before the actual financial integration. At the same time, it should be said that one of the most instructive examples of financial and monetary integration is an example of the Eurozone. However, as has shown experience, many aspects of integration were poorly thought out and resulted in negative consequences for the individual member countries. One of the key mistakes was the lack of effective harmonization of markets, regulatory institutions, financial intermediation and fiscal policy.

At the same time, taking into account the impact of the Russian economy on the economies of EAEC, should be taken to the issue of harmonization of monetary policies very carefully in the generated integration association. The events of the past year revealed the close dependence of economies of Eurasia as well and other post-Soviet countries, on the volatility, in particular, on the Russian currency market. The choice of currency regulation strategy by the Central bank always was and is one of the most complex challenges for "the monetary authorities" in emerging markets. On the one hand, to achieve effective interaction of market mechanisms in the economy must be accompanied by the presence of a floating exchange rate of the national currency. On the other hand, emerging markets are always characterized by significant risks associated with inflationary pressures; undeveloped financial system that denies, in fact, "the monetary authorities' ability to apply more market-based mechanisms of

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regulation of the money market and the impact on prices; the overall macroeconomic instability undoubtedly affects the very high volatility of the exchange rate, which is also a negative impact on the real sector, etc. All these things together force the central banks of developing countries to resort to non-market mechanisms of regulation of the exchange rate. Armenia in this sense is no exception. Events of the last two years have shown that the policy of soft regulation of the exchange rate, combined with monetary inflation containment mechanisms, is used as a short-term anti-crisis mechanism for balancing state budgets and stimulate economic growth in the majority of the EAEC countries. At the same time, all the Union's members are implementing uncoordinated monetary and foreign exchange policy. The dissonance in the policy of currencies exchange rate regulation was most shown between the Russian Federation and Armenia. It is only enough to compare levels of devaluation of national currencies in relation to the US dollar. So, if in the period from 1 January 1 2014 to 1 January 2016 the Russian ruble depreciated 123.3% against the US dollar (the Central Bank of the Russian exchange rate as follows: As of 01.01.2016 - 72.9299 rubles for 1 US dollar, and as of 01.01.2014 - 32.6587 rubles per 1 US dollar), only 19.3% against the Armenian dram in the same period of time (the Central Bank of the Republic of Armenia exchange rate as follows: as of 01.01.2016 - 483,75 AMD per 1 US dollar, as of 01.01.2014 - 405,64 AMD per 1 US dollar)[2]. This discrepancy is also observed in the level of inflation (if the CPI in 2015 relative to 2014 in Russia amounted to 12.9%, in the Republic of Armenia, respectively- 4.1%[3]). In other words, the monetary authorities in the Russian Federation and the Republic of Armenia for the past two years used the opposite approach to "protect" their markets and stimulate economic growth, including in the field of expansion of exports and import substitution. In the context of the above, considered topic is relevant and requires more detailed study.

**Keywords**   Exchange rate - Integration - Central Bank - Inflation - Monetary regulation

**JEL Classification** E52 - O24

## Theoretical basis of monetary integration associations

The processes of regionalization, formation of various trade unions, inter-country agreements on various economic issues, economic integration, monetary integration, starting from the second half of the XX century, are the most relevant economic and political issues of recent times. Since the 1960s, economists talk about the choice concept of monetary policy for member countries of a free economic zone. What currency should be used in mutual trade?

One of the first economists to begin consideration of the issue was Robert Mundell. In 1961, in the case of Canada and the United States he put the emphasis on the mobility of factors, in particular he noted that if the region has a high degree of labor mobility, it should have a fixed exchange rate within the borders of that region and a flexible exchange rate with the rest of the world. But if there is no labor mobility in the region, it does not matter which exchange-rate regime the country has. He also notes the importance of wage and price flexibility as a mechanism of demand shocks regulation. Therefore, if there is labor mobility, price and wage flexibility in an economy of a region, there is no need to exchange rate changes.[4] Mundell's work is often cited significantly over the years, but it has also generated criticism, which helped develop the theory of optimum currency areas.

2 Website Central Bank of Armenia:  https://www.cba.am/am/SitePages/ExchangeArchive.aspx
3 Russian Federation Federal State Statistics Service - http://www.gks.ru; National Statistical Service of the
  Republic of Armenia - www.armstat.am
4 R. A. Mundell (1961) "A Theory of Optimum Currency Areas", American Economic Review, pp. 657-665

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Many analysts, like Paolo Pesenti[5], Felipe Larrain[6], Andres Velasco[7] and Roberto Chang[8] have pointed out that the international financial crises of 1994-95 (the Mexican crisis), 1997-98 (Asian crisis) were caused or reinforced, at least in part, by the predominance of fixed or semi-fixed exchange rate regimes in the affected countries, and, therefore, it is justified by the idea that flexible exchange rates may have been a better choice.

In 1988 Friedman found that the system of flexible exchange rates is a fundamental prerequisite for economic integration.[9,10] Nevertheless, the flexible exchange rate regimes have been subject to criticism, in particular that referred to the emerging economies. Emerging markets, which use flexible exchange rate regimes are prone to instability and wide fluctuation in terms of exchange rates, which hinder long-term planning that is necessary for successful economic development.[11] However, knowing that fixed or semi-fixed regimes are sensitive to the crisis, it has been observed in Asia that a fixed exchange rate with the world's major currencies - US dollar, euro, yen - is often considered to be more advantageous than a flexible exchange rate. From the date of the entry of the Republic of Armenia in the Eurasian Economic Community discussions are under way on the problems of monetary policy coordination with the Member States. There is a high risk of devaluation of the national currency in the countries of the economic block that export energy resources (like Russia and Kazakhstan), and in order to maintain their position in the market of the EAEC and empowerment in foreign markets others have consistently lower rates of exchange that is not conducive to the development of integration processes between the EAEC countries. The depreciation of the national currency leads to more expensive imports and the expectation of rising prices, causing an immediate increase in prices. Theoretically there could be a special case in which the continuous devaluation of the national currency could ensure a competitive advantage for the country, without affecting producer prices and export prices. In practice, this would last for a very short period, and in the medium and long term continuous devaluation lowers the volume of foreign trade and balance of payments worsens.

Article 64 of Section XIV of the Treaty on the Eurasian Economic Union describes the objectives and principles of the agreed monetary policy. Annex 15 of this article explicitly mentioned the need for coordination of exchange rate policies to ensure mutual settlements between residents of Member States in the national currencies of the Member States.[12] If Member States will not make settlements in national currency, at least in certain product segments, central banks will have no incentive to comply with the requirements of the EAEC Treaty and to negotiate and adopt appropriate standards and documents. Settlements in national currencies directly contribute to a coordinated and more efficient policy of floating exchange rate.

5 Roubini, Nouriel, Giancarlo Corsetti, and Paolo Pesenti. (1998). "What Caused the Asian Currency and Financial Crisis? Part I: A Macroeconomic Overview", New York University, September.

6 Sachs, Jeffery and Felipe Larrain (1999): "Why Dollarization Is More Straitjacket Than Salvation. Foreign Policy 116 (Fall): 80–92;

7 Andres Velasco (1988): "Trade, Development and the World Economy: Selected Essays of Carlos Díaz-Alejandro". A. Editor. Oxford: Basil Blackwell.

8 Chang, Roberto and Andres Velasco (1998): "The Asian Liquidity Crisis." National Bureau of Economic Research Working Paper 6796, November

9 M. Friedman. (1988): "The Case for Flexible Exchange Rates." In The Merits of Flexible Exchange Rates, edited by Leo Melamed: George Mason University Press.

10 Michael Chriszt (2000): "Perspectives on a Potential North American Monetary Union". Economic Review, Vol. 85, No. 4

11 Hausmann Ricardo (1999): "Should There Be Five Currencies or One Hundred and Five?" 65–79

12 Eurasian Economic Commission, https://docs.eaeunion.org/ru-ru/

## Monetary and exchange rate policy in Armenia: threats and prospects in the context of the entrance into the EAEC

A comparison of the national currencies exchange rates dynamics of EAEC countries allows to note that, unlike Armenia, in all countries of the Union for the mentioned period there was a significant depreciation of the exchange rates of national currencies and a substantial increase in the rate of inflation. Armenia was the only country that has managed to maintain the stability of the exchange rate substantially and to prevent inflation.

It should be noted that the policy of hard currency regulation in Armenia is not new and has already a long tradition[13]. The result of the maintained policy is the relative low level of prices, as well as the stability and predictability of foreign exchange and investment risks. On the other hand, it is important to understand the "price" of the achievement of such a stability and what risks add to the competitiveness of the Armenian economy, including in terms of the country's economic potential in the EAEC markets. The Central Bank of Armenia managed to "ensure" the stability of the exchange rate mainly due to the use of foreign exchange intervention (in the period from 1 January 2014 to 1 January 2016 about 30% of foreign exchange reserves of the Central Bank[14] were lost, in the same period the Central Bank lost 27,8% of its international reserves[15]), as well as the establishment of the "rough" increased rates of compulsory redundancy of foreign exchange liabilities of commercial banks in the amount of 20% with the condition of redundancy in the national currency (in Russia - 4.25%), so that now "connected" 7,5% of bank assets. Such a rigid approach to the reserve requirements which creates an unprecedented "artificial" demand for the national currency, leads to significant negative consequences - reducing the volume of lending to the economy, reducing the profitability of commercial banks, raising interest rates and finally it is responsible for derailing economic growth.

Such an approach could be justified if the Armenian producers managed to reach the "new" markets that do not depend on the ruble market. However, this did not happen. The situation was aggravated also by the reduction of the world prices for non-ferrous metals by about 40%[16], in particular prices for copper and molybdenum which are exported to European and other foreign markets dropped by 11%. The natural result of the Armenia monetary policy was a significant deterioration in the competitiveness of the Armenian economy.

Let's point out the main channels of the impact of the Russian economy on the economy of Armenia.

*First Channel - private foreign transfers.*

Armenia is known to be a rather transfer dependent economy. About 30% of GDP is cash transfers flows from abroad. At the same time, the main share of money transfers falls on Russia. One example of the negative impact of the crisis in Russia is considered to be the period 2014-2015. In connection with the devaluation of the ruble against the backdrop of falling oil prices and the strong dependence of the Russian economy on oil revenues, and as a result of a general decline in living standards, the overall level of cash flow declined significantly over the period. So, starting from 2014 to 2015 transfers decreased by 499 964 thousand USD including from Russia by 553 387 thousand dollars. (see Chart 1 и 2).

13 See. Eg: Sandoyan E.M., Voskanyan M.H., Mnatsakanyan L.A. «Evaluation of the influence of inflation and exchange rate in Armenia» Eighth Annual scientific conference (2-6 December 2013). Collection of scientific articles: Social and Humanities Sciences. Part II. - Yerevan.: Pub. RAU, 2013. - 344p. pp. 63-70; Voskanyan M.H. Currency regulations in Armenia in the framework of inflation targeting: myth and reality. XIX Kondratieff reading «Modernization of the Russian economy: lessons from the past, chances and risks», Participant s' theses. N. D. Kondratieffs' International Fund, pp. 69-71.
14 Webpage Central Bank of Armenia: https://www.cba.am/am/SitePages/statexternalsector.aspx
15 Webpage Central Bank of Russian Federation: http://cbr.ru/hd_base/Default.aspx?Prtid=mrrf_7d
16 http://money.cnn.com/data/commodities/?iid=intnlmrkt

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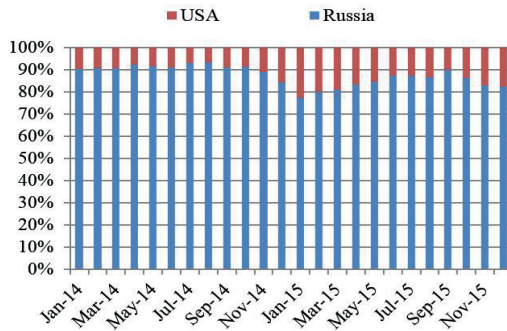
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**Chart 1 Private transfers, Private transfers, thousands USD**
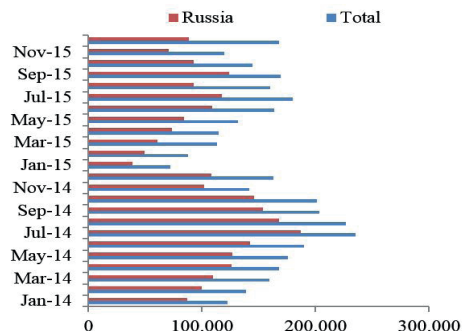


Source: Database of the Central Bank of Armenia - http://www.cba.am/

**Chart 2 Share of Russia and the United States in foreign private transfers to Armenia**



Source: Database of the Central Bank of Armenia - http://www.cba.am/

If this trend continues, we can predict that by the end of 2016, the inflow of private foreign cash transfers into the Armenian economy will decrease by approximately 700-800 thousand USD. The reason for the reduction of transfers is the reduced current income of the Armenian Diaspora in Russia. Also the currency structure of the transfers changed - the share of ruble transfers in relation to the dollar, i.e. inflow is reduced not only in physical terms, but also because of the devaluation of the ruble. The first reaction to the decline in population income transfers line is to reduce the volume of sales of goods and services on the domestic market which in turn affects a significant reduction in imports.

*The second channel - a decline of exports to Russia.*
We cannot say that Armenia's economy is characterized by high export levels. However, one of the positive factors of the Armenian entry in the EAEC should be the improvement of the export position of the countries in the integration association. At the moment, the share of Kazakhstan and Belarus in the export of Armenia is scanty, while exports to Russia take the second place in the overall structure of exports from Armenia. Thus, exports to Russia can be considered a significant channel of influence of the Russian economy on Armenia.

Again, the crisis of 2014-2015 and had a negative impact on economic relations between Russia and Armenia. According to official statistics in Armenia sales of goods and services, aggregate demand and income decreased. According to the NSS imports to Armenia in 2015 decreased by 19,3% while export from Armenia fell by 26,7%. At the same time, according to the Eurasian Economic Commission, the export from Armenia to Russia in 2015 compared with 2014 decreased by 26,5%, while imports from Russia to Armenia on the contrary increased by 3,8%. EAEC Statistics show that in 2015 Armenia lost markets in Russia on a number of traditional product groups, furthermore, the relevant goods from Russia began to replace the appropriate goods of Armenian origin already in the Armenian market. If we consider the export from Armenia to Europe, we can see that there was a reduction of 5.4%, i.e. in this case the situation is much better. However, there are significant problems associated with the reduction of stock in world prices for copper and associated non-ferrous metals. The price of copper fell by 26% in 2015 as a result of Armenia suffered losses in exports of raw materials and / or was forced to increase the volume of ore mining.

*The third channel - Significant decline in FDI.*
The Russian economy in Armenia is also a significant source of foreign direct investment. Much of the capital invested in the economy of Armenia is the name of the Russian. Therefore, of

course, the reduction of Russian direct investment flows will affect the economic development of Armenia.

**Chart 3 Direct foreign investment in the Armenian economy, mln.USD**
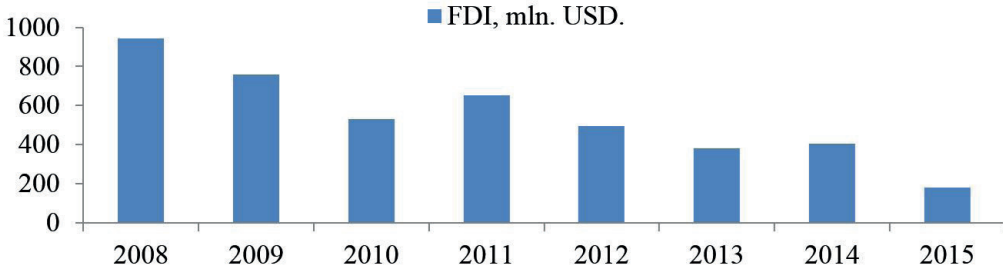


Source: National Statistical Service of the Republic of Armenia, www.armstat.am

Over the past three years, there was a significant decline in FDI in the Armenian economy (see Chart 3), which is explained along with the "Russian" factor, i.e. the reduction of the investment potential of the Russian Diaspora, the traditional problems of an institutional nature (disadvantaged investment climate and business environment, high concentration in the markets, monopolization of the economy).

*The fourth channel - a reduction of tourism*

Finally, the tourism sector of Armenia is also in many ways associated with Russia. A significant proportion of tourist spots in Armenia attract flows from Russia. According to the NSS in the fourth quarter 2015 256 572 tourists arrived in the republic. Compared to the same period of 2014 the tourist inflow decreased by 3.2%.[17] If we consider the balance of payments data for tourism in the current account, we can see that there was a significant reduction in income compared with the same period last year. Thus, as has been shown above, there is a close macroeconomic relationship between the Armenian and the Russian economy. It is clear that at the level of one of the most important instruments of macroeconomic regulation, namely at the level of monetary and exchange rate policy the volatility relationship between drama and ruble is evident.

Let's consider the results of the monetary policy of the Central Bank in recent years. In early 2006, the Central Bank switched to inflation target regime. However, as the experience of recent years has shown, monetary policy in Armenia is not sufficiently effective. Besides the fact that half of the central bank failed to achieve a nominal anchor (see Table 1), the analysis shows that most of the necessary preconditions for Inflation Target in Armenia is absent.

**Table 1 CPI and the target RA landmark annually**

|               | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 |
|---------------|------|------|------|------|------|------|------|------|------|------|
| Bottom target | 1.5  | 2.5  | 2.5  | 2.5  | 2.5  | 2.5  | 2.5  | 2.5  | 2.5  | 2.5  |
| Top target    | 4.5  | 5.5  | 5.5  | 5.5  | 5.5  | 5.5  | 5.5  | 5.5  | 5.5  | 5.5  |
| The real CPI  | 2.9  | 4.4  | 8.9  | 3.4  | 8.2  | 7.7  | 3.2  | 5.8  | 3    | 3,7  |
| Deviation     | 0%   | 0%   | 61%  | 0%   | 49%  | 40%  | 0%   | 5.5% | 0%   | 0%   |

Source: Database of the Central Bank of Armenia - http://www.cba.am/

It comes, first of all, to the credibility of the Central Bank, transparency policy, freely floating exchange rate of the national currency, a high degree of central bank independence, the presence of adequate development of the stock market and a substantial amount of short-term, medium-term and long-term government debt. In the period from 2009 to 2015 there was a steady growth in the value index of monetization economy of Armenia (the ratio of money supply to GDP), but

17 http://armstat.am/file/article/sv_12_15r_421.pdf

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compared with other countries, EAEC and Georgia, Armenia has a rather poor performance. In part, this situation is due to the presence of the "Dutch disease" in the economy of Armenia, when the expansion of monetary aggregates is accompanied by an increase in inflationary pressures.

Over the entire period of inflation targeting in the context of the CBA quarterly almost never missed the mark. Moreover, it should be noted that practically throughout the entire period of the inflation targeting CBA conducted a policy of "expensive money" Even during the crisis, when the world adopted a policy of lowering interest rates in order to stimulate economic activity, the Central Bank, however, continued a policy of "expensive money".

However, the strict policy pursued by "monetary authorities" in Armenia did not lead to effective results. The annual cross-sectional picture of a rainbow. However, in two of the five years of inflation targeting in Armenia, the Central Bank did not achieve this goal. So, with regret we can say that one of the main instruments in the conditions of inflation targeting tools "monetary authorities" - the interest rate - is not effective from the point of view of the impact on the real economy and the reduction of inflationary pressures (see Chart 4). The underdevelopment of the financial system as a whole does not allow the Central Bank to effectively use the interest rate instrument.

**Chart 4 The refinancing rate of the Central Bank and the CPI in the period of inflation targeting in RA.**
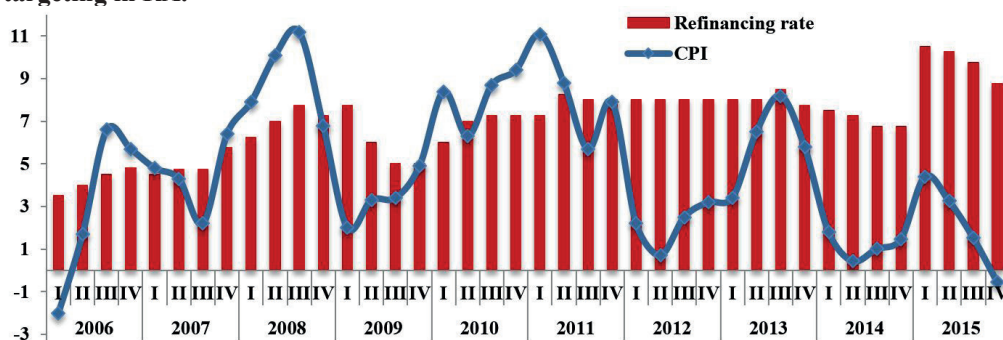


Source: Database of the Central Bank of Armenia - http://www.cba.am/

On the other hand, if we take into account that in the conditions of inflation targeting, the main instrument of the Central Bank, as a rule, are open market operations, it becomes clear that in an underdeveloped capital market in Armenia, this channel is the impact of the Central Bank on the aggregate demand also it does not work.

**Chart 5 Monetary aggregates RA (mln. AMD)**
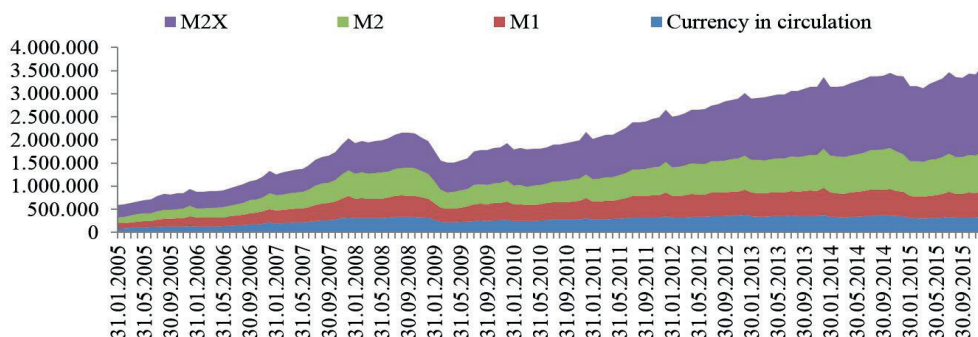


Source: Database of the Central Bank of Armenia - http://www.cba.am/

Finally, the structure of money supply in Armenia indicates a high degree of dollarization and the virtual absence of long-term financial resources (see Chart 5). At the same time, against the backdrop of, say, Georgia, Kazakhstan, Armenia seems quite poorly as regards the presence of at least medium-term financial resources in the economy. In addition, almost from the start of inflation targeting, the Central Bank has followed a strict monetary policy. Artificial strengthening of national currency exchange rate, which is carried out by the Central Bank, led to significant negative consequences. But it is also necessary to mention one of the most important conditions for the successful implementation of inflation targeting, namely free-floating exchange rate. In this sense, the Central Bank's de facto implementing of strict exchange control initially excludes the possibility of an effective monetary policy under inflation targeting.

With a view to keep depreciation of the dram the Central Bank in the period from December 2013 to February 2015 has lost about 1.0 billion US dollars to its international reserves, i.e. almost 30%, and the Bank of Russia, for example, which, in contrast to the CBA, has not borrowed and own and significant international (gold and foreign-exchange) reserves - much smaller - less than 15% (see Graph 6.).

**Chart 6 Gold and foreign-exchange reserves of the Russian Federation, Armenia**
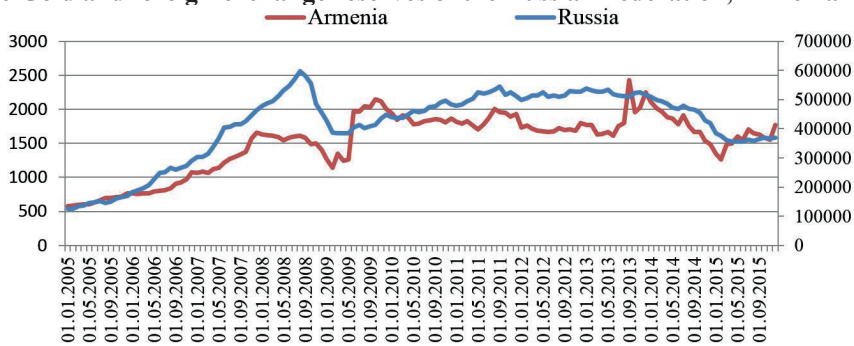


Source: https://www.cba.am, www.cbr.ru,

The significant reduction of foreign currency inflow to Armenia from the above noted 4 channels (investment, private transfers, tourism, exports, which have been discussed above) had an impact on the sharp drop in the national currency. And on December 17 2014 AMD exchange rate rose to 527 (in exchange offices and 600), that is, A`MD depreciated by 48% (from the pre-crisis rate of 405) in such a short period. This fall caused a shock reaction. The Central Bank had to find a solution for the current situation.

After the Central Bank, trying through foreign exchange intervention, to suspend the depreciation of the national currency, could not withstand the excessive demand and the prevailing negative expectations for the exchange rate, it was decided the most non-market and can lead to negative consequences of the decision. On December 17th, 2014 the Central Bank increased the statutory rate of compulsory reservation bank liabilities in foreign currency from 12% to 24% with the condition of placement of reserves in the Central Bank exclusively in AMD (previously 6% required to reserve in drams, the remaining 6% - in the deposit currency), which caused a sharp strengthening of the drama the next day. Since 18 December, the dollar fell to 30.2 points and was fixed at around 497 AMD per 1 USD. According to AMD deposits this rate remains 2%. Later, on 23 December 2014, the Central Bank revised and lowered the reserve requirements rate from 24% to 20%, which operates to this day. Due to the action of the norm still the banking system forced freezes a significant amount on reserve accounts in the Central Bank (about 512 mln USD, or about US $ 245 bln AMD, about 170 bln AMD of which are additional to the previously applicable requirements), carrying on These currency and interest rate risks to their investors. (see table 2).

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**Table 2 Foreign currency deposits of the banking system of Armenia**

|  | AMD, mil. | USD, mil. |
|---|---|---|
| Foreign currency liabilities: | 1,228,224 | 2,559 |
| Required reserves: | 245,645 | 512 |

Source: Database of the Central Bank of Armenia - http://www.cba.am/

## Correlation of volatility of the exchange rate in EAEC countries

Thus, the exchange rate plays an important role in the country's trade policy. Relative revaluation of currencies and their volatility often have important implications for international trade, balance of payments and on the overall economic performance. Within the framework of this model the importance of exchange rates for trade by analyzing the impact of exchange rate volatility on trade will be discussed.

Let us consider this relationship based on the example of EAEC Union countries. We study how the volume of Armenian export to countries of the Customs Union is interconnected to exchange rate volatility, the coefficient recalculation of PPP, GDP per capita and 2 fixed time shocks: Macroeconomic Shocks and membership in the EAEC.

To calculate volatility methods are used where the volatility of the bilateral exchange rate is measured as the standard deviation of the difference between quarterly exchange rate values. exchange rate volatility between K and J countries in year T is defined by the formula:

$$ERvol_{kjt} = std.dev.[\ln(ER_{kjt,m}) - \ln(ER_{kjt, m-1})]$$

where *ER* - the nominal exchange rate,

*m* - quarter

$ERvol_{kjt}$ value, which equals to 0 means there is no volatility, as in the case of a fixed exchange rate regime. The standard deviation is calculated for a single quarter. Aggregate volatility at the country level is a weighted average of bilateral trade volatility.

A more general measure of exchange-rate misalignment is a deviation from the value of purchasing power parity (PPP). As the PPP index PPP conversion factor was taken in quarter section for the currency of each country. As fixed variables we took a number of macroeconomic shocks in the countries and the entry into an economic union. These variables act as binary and have the values {0, 1} for the corresponding quarter.

To test the relationship between exchange rates and trade, we are using a simple econometric analysis of quarterly data which covers 4 countries of the Customs Union in the period from 2008 to 2015. As the dependent variable appears gross export from Armenia to Russia, Kazakhstan and Belarus for the quarter. (Xjkt) We estimate the model which is designed to explain the effect of the exchange rate and other variable data on trade between Armenia and these countries.

Assessment of the impact on trade due to changes in the variable data is calculated by the following formula:

$$X_{jkt} = \beta_0 + \beta_1 GDPPC_{jt} + \beta_2 PPP_{jt} + \beta_3 xratevol_{jkt} + \omega_{jt} + \Psi_{jt} + \varphi_{jkt}$$

where GDPPC – GDP per capita of country j in quarter t, PPP –conversion factor of the currency of country j in quarter t and xratevol – the volatility of currency j relative to k in quarter t. $\omega_{jt}$ – a shock in country j in quarter t. $\Psi_{jt}$– membership in the Union of country j in quarter t. As Russia, Belarus and Kazakhstan have become members of the Union at the same time, we considered as variable only Russia, in order to avoid singular matrices and multicollinearity.

## Methodology and model results

This study analyzed the quarterly data for 2008 - 4rd quarter of 2015 for 4 countries (Armenia, Russia, Belarus, Kazakhstan).

### Background of the model:

- There is no correlation between macroeconomic shocks and country's membership in the Customs Union.
- The relationship between trade and the exchange rate is considered under the influence of a fixed time.
- GDP per capita and the PPP conversion factor - the best options that describe the willingness of the population to the imported products.

### Hypothesis ($H_0$):

Fixed time effects have a significant impact on the volume of export from Armenia to Russia, Belarus and Kazakhstan.

### Data analysis

Tables 1, 3 and 5 (see Appendix) show the descriptive statistics between these indicators. In table 2 (see Appendix) regression can be seen on the volatility of currency trading. A very small part of trade is due to the volatility of currencies and none of them is a significant factor since all p-values are greater than 5%. **In addition, even the Belarusian ruble absolutely not a significant factor, the likelihood that its coefficient is zero** - 93.52%. This can be explained by the fact that all these currencies are multicorrelated and they all depend on the dollar exchange rate. Table 4 (see Appendix) shows the regression of trade and GDP per capita of the population. It is important to note that the GDP per capita of the population of Kazakhstan is the most significant factor for the Armenian exports as a whole, as its p-value equal to 0.0065 while the same figure for Belarus makes this country again insignificant. In the final model, we eliminate all insignificant factors. Regression of trade and PPP conversion factors are presented in Table 6 (see Appendix). As it was expected, PPP to AMD is a very important factor for the Armenian exports. The most important thing to take into account is that the exchange rate is also very important in this case. The next step is to consider all of the variables with the fixed time effects and to find the best model that explains changes in commerce. Models with variable and fixed exposure time are presented in Table 7.

### Formula 1

TRADE = 0.0577*ARMGDP - 0.01082*BELGDP + 0.02232*KAZGDP + 0.00959*RUSSIAGDP + 215.43*AMDPPP - 0.4559*BYRPPP - 0.80141*KZTPPP + 134.9*RUBPPP - 54.292*BYRAMDVOL + 106.364*KZTAMDVOL + 55.723*RUBAMDVOL - 11.6543*SHOCKARM - 4.410*SHOCKBEL + 59.036*SHOCKKAZ - 41.751*SHOCKRUS - 34.1503*UARM - 2.003*URUS - 99.83

As seen from the results shown in Table 7 (see Appendix), all the factors together account for almost 91.6% of Armenian export changes, as adjusted R-square is 0.916. However, there are factors that are more important than others. If we consider the probability of the table to the right, we note that the most significant factor is GDPPC of Armenia, Kazakhstan and Russian and Kazakh GDPPC economic shocks and Armenia's membership in the Union.

Thus, we can conclude that the PPP conversion rate and the exchange rate are less important factors for the Armenian exports than shocks in Russia and Kazakhstan. To test our hypothesis we construct a model including GDP per capita of the population of Armenia, Russia and shocks in Russia and Kazakhstan and Armenia's membership in the Union. Consider the table 8 (see Appendix). R-square is less than in the model described in Table 7. However, the coefficients are

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greater which gives greater reliability and confidence. Only UARM and Armenia's GDP are not significant in this case, so we remove them and get the final model.

$$TRADE = -39.77*SHOCKRUS + 57.9763*SHOCKKAZ + 0.038*RUSSIAGDP - 59.204$$

In this case, all the variables are significant and the adjusted R-squared is equal to 80.4%. Thus, our hypothesis is that the fixed time effects have a significant impact on the volume of export from Armenia to Russia, Belarus and Kazakhstan holds 95% level of significance.

Thus, on the basis of the constructed model and the analysis it is revealed that Russia and Kazakhstan shocks are more significant factors in the Armenian export volume than the volatility of the exchange rate and conversion factors for PPP in these countries.

## Conclusions and recommendations

Since 1 January 2015, after the Republic of Armenia officially became a member of the Eurasian Economic Union, it has already been a year. During this period there have been significant changes in the mutual trade regimes in the formation of a unified tariff policy.

Membership of Armenia in the EAEC from 1 January 2015 was accompanied by the intention of expansion of Armenian exports to the markets of the member-countries of the Union and increase the investment attractiveness of the country, primarily to Russian investors. However, in reality, is primarily due to the implementation of the RA inconsistent with the countries of the EAEC monetary and foreign exchange policies, there was a deterioration of the main indicators of the international trade and investment cooperation. It is important to note that the scope of trade and economic cooperation between Armenia and other countries of the EAEC, with the exception of the Russian Federation, is so small that it does not play any significant role, so in the foreseeable future Russia will continue to be the basic guideline for the development of Armenia's foreign trade. To date, Russia has found itself in two crises. The first is due to the oil factor which led to budget and other financial problems in the Russian Federation. The second is caused by the embargo policy. Russia solved these problems with the help of a floating exchange rate policy. The Russian Federation did not actually lose its reserves. CBR, applying the policy of floating exchange rate, continues to buy foreign currency and contribute to the depreciation of the ruble. It would seem that, in this period, the economy of Armenia, through integration, the oil crisis and the embargo policy has a chance to fill a niche, thus increasing exports to Russia. However, our products were not competitive in the Russian market.

Thus, taking into account the expected reduction in foreign exchange inflows through foreign private transfers, export, foreign direct investment and tourism in 2015 of Armenia may face the problem of "shortage" of foreign currency that must necessarily affect the course of the Armenian dram, deterrence which creates deeper and more difficult to insurmountable problems. Our calculations show that at the moment the market rate of the Armenian dram should be about 600 units per US dollar which will restore parity competitiveness of Armenian goods in the Russian market and prevent the substitution of Armenian goods that are cheaper than Russian goods, as well as to involve all the other benefits of with integration into the EAEC.

The current situation of the economy of Armenia, taking into account significant changes of external and internal factors, involves the use of new and more effective mechanisms of regulation of the financial intermediation system, aimed at improving the competitiveness of the Armenian economy.

The artificial strengthening of national currency exchange rate, which is carried out by the Central Bank, led to significant negative consequences. Of course, to some extent, this policy has led to the growth curb money supply and, consequently, reduced inflationary pressures to some extent. However, as shown above, CBA attempts have not led to significant successes. As a result, the tightening of foreign exchange controls have not allowed to keep the inflation rate

within the band and at the same time significantly reduced the export potential of the Armenian economy. It is also necessary to mention one of the most important conditions for the successful implementation of inflation targeting, namely free-floating exchange rate. In this sense, the Central Bank's de facto implementing a strict exchange control, initially excluded the possibility of an effective monetary policy under inflation targeting.

It is necessary to revise the current monetary policy, adhere to the target with corresponding real inflation in the country in order to stimulate economic growth. Thus it is necessary to target the significant lag of inflation from the devaluation of the dram, which will provide export promotion and increasing real incomes of those dependent on foreign transfers.

The Government of the Republic of Armenia in cooperation with the Central Bank must implement a policy aimed at identifying the main causes of poor access to financial resources for small and medium-sized businesses. It is necessary to develop mechanisms that allow through the development of non-bank financial intermediation institutions to shape the market demand for capital in the long-term and medium-term financial products and diversified offer on them. It should also tighten the requirements for financial reporting in the real economy, to ensure transparency of operations of business entities, to develop principles and corporate governance system that will significantly reduce the risks in the credit market.

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## APPENDIX

**Table 1**

|  | TRADE | BYRAMDVOL | KZTAMDVOL | RUBAMDVOL |
|---|---|---|---|---|
| Mean | 60.30979 | 0.044922 | 0.013882 | 0.055493 |
| Median | 65.61690 | 0.017424 | 0.006409 | 0.018608 |
| Maximum | 105.5662 | 0.544087 | 0.067447 | 0.885149 |
| Minimum | 1.422223 | 0.001540 | 0.001014 | 0.004894 |
| Std. Dev. | 25.79242 | 0.104003 | 0.017160 | 0.156018 |
| Skewness | -0.272982 | 3.974731 | 1.922261 | 5.082245 |
| Kurtosis | 2.317572 | 18.76906 | 5.741316 | 27.54718 |
|  |  |  |  |  |
| Jarque-Bera | 0.986554 | 402.8154 | 28.79793 | 911.7628 |
| Probability | 0.610622 | 0.000000 | 0.000001 | 0.000000 |
|  |  |  |  |  |
| Sum | 1869.603 | 1.392594 | 0.430350 | 1.720268 |
| Sum Sq. Dev. | 19957.47 | 0.324497 | 0.008834 | 0.730252 |
|  |  |  |  |  |
| Observations | 31 | 31 | 31 | 31 |

**Table 2**

| Variable | Coefficient | Std. Error | t-Statistic | Prob. |
|---|---|---|---|---|
| RUBAMDVOL | -36.80974 | 67.18096 | -0.547919 | 0.5882 |
| KZTAMDVOL | 309.6833 | 293.4110 | 1.055459 | 0.3006 |
| BYRAMDVOL | 8.102195 | 98.66470 | 0.082118 | 0.9352 |
| C | 57.68938 | 6.445553 | 8.950261 | 0.0000 |
|  |  |  |  |  |
| R-squared | 0.059719 | Mean dependent var |  | 60.30979 |
| Adjusted R-squared | -0.044756 | S.D. dependent var |  | 25.79242 |
| S.E. of regression | 26.36329 | Akaike info criterion |  | 9.501736 |
| Sum squared resid | 18765.63 | Schwarz criterion |  | 9.686767 |
| Log likelihood | -143.2769 | Hannan-Quinn criter. |  | 9.562052 |
| F-statistic | 0.571611 | Durbin-Watson stat |  | 1.188778 |
| Prob(F-statistic) | 0.638549 |  |  |  |

**Table 3**

|  | TRADE | ARMGDP | KAZGDP | BELGDP | RUSSIAGDP |
|---|---|---|---|---|---|
| Mean | 60.30979 | 806.1743 | 2690.767 | 1591.510 | 2963.800 |
| Median | 65.61690 | 790.4595 | 3025.700 | 1593.882 | 3034.746 |
| Maximum | 105.5662 | 1277.599 | 3577.500 | 2008.977 | 3929.733 |
| Minimum | 1.422223 | 436.0000 | 1791.275 | 1067.382 | 1701.755 |
| Std. Dev. | 25.79242 | 230.9679 | 644.4634 | 285.3485 | 618.1815 |
| Skewness | -0.272982 | 0.126622 | -0.030577 | -0.141987 | -0.395383 |
| Kurtosis | 2.317572 | 1.886428 | 1.378085 | 2.252511 | 2.152079 |
|  |  |  |  |  |  |
| Jarque-Bera | 0.986554 | 1.684558 | 3.402702 | 0.825866 | 1.736363 |
| Probability | 0.610622 | 0.430728 | 0.182437 | 0.661707 | 0.419714 |
|  |  |  |  |  |  |
| Sum | 1869.603 | 24991.40 | 83413.78 | 49336.80 | 91877.80 |
| Sum Sq. Dev. | 19957.47 | 1600385. | 12459993 | 2442713. | 11464452 |
|  |  |  |  |  |  |
| Observations | 31 | 31 | 31 | 31 | 31 |

**Table 4**

| Variable | Coefficient | Std. Error | t-Statistic | Prob. |
|---|---|---|---|---|
| ARMGDP | 0.067970 | 0.013284 | 5.116538 | 0.0000 |
| KAZGDP | 0.024957 | 0.008442 | 2.956353 | 0.0065 |
| BELGDP | -0.000120 | 0.016127 | -0.007421 | 0.9941 |
| RUSSIAGDP | -0.003678 | 0.008827 | -0.416676 | 0.6803 |
| C | -50.54872 | 14.89591 | -3.393462 | 0.0022 |
|  |  |  |  |  |
| R-squared | 0.771413 | Mean dependent var |  | 60.30979 |
| Adjusted R-squared | 0.736246 | S.D. dependent var |  | 25.79242 |
| S.E. of regression | 13.24622 | Akaike info criterion |  | 8.151992 |
| Sum squared resid | 4562.021 | Schwarz criterion |  | 8.383280 |
| Log likelihood | -121.3559 | Hannan-Quinn criter. |  | 8.227386 |
| F-statistic | 21.93555 | Durbin-Watson stat |  | 1.899820 |
| Prob(F-statistic) | 0.000000 |  |  |  |

**Table 5**

|  | TRADE | AMDPPP | BYRPPP | RUBPPP | KZTPPP |
|---|---|---|---|---|---|
| Mean | 60.30979 | 0.187536 | 2.597175 | 0.016931 | 0.074095 |
| Median | 65.61690 | 0.185855 | 1.891373 | 0.016524 | 0.080108 |
| Maximum | 105.5662 | 0.221118 | 6.155452 | 0.025380 | 0.093817 |

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|  | TRADE | AMDPPP | BYRPPP | RUBPPP | KZTPPP |
|---|---|---|---|---|---|
| Minimum | 1.422223 | 0.166320 | 0.968620 | 0.013158 | 0.056441 |
| Std. Dev. | 25.79242 | 0.013744 | 1.706659 | 0.002642 | 0.013403 |
| Skewness | -0.272982 | 0.297624 | 0.449776 | 0.898845 | -0.061338 |
| Kurtosis | 2.317572 | 2.402371 | 1.633791 | 4.438962 | 1.541982 |
|  |  |  |  |  |  |
| Jarque-Bera | 0.986554 | 0.918996 | 3.456137 | 6.848801 | 2.765286 |
| Probability | 0.610622 | 0.631601 | 0.177627 | 0.032569 | 0.250915 |
|  |  |  |  |  |  |
| Sum | 1869.603 | 5.813602 | 80.51242 | 0.524855 | 2.296942 |
| Sum Sq. Dev. | 19957.47 | 0.005667 | 87.38050 | 0.000209 | 0.005389 |
|  |  |  |  |  |  |
| Observations | 31 | 31 | 31 | 31 | 31 |

**Table 6**

| Variable | Coefficient | Std. Error | t-Statistic | Prob. |
|---|---|---|---|---|
| ARMGDP | 0.057774 | 0.013764 | 4.197426 | 0.0010 |
| BELGDP | -0.010825 | 0.025417 | -0.425911 | 0.6771 |
| KAZGDP | 0.022328 | 0.010841 | 2.059663 | 0.0600 |
| RUSSIAGDP | 0.009597 | 0.011523 | 0.832849 | 0.4200 |
| AMDPPP | 215.4379 | 359.1903 | 0.599788 | 0.5590 |
| BYRPPP | -0.455984 | 4.035304 | -0.112999 | 0.9118 |
| KZTPPP | -0.801417 | 449.6403 | -0.001782 | 0.9986 |
| RUBPPP | 134.9786 | 1211.406 | 0.111423 | 0.9130 |
| BYRAMDVOL | -54.29286 | 40.68747 | -1.334388 | 0.2050 |
| KZTAMDVOL | 106.3640 | 141.2140 | 0.753211 | 0.4647 |
| RUBAMDVOL | 55.72374 | 28.18849 | 1.976826 | 0.0697 |
| SHOCKARM | -11.65435 | 8.402172 | -1.387064 | 0.1887 |
| SHOCKBEL | -4.410031 | 11.81644 | -0.373212 | 0.7150 |
| SHOCKKAZ | 59.03698 | 10.87507 | 5.428652 | 0.0001 |
| SHOCKRUS | -41.75110 | 19.39924 | -2.152202 | 0.0508 |
| UARM | -34.15037 | 15.93469 | -2.143146 | 0.0516 |
| URUS | -2.003234 | 7.345698 | -0.272708 | 0.7894 |
| C | -99.83092 | 71.74051 | -1.391556 | 0.1874 |
|  |  |  |  |  |
| R-squared | 0.963509 | Mean dependent var |  | 60.30979 |
| Adjusted R-squared | 0.915789 | S.D. dependent var |  | 25.79242 |

| Variable | Coefficient | Std. Error | t-Statistic | Prob. |
|---|---|---|---|---|
| S.E. of regression | 7.484733 | Akaike info criterion | | 7.155860 |
| Sum squared resid | 728.2760 | Schwarz criterion | | 7.988498 |
| Log likelihood | -92.91583 | Hannan-Quinn criter. | | 7.427279 |
| F-statistic | 20.19108 | Durbin-Watson stat | | 2.436108 |
| Prob(F-statistic) | 0.000001 | | | |

## Table 7

| Variable | Coefficient | Std. Error | t-Statistic | Prob. |
|---|---|---|---|---|
| UARM | -13.66280 | 12.19762 | -1.120120 | 0.2733 |
| SHOCKKAZ | 61.80057 | 13.57598 | 4.552198 | 0.0001 |
| SHOCKRUS | -49.94936 | 15.01622 | -3.326361 | 0.0027 |
| ARMGDP | 0.023439 | 0.011516 | 2.035307 | 0.0526 |
| RUSSIAGDP | 0.031285 | 0.004732 | 6.611268 | 0.0000 |
| C | -55.12127 | 11.68419 | -4.717594 | 0.0001 |

| | | | | |
|---|---|---|---|---|
| R-squared | 0.852526 | Mean dependent var | | 60.30979 |
| Adjusted R-squared | 0.823031 | S.D. dependent var | | 25.79242 |
| S.E. of regression | 10.85028 | Akaike info criterion | | 7.778244 |
| Sum squared resid | 2943.213 | Schwarz criterion | | 8.055790 |
| Log likelihood | -114.5628 | Hannan-Quinn criter. | | 7.868717 |
| F-statistic | 28.90423 | Durbin-Watson stat | | 1.373053 |
| Prob(F-statistic) | 0.000000 | | | |

## Table 8

| Variable | Coefficient | Std. Error | t-Statistic | Prob. |
|---|---|---|---|---|
| SHOCKRUS | -39.77057 | 10.72181 | -3.709316 | 0.0009 |
| SHOCKKAZ | 57.97643 | 8.912501 | 6.505068 | 0.0000 |
| RUSSIAGDP | 0.038468 | 0.003590 | 10.71587 | 0.0000 |
| C | -59.20462 | 11.11350 | -5.327268 | 0.0000 |

| | | | | |
|---|---|---|---|---|
| R-squared | 0.823974 | Mean dependent var | | 60.30979 |
| Adjusted R-squared | 0.804416 | S.D. dependent var | | 25.79242 |
| S.E. of regression | 11.40668 | Akaike info criterion | | 7.826189 |
| Sum squared resid | 3513.030 | Schwarz criterion | | 8.011219 |
| Log likelihood | -117.3059 | Hannan-Quinn criter. | | 7.886504 |
| F-statistic | 42.12887 | Durbin-Watson stat | | 1.565614 |
| Prob(F-statistic) | 0.000000 | | | |

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**Abbreviation**

- BYR – Belarusian ruble

- RUB – Russian ruble

- AMD – Armenia dram

- KZT – Kazakhstan tengeVol – volatility

- Armgdp, rusgdp,belgdp, kazgdp – GDP per capita of the countries

- Amdppp, rubppp, byrppp, kztppp –PPP conversion factors for this currencies Shock-arm, shockbel, shockkaz, shockrus - macroeconomic shocks in countries

- Uarm, urus, ubel, ukaz – membership in the Union

PAPER

# Variable Annuities: New Solution
# to Long-Term Investment Problem

## Ludovic Goudenège • Andrea Molent • Antonino Zanette

**Abstract**   In this article we provide an introduction to a class of insurance product called Variable Annuities and to pricing methods that can be used to evaluate them. These products have been present for a few years on the American, European and Asian markets, and continue to capture the attention of new investors. They could become the solution to retirement problems even in countries like China and India that, after the booming economy, will now face the social security problem of the new middle class.

## Introduction

In 2008 following the subprime crisis, financial markets have suffered the upheavals that have affected the entire world economy. Other events have recently rocked the financial markets: in 2015 the slowdown of Chinese growth and in 2016 the Brexit. Since the subprime crisis, these markets were extremely volatile: this situation persists and perhaps became the new standard. After many failures, the gap between the different interest rates applied to different transmitters has become larger and larger and a discussion on the identification of the risk-free rate is open. The ECB and the Fed's rates gradually declined, while the rate on sovereign debt increased gradually, and then dropped. For customers, it is difficult to balance risk and return. In this context, clients seek protection for their savings, and the ability to take advantage of the positive changes in the market. With regard to the social problematic, following the increase in life expectancy, standard annuities for retirement dropped. The mission of insurance companies is to answer the request for protection and compensation of their customers. The solution is to provide the customer an investment account and cover its value with guarantees.

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These products are called Variable Annuities. In the words of François Robinet, CEO of AXA Life Invest, "These products, unit of account guaranteed, will become a solution to solve the long-term investment problems with security, and prepare for retirement". Variable Annuities are insurance life contracts in account units with guaranteed revenues or capital. They were launched by AXA in the United States in 1995, and appeared in Italy in 2008. Variable Annuities are mainly diffused in USA, Japan, and North Europe; they are attractive products especially with the retirement reforms and the new sales may reach $22 billion by 2018, with a 57% increase from 2012 (Think Advisor, 2014). Variable Annuities are nevertheless exotic products with hidden options (the main one is the lapse option) and two kinds of risk: the market risk and the actuarial risk. Because of these characteristics, it is difficult to price these new kinds of optional products, and manage the ingrained risks.

This paper is organized as follows. In Section 1 we present an overview of Variable Annuities (definition, properties, guarantees and fees). In Section 2 we present some example of Variable Annuities sold in different countries (Europe, US, and Asia). In Section 3 we focus on Risk Management, and Pricing (risks associated with these products and pricing methods).

## 1. Variable Annuities: an overview

The term Variable Annuity is used to refer to a wide range of life insurance products, whose benefits can be protected against investment and mortality risks by selecting one or more guarantees out of a broad set of possible arrangements. Despite the unique characteristics can change, there are some common to all of them: a Variable Annuity is a long-term, tax-deferred investment, designed for obtaining a post-retirement income. Formally, a Variable Annuity is a contract between a policyholder and an insurance company, under which the insurer agrees to make periodic payments to the policyholder beginning either immediately or at some future date. The holder buys a Variable Annuity contract by making either a single purchase payment (lump sum) or a series of purchase payments (accumulation phase).

Variable Annuities were introduced in the 1970s in the United States and in the first years of 2000, they became popular in Europe (especially Germany, UK, and France) and known in other European countries such as Italy: see Bonafede (2008). In the late 1990's Variable Annuities were introduced by insurance companies in Asia and have been popular ever since: see Summit (2012).The cause of the success of these policies is that they offer a range of investment options. The value of the investment will change depending on the performance of the investment options chosen. The investment options for a Variable Annuity are typically mutual funds that invest in stocks, bonds, money market instruments, or some combination of the three.

Variable Annuities are designed to be long-term investments, to meet retirement and other long-range goals. Despite the ingrained guarantees, these products involve investment risks, just as mutual funds do. Although Variable Annuities are typically invested in mutual funds, they differ from mutual funds in several important ways. First, Variable Annuities may let the policyholder receive periodic payments for the rest of his life (or the life of any other person designated). This feature offers protection against the possibility that, after retirement, the policyholder will outlive his assets.

Second, Variable Annuities may have a death benefit. If the policyholder dies before the insurer has started making payments, the beneficiary is guaranteed to receive a specified amount - typically at least the amount of the purchase payments. The policy beneficiary will also get a benefit from this feature if, at the time of the death of the policyholder, his account value is less than the guaranteed amount.

Third, Variable Annuities are tax-deferred. That means the policyholder pays no taxes on the income and investment gains from his annuity until he withdraws his money. He may also transfer his money from one investment option to another within a Variable Annuity without paying tax at the time of the transfer. When the policyholder takes his money out of the Variable Annuity, however, he will be taxed on the earnings at ordinary income tax rates (for example, according to Italian Law, the financial return, equal to the difference between the amount paid and the premiums paid, shall be subject to the application of a substitute tax on income, at the time of payment of the benefit, according to what provided by the D.L. August 13, 2011 n. 138, converted into Law 148 of 14 September 2011). For more information, see the webpage (Formula Accumulation).

A Variable Annuity has usually two phases: an accumulation phase and a payout phase. During the accumulation phase, the policyholder makes purchase payments, which he can allocate to a number of investment options. For example, he could designate 40% of his purchase payments to a bond fund, 40% to a U.S. stock fund, and 20% to an international stock fund. The money he has allocated to each mutual fund investment option will increase or decrease over time, depending on the fund's performance. In addition, Variable Annuities often allow the policyholder to allocate part of his purchase payments to a fixed account. A fixed account, unlike a mutual fund, pays a fixed rate of interest. The insurance company may reset this interest rate periodically, but it will usually provide a guaranteed minimum (e.g., 1% per year). During the accumulation phase, the policyholder can typically transfer his money from one investment option to another without paying tax on his investment income and his accumulation phase, but in case of lapse, he may have to pay "surrender charges" to the insurance company, which are discussed below. At the beginning of the payout phase, the policyholder may receive his purchase payments plus investment income and gains (if any) as a lump-sum payment, or he may choose to receive them as a stream of payments at regular intervals (generally monthly). If he chooses to receive a stream of payments, he may have a number of choices of how long the payments will last. Under most annuity contracts, he can choose to have his annuity payments last for a period that he sets (such as 20 years) or for an indefinite period (such as his lifetime or the lifetime of him and his spouse or other beneficiary). During the payout phase, policyholder's annuity contract may permit him to choose between receiving payments that are fixed in amount or payments that vary based on the performance of the mutual fund investment options. The amount of each periodic payment will depend, in part, on the time period that the policyholder selects for receiving payments. Some annuities do not allow withdrawing money from the account once the policyholder has started receiving regular annuity payments. In addition, some annuity contracts are structured as immediate annuities, which means that there is no accumulation phase and the policyholder will start receiving annuity payments right after he purchases the annuity. Unlike the with-profit or participating business, reference funds backing Variable Annuities are not required to replicate the guarantees selected by the policyholder, as specific assets hedge these ones. Therefore, reference fund managers have more flexibility in catching investment opportunities. One of the peculiarities of Variable Annuity policies is not making use of traditional financial management, but using of hedging techniques - called the "dynamic hedging" - thanks to which the insurance company has no direct impact on the asset allocation funds. Through these programs, it is therefore always possible to rebalance its market position following the changes in benchmark indices which allow to counteract their liabilities, but without directly engaging the fund of the policy. Therefore, the guarantee is external to the fund and does not affect the asset allocation. For this reason, Variable Annuity products may be defined multidimensional guaranteed products as opposed to traditional unit-linked products that can be considered one-dimensional structures.

Guarantees of performance associated with unit-linked products of the first generation are normally made through the annexation of a guaranteed fund to the family of funds available for the product concerned. The financial guarantee (of performance, capital etc.) is then "included" in specific funds with assets specifically chosen to cope with the guarantee offered by the funds themselves.

Instead, the return guarantees associated with Variable Annuities are options associated to the contract: they are additional features that policies designer add to the contracts. At each fund (not guaranteed) and at each benefit is associated a cost: the total cost is theoretically equal, for each fund selected by each insurance position, to the sum of the cost of the fund and of the guarantees associated with it. Variable Annuities typically offer a greater growth potential and greater risk than a fixed annuity. That is because, with a Variable Annuity, holders are able to select from a variety of professionally managed investment options, which may contain stock and/or bond portfolios. The account value is directly exposed to market variations, but the policy value is protected by guarantees.

### *The Death Benefit and other features*

A common feature of Variable Annuities is the death benefit. If the policyholder dies, a person he selects as a beneficiary (such as his spouse or child) will receive the greater of: all the money in the policyholder account, or some guaranteed minimum (such as all purchase payments minus prior withdrawals). This second case is known as GMDB (Guaranteed Minimum Death Benefit). Some Variable Annuities allow the policyholder to choose a "stepped-up" death benefit. Under this feature, the guaranteed minimum death benefit may be based on a greater amount than purchase payments minus withdrawals. For example, the guaranteed minimum might be the account value at a specified date, which may be greater than purchase payments minus withdrawals if the underlying investment options have performed well. The purpose of a stepped-up death benefit is to "lock in" the investment performance and to prevent a later decline in the value of the account from eroding the amount that the holder expects to leave to his heirs. This feature carries a charge, however, which will reduce the account value.

Variable Annuities sometimes offer other optional features, which also have extra charges. The policyholder pays for each benefit provided by his Variable Annuity. These charges are usually independent and tied to the relative benefit. The following are the most common optional features. For more details, see Bacinello, Millossovich, Olivieri, and Pitacco (2011).

- GMAB (Guaranteed Minimum Accumulation Benefit): this feature provides to guarantee the minimum amount received by the annuitant after the accumulation period, protecting the value of the annuity and the annuitant from market fluctuations. The GMAB will be used only if the market value of the annuity is below the minimum guaranteed value.
- GMIB (Guaranteed Minimum Income Benefit): a common feature that guarantees a particular minimum level of annuity payments, even if the policyholder does not have enough money in his account (perhaps because of investment losses) to support that level of payments. When the annuity has been annuitized (start the paying of the annuities), this specific option guarantees that the annuitant will receive a minimum value's worth of payments.
- GMWB (Guaranteed Minimum Withdrawal Benefit): this specific option gives annuitants the ability to protect their retirement investments against downside market risk by allowing the annuitant the right to withdraw a maximum percentage of their entire investment each year until the initial investment amount has been recouped. The GMWB is the real novelty of Variable Annuities in respect of traditional life insurance contracts.

These three options are also called GMxBs guarantees (namely, Guaranteed Minimum Benefits of type 'x'). Another Variable Annuity adds to the previous three:

- GLWB (Guaranteed Lifelong Withdrawal Benefit): this option is similar to GMWB, but this policy has no fixed maturity. The annuitants has the right to perform periodic withdrawals, with a minimal guaranteed withdrawal, for all his life. A priori, there are no limits on guaranteed withdrawals, and on the total guaranteed withdrawal. Usually, a death benefit is always included.

These contracts may include other features such as long-term care insurance (LTC), which pays for home health care or nursing home care if the policyholder becomes seriously ill. The most common forms of guarantees associated with the growth of the benefit base are roll-ups: this is the simplest form of return guarantee. A roll-up provides guaranteed appreciation of the benefits base at a specific interest rate. The guarantee may accrue on a simple or compound interest basis. A 0% roll-up is the same as a return-of-principal guarantee.

Some products include ratchets, also called a "high watermark." With a ratchet, the benefits base is set equal to the highest of all values of the underlying funds throughout the accumulation phase, evaluated at a pre-defined time interval (e.g. annually). At various frequencies the existing benefits base is compared to the account value, and if the account value is higher, the benefits base is "ratcheted" up to the new level.

Another feature that may be included in some products are resets: resets are triggered at the discretion of the policyholder. They involve a comparison of the current account value to the original account value, and the benefits base is reset to the higher level. Other policy provisions such as a waiting period may be reset as well. Finally, some Variable Annuities offer guaranteed appreciation of the benefits base that combines one or more of the above forms of guarantees. For example, a common combination guarantee is the maximum of a roll-up and a ratchet.

For example: a man owns a Variable Annuity that offers a death benefit equal to the greater of account value or total purchase payments minus withdrawals. He has made purchase payments totaling 100000 €. In addition, he has withdrawn 10000 € from his account. Because of these withdrawals and investment losses, his account value is currently 80000 €. If he dies, his designated beneficiary will receive 90000 € (the 100000 € in purchase payments he put in, minus 10000 € in withdrawals).

## *Charges and other costs*

Variable Annuities include many charges that the policyholder has to pay. The insurance company withdraws most of them from the holder account.  Some of these charges are used to hedge the policy guarantees, while other are used to cover administrative expenses. These charges will reduce the value of the account and the return on policyholder investment. The insurance company uses the guarantee charges to cover the guarantees of the policy. They are a fixed percentage of the account value, and are usually withdrawn continuously. These charges are active for the whole product life and are fixed at the beginning in the contract; finding the fair value of these fees, consists in pricing the product.

For example, the guarantee charges of a Variable Annuity are 2%. If the initial account value is 10000 €, and the linked found increases of 5%, then the final value of the account value is .

Usually, the policyholder can withdraw money from his policy within certain limits; usually this upper bound is a maximum sum of money per period. The contract may provide this upper limit to be exceeded by the holder. In this case, he will have to pay a penalty for the overdraft. The policyholder may also decide to withdraw the maximum possible and terminate the contract. In this case, he takes the value of the account reduced by a given percentage in addition to fixed

administrative costs for an anticipated recession. These expenses for contract termination are called surrender charges. These charges are partially used to pay a commission to his financial professional for selling the Variable Annuity. Generally, the surrender charges consist for the most in a percentage of the amount withdrawn, and declines gradually over a period of several years, known as the surrender period. For example, a 7% charge might apply in the first year after a purchase payment, 6% in the second year, 5% in the third year, and so on until the eighth year, when the surrender charge no longer applies. For example, let us suppose that a man purchases a Variable Annuity contract with a 10000 € purchase payment. The contract has a schedule of surrender charges, beginning with a 7% charge in the first year, and declining by 1% each year. In addition, the contract allows the policyholder to withdraw 10% of his contract value each year free of surrender charges. In the first year, he decides to withdraw 5000 €, or one-half of his contract value of 10000 € (assuming that his contract value has not increased or decreased because of investment performance). In this case, he could withdraw 1000 € (10% of contract value) free of surrender charges, but he would pay surrender charge of 7%, or 280 €, on the other 4000 € withdrawn.

Mortality and expense risk charge are equal to a certain percentage of the account value, typically in the range of 1.25% per year. This charge compensates the insurance company for insurance risks it assumes under the annuity contract. The profit from the mortality and expense risk charge is sometimes used to pay the insurer's costs of selling the Variable Annuity, such as a commission paid to the financial professional for selling the Variable Annuity. For example, a Variable Annuity has a mortality and expense risk charge at an annual rate of 1.25% of account value. The average account value during the year is 20000 € so the policyholder will pay 250 € in mortality and expense risk charges that year. The insurer may deduct charges to cover record-keeping and other administrative expenses. This may be charged as a flat account maintenance fee (perhaps 25 € or 30 € per year) or as a percentage of his account value (typically in the range of 0.15% per year).

Finally, special features offered by some Variable Annuities, such as a stepped-up death benefit, a guaranteed minimum income benefit, or long-term care insurance, often carry additional fees and charges. Other charges, such as initial sales loads, or fees for transferring part of the account from one investment option to another, may also apply.

### Bonus credits

Some insurance companies offer Variable Annuity contracts with "bonus credit" features. These contracts promise to add a bonus to the contract value based on a specified percentage (typically ranging from 1% to 5%) of purchase payments. Variable Annuities with bonus credits may carry a downside; higher expenses can outweigh the benefit of the bonus credit offered. Frequently, insurers will charge the policyholder for bonus credits in one or more ways. Surrender charges may be higher for a Variable Annuity that pays a bonus credit than for a similar contract with no bonus credit; the policyholder purchases payments may be subject to surrender charges for a longer period than they would be under a similar contract with no bonus credit; higher annual mortality and expense risk charges may be deducted for a Variable Annuity that pays the holder a bonus credit. Although the difference may seem small, over time it can add up. In addition, some contracts may impose a separate fee specifically to pay for the bonus credit.

## 2. Examples from the international market

In this section, we present some real examples of Variable Annuities sold in different countries. The sophistication degree of these products is directly dependent from risk appetite and knowledge of financial markets of the country inhabitants.

### European market

Variable Annuities are available in the many European countries and here we present some examples. For more information about Variable Annuities in Europe, see the webpage (Borsa Italiana). The percentage data refers to insurance products sold in Italy, and they may be different for other European countries. Many insurance companies compete on the Variable Annuity market. For example, we talk about AXA, with the product of the Accumulator line, Assicurazioni Generali, with Generali Premium and Allianz with "Allianz Invest4Life".

The selection Accumulator by AXA offers GMAB products; for more details, see the webpage (La nostra offerta). For example, the Variable Annuity Accumulator Investimento offers a minimum return of 15.00% in 10 years in return for payment of an initial prize fund of at least 2500 €. If the policyholder keeps the investment after the expiry of the contract, it turns into a traditional unit-linked (so, by that date, there is no guarantee of capital) in the event of early redemption in the first four years instead the policyholder pays a penalty of 1.00%. The Variable Annuity "Accumulator Reddito" is instead a long-life product with accumulation guarantees. After at least five years from the effective date, the insurance policy provides, at the request of the policyholder and as long as he is alive, the chance to get a Performance Scheduled annual Guaranteed (PSG), which occurs through partial redemptions for a period of 20 years, equal to 5.00% of the greater of the premium paid capitalized at 2.50% compound annual rate of return for the first 5 years of the contract, and the value of the holder account upon receipt of the delivery request. A death benefit is included. The total fees paid by the policyholder is equal to 1.00%.

Generali Premium consists of a scheduled program of recurring single premiums, by installments (minimum 150 €), of the annual minimum of 1200 €; see the webpage (Generali Premium). It is possible to exercise the right of redemption if at least the top three premium annuities have been paid and the insured is alive. This product provides at the end of the accumulation phase (minimum 10, maximum 20 years) a 0.00% minimum guaranteed return. Generali Premium is characterized by the possibility of diversify the investment in more segregated funds and more internal funds; alternatively, the possibility to sign a savings plan linked to a segregated fund expressed in US dollars. The contract also includes a bonus at maturity. There is also coverage in the event of accidental death, doubling in case of road accident death (A.C.M.A -I.S.); the level of risk varies according to the investment allocation between the various segregated funds and any internal funds. A death benefit is included. This Variable Annuity offers a GMAB optional feature as AXA one.

Another product is Allianz Invest4Life by Allianz. It is a GLWB Variable Annuity type single-premium product, reserved for those who have already turned 45. The advantages of this product combine the opportunity to invest in the financial markets and the guaranteed minimum annuity. The contract provides for the payment of a minimum lump sum amount of 25000 €. Additional payments are not permitted. The disbursement of the annuity can be immediate or deferred, up to a maximum of 10 years. At the end of the accumulation period, the policyholder can choose the withdrawal frequency: monthly or yearly. This amount is determined by multiplying the premium paid by policyholder for conversion factor reported in the proposal form, which depends on the age of the insured at the time of subscription, and the period of deferment selected from policyholder: see Table 1 for an example of these coefficients. In addition to the annuity, the product offers insurance coverage in case of death insured. The contract provides for the coverage of commercial costs, a loading cost equal to 3.00% of the initial premium, a cost of hedging the guarantees amounting to 1.20% pa and an administration fee of 0.45% per annum. The contract does not include any cost of insurance coverage in case of death.

**Table 1 The conversion factors for annual annuities of "Allianz Invest4Life" Variable Annuity**

| Age of the Policyholder | Duration of the deferral period | | |
|---|---|---|---|
| | 0 years | 5 years | 10 years |
| 45 | n.a. | 2.41% | 2.77% |
| 50 | 2.31% | 2.66% | 3.11% |
| 55 | 2.54% | 2.97% | 3.54% |
| 60 | 2.83% | 3.37% | 4.13% |
| 65 | 3.19% | 3.91% | 4.96% |
| 70 | 3.65% | 4.63% | n.a. |
| 75 | 4.20% | n.a. | n.a. |

The acronym "n.a." means "not available".".

## American Market

The United States is the country where the first Variable Annuities were designed and sold. The insurance companies that sell these products are many, and the products that are sold have features among the most varied.

As an example, we present FlexChoice Level by Metlife: see (Metlife FlexChoice). It is a GLWB contract where payments are different if the account value is positive or null. The contract includes a 5% roll up feature for the first 10 years, and an annual ratchet (Automatic Step-Up) that may increase the base benefit, as well as additional purchase payments. The annual charge is 1.20% per year, but may be increased up to 2.00% in case of an Automatic Step-Up. The product includes a death benefit guarantee and this guarantee costs each year 0.65% of the death benefit base. The policyholder must allocate the 80% of the account value in some funds stated by the contract (Protected Growth Strategy Portfolios) and the remaining 20% to one or more of the available more aggressive funds (Asset Allocation Portfolios). FlexChoice Level provides the policyholder with a level amount of guaranteed payments for his lifetime (Single Lifetime option) or for the life of the policyholder and his (her) consort (Joint Lifetime option). The guaranteed withdrawals are calculated as the product of the Base Benefit and of the Withdrawal Rate. Withdrawal Rate are shown in Table 2.

**Table 2: The withdrawal rates for FlexChoice Level by Metlife**

| | Before AV reduces to zero | After AV reduces to zero | |
|---|---|---|---|
| Age at 1st withdrawal | Withdrawal Rate (% of Benefit Base) | Single Lifetime Guarantee Rate | Joint Lifetime Guarantee Rate |
| 59 ½ to less than 65 | 4.00% | 4.00% | 3.00% |
| 65 to less than 70 | 5.00% | 5.00% | 4.00% |
| 70 to less than 80 | 5.25% | 5.25% | 4.25% |
| 80 + | 5.75% | 5.75% | 4.75% |

## Asian market

According to Insurance News Net's "After financial crisis, Asia emerges as Variable Annuity growth area"; see Summit (2012). There is still a lot of potential for Variable Annuities growth in Asia even as the American Markets are increasing again after subprime crisis. In 2012, Rebecca

Ng of A.M. Best Company wrote an article about the potential for Variable Annuities growth in Asia and said that China looks to be the top spot for this growth; see Ng (2012). The rapid growth of the Japanese Variable Annuity market has begun after the Japanese financial deregulation from 1998 to 2001, which consisted of a series of measures to make it theoretically possible for Japanese, foreign institutions alike to perform banking, insurance, stock brokering, and investment services in yen or any other currency. The Variable Annuity product concept was unique, compared to the dominant traditional life products in the Japanese insurance market at that time, and has gained the interest of many investors. An emblematic example of Variable Annuity is the Yen Variable Annuity++ sold by AXA in the Japanese market.

**Figure 1  An example of the development of a Variable Annuity contract (YENVA++)**
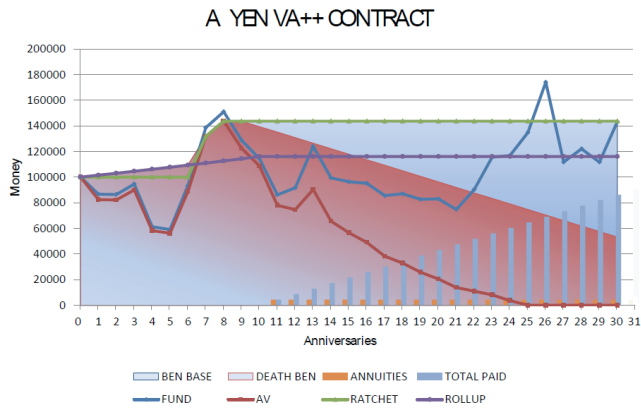


It is a Variable Annuity with GMIB and GMDB, with both roll-up (up to 10 times) and yearly ratchet. There exist two versions of this product: a 25 years TC (time certain) and a whole life (WL). The premium is paid as a unique solution (single premium), and invested in an investment fund. The policyholder can lapse anytime with no surrender charges. The ratchets take place yearly, every anniversary date throughout the contract. Let  be the value of the account linked to the fund. The initial income benefit of the ratchet is equal to the initial gross premium, and each year during the deferral period, it is updated as the max of the previous ratchet benefit and the actual account value. For the annuity payment period the ratchet, benefit is updated in two different ways for the two product types. For the TC product we continue to use define it as in the deferral period, while for the WL product we have

$$IB\_ratchet_t = \begin{cases} \max(IB\_ratchet_{t-1}, AV_t + \sum_{s<t} Payout_s, & \text{if } AV_t > 0 \\ IB\_ratchet_{t-1}, & \text{if } AV_t = 0 \end{cases}$$

The roll up benefit is calculated each year at the contract anniversaries, up to 10 years and only during the deferral period. The roll up rate is equal to 1.5% for the TC, and 2.5% for the WL. The initial roll up benefit is equal to the initial gross premium, and at each anniversary, the roll-up benefit is increased by a fixed roll-up rate. The GMIB is calculated as the max between the ratchet benefit and the roll-up benefit. At each anniversary, if the policyholder is still alive, he receives a sum equal to the product of the income benefit and a contract fixed ratio (for products sold in 2015, the factor is worth 3%  for the WL, and the inverse of the number of payout phase years for the TC). The policyholder can chose the last of the deferral period at the beginning of the contract with some duration limits.

The death benefit is calculated as

$$DB_t = \max(AV_t, IB_t - \sum_{s<t} Payout_s)$$

There are several charges: at the entry, a 5% is calculated on the single premium paid. Everyday throughout the contract life, mortality, expense, and fund management charges are calculated as a percentage of the AV, and withdrawn. Figure 1 shows an example of the development of a YEN Variable Annuity++ WL contract.

   Manulife (Singapore) introduced in 2007 *Secure Retirement Plus*, the first variable annuity product in Singapore; see the webpage (Retirement-insurance). Addressed specially to the territory's post-war "baby boomer" generation, Manulife Secure Retirement Plus offers a guaranteed withdrawal benefit that provides a regular stream of retirement income for at least 20 years (GMWB) or income for life (GLWB) from age 65, regardless of market performance. Unlike other annuity products, the GWB has growth potential through the Company's Loyalty Bonus and Step-Up mechanism. At a glance, Secure Retirement Plus provides an annual guaranteed withdrawal amount equal to 5% of the subscription for minimum of 20 years. The guaranteed retirement income is secure and will never go down, even in a declining market. A GMAB option may also be included: a 50% guaranteed Loyalty Bonus that upsizes the Guaranteed Withdrawal Benefit to 150 per cent of the initial investment if withdrawals are deferred in the first 10 years. An automatic step-up opportunity to lock in investment gains to the Guaranteed Withdrawal Benefit on every 5th policy anniversary up to age 80 is included. This could further enhance the stream of retirement income. Beginning at age 65, the policyholder can elect to make withdrawals that are guaranteed for the rest of life (GLWB). Investors have the flexibility to access their account value at any time or make switches from one portfolio fund to another. Finally, this product has a guaranteed death benefit: the heirs can chose between receiving the account value or the remaining regular withdrawals.

   The Chinese insurance market is rapidly developing, and the various insurance companies struggle to get more land. For example, according to Thevenin (2015), AXA is accelerating in China to reach 100 million customers in Asia by 2030, and also the rival companies such as ICBC and Tian Ping show strong growth.

   In June 2011, AXA-Minmetals and Sino-US United Metlife launched their first Variable Annuities on Chinese market; see Huang (2012). Both the two contracts provide for a single initial payment and include a GMAB. The maturity is respectively 7 and 10 years. The Guarantee Charges are around 1.5% of the Account Value per year for both the products. Surrender charges decrease and vanish after 6 or 4 years. The main difference between AXA and Metlife products is the way the insurance companies manage the guarantees: AXA declares to use internal synthetic hedging, while Metlife a simpler CPPI strategy.

## 3. Variable annuities Risk Management and Pricing

There are generally three buckets of risk that exist with almost all life insurance products, Variable Annuities included. These are insurance risk, market risk, behavioral or utilization risk. For Variable Annuities specifically, longevity risk is the primary insurance risk due to the nature of the income guarantees that are offered; some mortality risk exists due to the nature of the death benefit guarantees that are offered. Equity risk and interest rate risk are the primary market risks due to the underlying equity and fixed-income investments that drive the policyholder's account value performance and the long-term nature of the income guarantees. In addition, some credit risk are also present in the fixed-income investments. Persistence risk and benefit utilization risk are the primary behavioral or utilization risks due to the nature of the product structure

that generally has the insurer receiving revenue over time and insurance claims being paid well into the future. Insurers use a number of lines of defense to manage the above buckets of risks. First, they have to design products adopting prudence measures and assumptions. Financial risks are reduced by dynamic hedging that is usually performed daily by the Hedging team of the insurance company. Risk Management team has to evaluate the tightness of the system in the presence of shocks. Tests are conduced regularly, for both the interest of the insurance company and the fulfillment of international norms. Those tests include stress scenario analysis for single and combined shocks and the verification of appropriate provision and management of economic risk capital. Finally, risk pooling ("law of large numbers"), asset liability management (ALM) and reinsurance help in reducing the risks. These lines of defense are employed to varying degrees in an insurer's risk management strategy, depending on the nature of the risk and the availability and effectiveness of each method. Not all of the lines of defense listed are used with all risks or types of insurance. For instance, reinsurance is generally not used as a primary risk management strategy due to the current limited availability of reinsurance for Variable Annuities guaranteed benefits.

To regulate the management of risks associated with the Variable Annuities, EIOPA decided to create in 2010 a working group dedicated to variable annuities, with the aim of promoting a process of legislative harmonization among the countries of the European Economic Area already during transition from Solvency 2 to Solvency 3. The report published by the European Surveillance in 2011, stressed the importance of drawing a defining perimeter of Variable Annuity policies. In fact, those contracts are not expressly prescribed, and have been approached in a more or less coherent, homogeneous and detailed in the various Member States. Moreover, thanks to their extreme flexibility, they are present on the market through different combinations of possible guarantees. EIOPA insists on a clear and safe definition, by companies, of appropriate financial strategy to the reality of the company, with particular reference to risk appetite. In the chapter devoted to the actuarial profiles, the EIOPA's recommendations therefore focus on the periodic rebalancing modes of the risk margin. For example, they recommend using simulations and calculations of prospective values of the guarantees and of the underlying assets, but also on the frequency with which to update this evaluation and thus the hedging portfolio as a function of market movements. The particulars provided in the document refer to the hedging programs to be adopted, the calculation methods to be used for technical provisions and to further requirements and controls to be carried out in the course of management.

Among the different phases of the risk management process, the pricing and hedging of guarantees, i.e. of the relevant financial options, should be a major concern for the insurer when designing the contract. Appropriate evaluation techniques need to be developed in order to account on one hand for the interaction between financial and mortality/longevity issues, on the other for the policyholder behavior. Before the 2008 financial crisis, insurers were offering annuities that while generally seen as expensive, offered rich benefits. Some provided lifetime incomes that rose by 6 percent to 7 percent per year, no matter what happened with the underlying investments. The underestimation pricing error came out after the financial crisis and insurance companies offered buybacks to investors.

In recent years, Variable Annuities have attracted the attention of the academic world and the world of finance. Some authors have ventured in the difficult task of developing efficient methods for pricing these products. The article of Bacinello, Millossovich, Olivieri, and Pitacco, (2011) is a point of reference in this field: in this paper they classified main GMxBs Variable Annuities, and they computed and compared contract values and fair fee rates under "static" and "mixed" valuation approaches, via ordinary and least squares Monte Carlo methods, respectively.

Forsyth and Vetzal (2014) performed respectively pricing of GLWB and GMWB Variable Annuities in Black and Scholes framework via PDE methods. They considered both "static" and "dynamic withdrawals", pricing different versions of the products.

Another research article is that of Yang and Dai (2013) that used a tree based model to price GMWB in Black and Scholes model. They considered both "static withdrawal" and "optimal surrender".

In a recent research paper of Bacinello, Millossovich, and Montealegre (2016), the authors present in a dynamic programming algorithm for pricing variable annuities with Guaranteed Minimum Withdrawal Benefits (GMWB) under a general Lévy processes framework.

We would also cite the interesting research work of Donnelly, Jaimungal, and Rubisov (2014): the authors consider pricing and Greeks calculation through and Alternating Direction Implicit (ADI) method in the advanced Heston-Hull-White model for a simple static GWMB product (the policyholder cannot chose how much withdraw). They consider a complete stochastic model (stochastic volatility and stochastic interest rate), but they do not consider dynamic withdrawals as real products do.

Finally, Costabile (2015)  considers a trinomial tree method for evaluating GMWBs under a regime-witching model.

In two recent research papers Goudenège, Molent, and Zanette (2016) and (Working paper) the authors developed four numerical methods to evaluate GLWB and GMWB policies considering stochastic interest rates (Hull-White model) or stochastic volatility (Heston model). We present here some notes about the most important pricing methods. The pricing methods that are used in those papers are four: two Monte Carlo methods and two PDE methods. Two of these methods are "Hybrid" as they combine trees and Monte Carlo simulations or trees and PDE. Before presenting a summary of these four methods, it is worth spending a few words on the trees used.

Given the long maturity of the products studied, the classic trees presented in Nelson and Ramaswamy (1990) or Appolloni, Caramellino and Zanette (2014) are not suitable to discretize the stochastic volatility and the stochastic interest rate. The authors therefore introduced new quadrinomial trees to implement hybrid methods. They built these trees with the aim to combine exactly the first three moments of the associated processes.

Briani, Caramellino and Zanette (2015) introduced the Hybrid Monte Carlo method. The method involves the use of a tree to define a Markov chain for the volatility (respectively the interest rate): using a discrete variable distributed according to the transition probabilities of the Markov chain, a discrete process $\bar{\upsilon}$ (respectively $\bar{r}$ ) is defined in order to approximate the volatility (respectively the interest rate). The process moves from the root through the tree, describing the scenario for the volatility or the interest rate. The values of the underlying at each time step can be obtained using a simple Euler scheme.

The Standard Monte Carlo method that is used by the authors is defined using the best methods to generate scenarios in the two models considered. In the case of the Heston model, the reference method is a third order scheme by Alfonsi (2010). For the Black-Scholes Hull-White model, the authors have made reference to an exact discretization scheme presented in Ostrovski (2013).

Briani, Caramellino and Zanette (2015) and (2016) presented the Hybrid PDE method. The method uses a tree to define a Markov chain for the volatility (the interest rate). Then, a one variable partial derivative equation (in addition to the time variable) is solved at the tree nodes. To solve the problem of the correlation between the volatility (or the interest rate) and the underlying, an initial transformation is required. For the Heston model it is useful to set, $Y_t^E = \ln(S_t) - \frac{\rho}{\omega} v_t$, where $S_t$ is the value of the underlying fund and  $\upsilon_t$ its volatility. The $Y^E$

process can be used easily because it is not correlated with the process $\upsilon$. Freezing the value of $\upsilon$ at each node, it can be used to define a partial derivative equation (PDE) that is going to be solved by the tree. Similarly, for the Black-Scholes Hull-White we define $Y^U_T = \ln(S_t) - \rho\sigma X_t$ where $X_t$ is a process associated to the interest rate $r_t$. The $Y^U_T$ process can be used easily because it is not correlated with the process $X_r$ (and therefore with ). Freezing the value of $X_t$ (and $r_t$) at each node, it can be used to define a PDE that is going to be solved by the tree. Hybrid PDE method has proved to be very powerful. It features greater simplicity of coding, stability of results and good speed of convergence.

The ADI method is a method introduced in the 1950s by Peaceman and Rachford (1955) to solve parabolic PDEs. Since then, the method has been used in many sectors. It can be proved that, in the Heston model, the value of an option satisfies a partial derivative equation (PDE) that can be solved using an alternative direction method (ADI).

Such multidimensional equations can be solved using the composition of two schemes that discretize the pair $(S,\upsilon)$ (respectively $(S,r)$) implicitly w.r.t a variable and explicitly to the other. In particular, for Variable Annuities evaluation, the authors used the Douglas scheme with $\theta = \frac{1}{2}$.

The most difficult factor to consider when pricing a Variable Annuity is to determine the optimal withdrawal that the policyholder will choose to perform. In fact, taking the maximum guaranteed amount is not always the best choice: sometimes is more convenient to avoid the withdrawal, and sometimes to terminate the contract (total lapse). This is an optimal control problem. When using Monte Carlo pricing techniques this problem can be faced proceeding backward and applying Longstaff-Schwartz (2001) method. PDE methods naturally proceed backward and the choice of the optimal withdrawal can be faced simply comparing the value of the remaining assets after a given withdrawal. Figure 2 shows an example of this, where the optimal withdrawals for a GLWB Variable Annuity are given.

**Figure 2 Optimal strategy of withdrawal for a 66 years old GLWB holder at the first event time t=1**
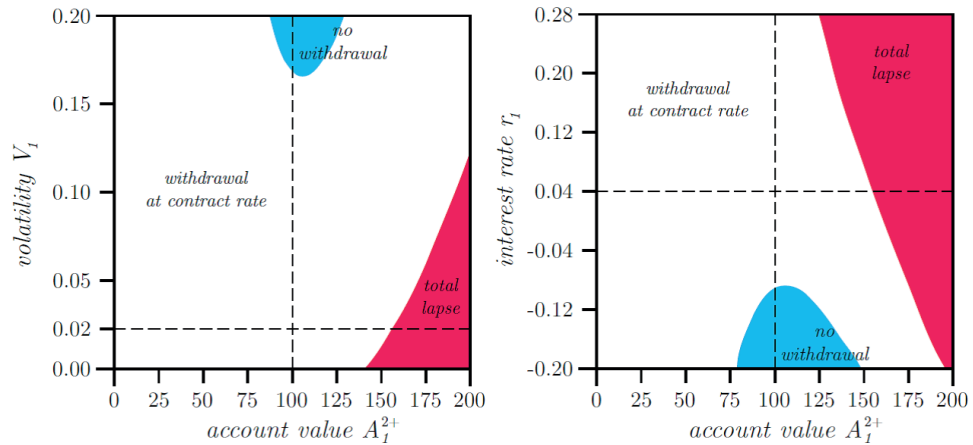


All the four numerical methods have been implemented and used to calculate the fair value of the parameter $\alpha_{tot}$, that express the amount of fees withdrawn by the insurance company from the holder's account. The various numerical tests focused on different variations of both products and they have been done fixing the computational time for all methods: working with a fixed time, it was possible to compare the quality of the results obtained by the different methods.
For both policies GLWB and GMWB, in the static case, the results were very good with all methods: the values obtained are consistent and they differ from each other in small relative

differences. Things have been rather different in the dynamic case. Monte Carlo methods have suffered from the problem of least squares regression: the difficulty of approximating accurately the value function  in multiple dimensions has meant that the values obtained by Monte Carlo methods were lower than those obtained with the PDE methods (the withdrawal strategy deducted by the Monte Carlo methods is not fully optimal). These latter, however, proved to be more stable and efficient to address problems of optimal withdrawal. In particular, the Hybrid PDE method provided, in general, the best results.

## Conclusion

In this paper, we provided an overlook about Variable Annuities: these interesting insurance products are available to customers of the most financially developed countries and in the last years, they began to be diffused also in new markets, such as China and India. For many investors they represent a valid solution for the retirement problems and it may be same for the new eastern middle class.

We presented some examples from the international markets: the assortment of these products and the different additional features offer to customers a broad range of possible choices attracting their attention.

We also outlined the pricing and hedging principles for these products. These products often have long maturity and researchers continue to work to find effective methods to evaluate these contracts.

This area of research involves problems of different nature: mathematical, probabilistic, numerical, financial, actuarial, stochastic control, social in addition to regulatory issues.

It seems clear that Variable Annuities represent for the coming years an area of research and development, theoretical and applicative.

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PAPER

# Japan's Foreign Policy Towards the South Caucasus States Policy of 'Low-Relevance and High Purpose' on the Crossroad Between Russian and Western Interests

## David Goginashvili

**Abstract**    The paper discusses motives, decisive factors and limits of Japan's decision-making process concerning its policy towards Armenia, Azerbaijan and Georgia – three South Caucasian states with drastically diverse foreign policy agenda. Academic analysis of Japan's policy towards the South Caucasus (SC) region is dramatically underdeveloped. Geographical remoteness is the main pitfall, preventing researchers from deeper scrutiny of the subject. However, Conceptualizing Tokyo's engagement in the SC gives valuable insight on Japan's positioning in the region, where Russia's Geopolitical interests encounter the West's increasing presence, which laid basement for reemergence of a so-called New Cold War international dimension. Japan's relations with these actors directly influence on its SC policy, circumscribing Tokyo's decision-making limits. Tokyo elaborated policy design with limited political element, both on bilateral and multilateral level, mainly based on depoliticized Official Development Assistance. We conceptualized Tokyo's strategy as a policy of low relevance and high purpose, whereas Japan is endeavored to uphold its high political, economic and humanitarian objectives, by retaining low posture amid geopolitical confrontation over the region, following the principle of ownership, and thus maintaining low risk exposure to its regional and wider multilateral interests. The paper introduces comparative case study of Japan's policy to the SC states and examines merits and disadvantages of such approach.

**Keywords**   Japan - South Caucasus - Foreign policy - Geopolitics - Foreign aid

**JEL Classification**  F50

## Introduction

Japan's foreign policy faced a range of new challenges along with the dissolution of the Soviet Union and following emergence of a new political map in 1991. Long established inflexible bureaucratic system of Japanese governmental bodies had to elaborate cutting-edge policy towards the newly emerged states with consideration of their individual external and internal agendas. The first step was the recognition of independence and subsequent establishment of diplomatic relations with the newly independent states. Armenia, Azerbaijan and Georgia – three former Soviet republics of the South Caucasus (SC) region sought to find their place in the post-Cold War international system, hence partnership with such economic power

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as Japan was a priority goal for their diplomacy, notably, given the economic and political turmoil the region had to experience since the end of 1980s and through the 1990s, when the region encountered such challenges as ethnic conflicts, interstate wars, civil war, corrupt state bureaucracy, excessively high crime rate, financial crisis, etc.

Given these conditions, international diplomatic support, as well as financial aid towards the SC played a significant role in maintaining the states relatively functional. Immediately after the restoration of independence, all three republics became direct beneficiaries of Japan's Official Development Assistance (ODA)[1]. Increasing involvement of such powerful donor, as Japan, was an important move for the region, notably since the late 90s, when Tokyo considerably boosted its aid disbursement in the SC and placed itself among the leading donor states for the region.

From the beginning of the 1990s till 2013 allocation of Japan's ODA per capita in the SC exceeded 87 US$, which outstrips even such traditional beneficiary regions, as ASEAN.[2] In 2002, Azerbaijan became one of the top 10 recipient countries of Japan's bilateral official development assistance. In 2009 Armenia accounted number 8 among the largest yen loan recipient countries. However, despite the promising potential of Japanese involvement in the SC, its actual political and economic presence has been rather limited. Explaining Japan's unexplored potential in the region, specialists often limit the argument to geographical remoteness and disregard the complexity of international political conjuncture as one of the impeding factors. Due academic scrutiny has to be addressed to Japans decision-making in regards to collision of Russian and Western interests in the SC region, given the condition, where Japan's international stance is largely determined by the alliance with the West and at the same time it bears the burden of territorial disputes with Russia.

Russia's critical involvement in the Black Sea region, namely Russo-Georgian war and expansion in Ukraine resonated on a global scale, bringing cold war rhetoric back to the contemporary international political language. Being one of the worlds leading economies and having an ambitious foreign agenda, Japan is aptly expected to take a clear stance in the allegedly reemerging Cold War international dimension. Nevertheless the question over some dissonant ambiguity of Japanese international positioning is often raised amid media establishments, political commentators or think tanks. Tokyo's foreign policy has long been discussed in the scope of Japan's alliance with the United States. Due academic discourse has been addressed to Japan-Russian relations as well. However, qualitative research over Japan's foreign policy in the region where Russia's vital interests encounter Western increasing involvement is still underdeveloped. Closer study of Japan's foreign policy towards the SC provides a remarkable case for understanding Tokyo's search for its position in Russo-Western rivalry, since, within the same region each of the three countries pursue drastically diverse foreign policy. Georgia has set precise goals to integrate in Euro-Atlantic institutions, while Armenia positions itself as a strategic ally of Russia. Unlike the two Azerbaijan maintains more-less balanced foreign policy, making no major moves towards any of the vying powers. Overall task of this paper is to clarify differences and similarities between Japan's policies towards each of the three republics, as well as to analyze the correlation between Japan's approach to Russia, the West (notably the USA) and the SC states. Do US-Russia-Japan relations influence Japan's relations with the

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1 In fact, Russian Federation is the only former Soviet State, which did not receive Japan's ODA, although, Japan has provided aid from the non-ODA funds to Russia as well.

2 For example; within the same period, aid disbursement in the Central Asia, which has been considered as the region of Japan's main interest in the post Soviet space, equals only to 43.7 US$, amount of aid to former Yugoslavian states equals to 41.2 US$ per capita, at the same time, Japan's aid disbursement in the ASEAN countries, which have traditionally been foreseen as the main target of Japanese ODA, equals to 81 US$. Based on the official data by Japan's ministry of foreign affairs and World Bank.

SC countries? What purpose(s) does Japan's foreign policy pursue in Armenia, Azerbaijan and Georgia? What kind of policy is being deployed in order to accomplish this/these purpose(s)? Through answering the above stated questions we will conceptualize Japan's strategy towards the SC states on bilateral and multilateral levels.

Japan is willing to boost its presence in the SC to the frames in which it doesn't undermine pursued policy towards Russia. At the same time Japan is willing to pursue its Russian policy unless it undermines relations with the West, notably the United States. In order to maintain balanced foreign policy, Japan has been refraining from political engagement in the region of Russo-Western rivalry, limiting its foreign policy tools mainly to official development assistance. As the initial phase of our research showed Japan's aid policy in the SC often has rather ad hoc, circumstance driven nature, inflicting criticism for having ill-defined strategy. However, wider analysis of Japan's relations with the powers involved in the region demonstrates that farther proactive boost of Tokyo's political influence in the SC bears risk of bringing inconsistency in its overall foreign policy. In fact, Japan's relations with the major powers largely frame its policy towards the region, circumscribing the boundaries of Tokyo's decision-making limits, thus minimizing Japan's political influence on international level.

Restrained foreign policy framework has been linked to the popular criticism over Japan's inability to develop its independent action plan on international arena. However, within those frames Japan elaborated remarkably subtle policy structure, which can be shortly framed as *low-relevance and high-purpose* policy, whereas *low-relevance* framework can be divided into three main directions: low-posture, low-interference and low-risk. The concept of low-relevance has been derived from Japanese socio-cultural  perception of an ideal approach to life (however mainly limited to women only) – so called *Santei* (三低 - literarily means three lows), whereas it is important to maintain low posture, low dependence and low risk attitude in different spheres of social life. Despite the non-positive image of the word low, the term Santei does not necessarily have negative meaning. Low-posture refers to virtue of humbleness and respectful attitude to people, low-dependence stands for an independent stance in a society and low-risk praises the skills of avoiding troublesome and potentially risky activities in order to keep oneself and one's family safe. We slightly altered this essence by substituting low-dependence with the concept of low-interference and deployed the term for conceptualization of Japan's foreign policy to the SC. This paper discusses each direction basing on the case studies analyzed through the spectrum of Japan's wider foreign policy vision.

Low-relevance approach towards such risk-saturated environment as the SC region, serves Japan's higher objectives, which as well can be divided into three analytical dimensions; bilateral economical, multilateral political and humanitarian. The SC policy, based on non-political aid approach, secures bilateral intergovernmental relations, providing safe operational platform for Japanese companies, minimizes jeopardy to Japan's multilateral political objectives, and at the same time, ensures effective penetration of Japan's aid allocation. However, various aspects of this policy can be highly vulnerable to criticism, which as well will be discussed in this paper. The paper presents brief empirical insight of Japan's involvement in this complex Geopolitical entity and conceptualizes its low-relevance and high-purpose policy through the scope of Japan-Russian relations on the one hand and Japan-West relations on the other, at the same time, taking in account newly emerging Chinese factor as well. The paper aims to contribute into long lasted theoretical discourse over Japan's foreign policy. Providing structural analysis on bilateral and multilateral levels, we will conceptualize Japanese SC relations and point out merits and pitfalls of the low-relevance and high-purpose policy approach.

## 1. Japan in the South Caucasus

The history of Japan's cooperation with the SC can be traced back to the Czarist era, when Japanese government funded Caucasian national movements through its Europe based agent Baron Motojiro Akashi. In particular Japanese intelligence supplied immense funding for military equipment to Georgian social-democratic movement in order to undermine Czarist regime in its peripheral areas.[3] Later in pre World War II period Japan continued support of the South Caucasian anti-Kremlin movements, such as Georgia's national democrats and Azerbaijani anti-Soviet activists, as well as Haydar Bammat lead North-Caucasian groups.[4] The cooperation lasted throughout the World War II, but did not lead to any substantial change for the Caucasian independence movements.

Classical realism views military aid as a mutually beneficial cooperation, which often benefits a provider more than a beneficiary, thus largely serves to the donor's interests. Hans Morgenthau distinguishes 6 types of foreign aid, "which have only one thing in common: transferring money, goods and services from one nation to another." These 6 types include such methods as military aid and bribery as well. He claims that even per se non-political humanitarian aid "can indeed perform a political function when it operates within a political context."[5] DAC attempted to limit political element in international aid by setting strict rules of what type of aid can fit the definition of Official Development Assistance (ODA). Nevertheless, non-political, welfare-oriented aid has been exposed to well-founded criticism in the context of political science, as well as the economical point of view. The leading donor states do pursue political or ideological purposes by the means of foreign aid – so called Other Official Flows (OOF). However, the same statement cannot be addressed to Japan's SC policy, since, it drastically lacks political element. The first Japanese aid provision to the SC since the establishment of the Cold War was recorded in 1988, when devastating earthquake hit northern part of Armenia, killing over 25000 people and leaving around 500 000 Armenians homeless. The Cold War tensions were rapidly de-escalating and the Soviet Union, for the first time, since the World War II, officially requested for international aid. Tokyo deployed disaster relief group and special debris removal equipment in order to assist the post-earthquake relief efforts. A few years later, after the dissolution of the Soviet Union Japan continued increasing aid allocation to the SC states on bilateral basis. It should be mentioned that adaptation of Japan's ODA Charter in 1992 amid the years of drastic boost of foreign aid does not find chronological reflection in the aid disbursement to the SC. On the contrary, Japan's aid fund towards the SC started substantially increasing through the 2000s while its overall aid budget allegedly was in relative crisis. Moreover, the second ODA Charter adapted in August 2003 calls for rather rational and interest oriented disbursement of the ODA. Thus we exclude the argument that aid allocation to the SC was put in the frames of the general disbursement trends.

Usually, Japan is hardly mentioned while analyzing the international political conjuncture of the SC, however, being one of the leading donor countries, Japan is significantly involved in the region's development issues. As a result, Tokyo maintains extensive space for maneuvers in Russia's backyard. Traditionally, Russia painfully reacts against any political intrusion of a third party in its near abroad. The non-political design of Low relevance policy doesn't inflict Moscow's fury, but it provides strong foothold for Tokyo to efficiently insert political element in its SC policy and reinforce pressure on Russia, in case if Kasumigaseki decides to bring rather hawkish element in its Russia policy.

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3 About relatons of Motojiro Akashi and leader of Georgian social-democratic movement Giorgi Dekanozishvili see: Kuromiya, & Mamoulia, 2009, 1416 – 1418.
4 Ibid, pp. 1423 - 1424.
5 Morgenthau, 1962, 301.

## 2. Low Posture

### 2.1 Japan's Eurasian Diplomacy and the SC

As the empirical analysis shows, Japan's political agenda has been underrepresented in the SC. However, Tokyo not once declared the plans to bolster its presence in the region. In 1997 Japan's assertive Prime Minister Hashimoto enounced Eurasian Diplomacy as a new dimension of country's foreign policy, whereas the SC together with the Central Asian countries was perceived as a region, towards which "Japan has deep-rooted nostalgia […] stemming from the glory of the days of the Silk Road." Hashimoto outlined three main pillars of Eurasian Diplomacy: "First of all, there is political dialogue aiming to enhance trust and mutual understanding. Secondly, there is economic cooperation as well as cooperation for natural resource development aiming to foster prosperity. Thirdly, there is cooperation to build peace through nuclear non-proliferation, democratization and the fostering of stability."[6] However, in fact the main focus was placed on economic cooperation and resource diplomacy. As Ferguson points out, Hashimoto's speech was drafted "with the help of officials at MITI (including section chief of the policy division Kenji Isayama) and an emphasis was placed on energy cooperation."[7] Kazuhiko Togo, then official of the Ministry of Foreign Affairs (MOFA), who insisted on excluding the emphasis on disputed islands from the new policy, later wrote, that the main objective of Hashimoto's diplomacy was to get Russia involved in Asia pacific region in order to balance China and the USA.[8] Relations between the leaders of the two countries were indeed developing positively. Yeltzin even announced that the long-craved peace agreement would have been achieved by the end of the century, bringing false expectations to Japanese society. A few in Japan understood that Russian Duma (Russia's legislative body) was dominated by the ideas opposing the President's policy. Thus, Japanese scenario of resolution of the territorial dispute was less likely to be implemented. Moreover, Yeltzin never specified what sort of conditions he suggested for the potential peace treaty.

Michael Green claims that Japan was short of a choice but to abandon robust policy towards Russia due to so-called Gaiatsu (external pressure). In 1997 President Clinton made his infamous phone call to Hashimoto, searching for his consent on inclusion of Russia to G-7 summits, which eventually "catalyzed quiet rethinking of Russia policy already under way in MOFA, MITI and the prime minister's office itself."[9] Tokyo decided to lead the process, rather then to be driven by external forces into the newly forming international reality, however inability to implement value driven political agenda led to partial failure of Eurasian diplomacy. Nevertheless, Hashimoto's policy did contribute to development of bilateral relations between japan and the SC states and successfully introduced Japanese companies to the region, namely to the region's large scaled energy projects.

### 2.2 The Arc of Freedom and Prosperity and the SC

The second attempt to reconsider Japan's SC approach was in 2006, when foreign minister Aso introduced the policy of Arc of Freedom and Prosperity.[10] As then counselor of Azerbaijan to Japan, Gursel Ismaylzade stresses, Aso's speech was perceived as statement of a new pillar of Japan's foreign policy, which hitherto was "based on three existing pillars: reinforcement of the Japan-U.S. alliance, international cooperation, most notably under the auspices of the United Nations, and relations with neighboring countries, namely China, Russia and the Republic of

6 Hashimoto, 1997.
7 Ferguson, 2008, 83.
8 Togo, 2014.
9 Green, 2001, 151-152.
10 Aso, 2006.

Korea."11 The speech was drafted in close cooperation with the specialists of the Black Sea and the Caucasus regions. The interest toward this region is believed to have served as a major incentive for elaborating this policy. However the Geography of the announced policy expanded from "Northeast Asia to Central Asia and the Caucasus, Turkey, Central and Eastern Europe and the Baltic states."[12] The Arc encircles Russia forming the region, which in Mackinder's geopolitical terms represents vital periphery of heartland – so called inner or marginal crescent. Spykman later reviewed Mackinder's theory of Heartland supremacy and placed greater importance on this very inner crescent, which he calls Rimland - "Who controls Rimland controls Eurasia; who rules Eurasia, controls the destinies of the world" – argues Spykman.[13] Rimland largely overlaps with the geographical area of the Arc of Freedom and Prosperity. From Geopolitical point of view, Western advancement in this Geographical area leads to the supremacy of Sea Powers and inevitable decline of Land Powers, thus represents immediate threat to Russia's vital interests. The recent history of the Black Sea region proves that Moscow acts based on its Geopolitical interests, while for the West the primary goal is economic and ideological expansion.

The Arc of Freedom and Prosperity was supposed to be primarily based on "value oriented diplomacy," promoting so-called Western liberal democratic values in the region. The Second dimension of this policy is focusing on economic cooperation, especially in such field as energy security, whereas Georgia and Azerbaijan are seen as "extremely important with regard to the supply of natural resources to the globe."[14] Undoubtedly, Russia did not welcome Aso's policy and its implementation would negatively reflect on Russo-Japanese relations. As one Georgian diplomat mentioned in the interview with the author, "The Arc f Freedom and Prosperity is a stillborn policy, unless Tokyo is ready to pursue rather assertive policy toward Russia."[15]

## 2.3 Low Posture in Japan's aid Policy

Indeed, Japan's SC policy cannot be discussed out of the context of the major actors' interests involved the SC's international politics, namely the interests of Russia and the U.S., or even newly emerging China. Inserting political agenda in the SC policy is highly likely to counter these interests and trigger the possibility of undermining Japan's policy on a higher, multilateral level. Tokyo has been reluctant to take sharp position in the SC's internal and/or international conflicts. For ex. being the West's ally Japan recognizes and supports Georgia's territorial integrity, but has always been reluctant to make critical statements towards Russia. On the contrary, In July 2011 the web site of Japan International Cooperation Agency (JICA) uploaded a map of Georgia without its breakaway regions of Abkhazia and South Ossetia (See map 1). The next day the author interviewed a representative of the MOFA, who explained that JICA displayed only the map of the regions where it operated in and had no political background behind it. Abkhazia and South Ossetia were absent as JICA had never conducted any project in those regions.16 Nevertheless, the map was taken down from the web site the same day. Moreover, the argument was less convincing, as for ex. Azerbaijan's breakaway Nagorno-Karabakh region, which as well had never been targeted by JICA projects, was included in the same map. Attempts of MOFA to reconsider uncompromised stance towards Russia have traditionally been regarded as a policy lobbied by relatively pro-Russian representatives of so-called Russian School. However, we cannot exclude the possibility of a mere technical mistake on a lower bureaucratic level. Thus,

11 Ismaylzade, 2008, 196.
12 Aso, 2006.
13 Cohen, 2003, 22.
14 Aso, 2006.
15 Georgian diplomat, Tokyo, April 22, 2013.
16 Employee of MOFA, Central Asia and Caucasus department, Tokyo, July 26, 2011.

any farther considerations over this incident without deeper research of an actual reason behind it bear the risk of stepping into the sphere of ill-founded speculation.

**Map 1**



Map taken from the Web page of JICA, accessed July 2011,
 http://www.jica.go.jp/english/countries/asia/index.html.

Noteworthy for us is that unlike the EU or the USA, Japan has been reluctant to elaborate peace building oriented projects even on aid level. The United States Agency for International Development (USAID) has been actively supporting various conferences, symposiums, etc. aimed on promotion of intercultural and interethnic dialogue[17] and even provided direct aid to Nagorno-Karabakh region. The EU has been committed to "funding for conflict resolution efforts through its financial instruments"[18] and aided joint infrastructural projects aimed on re-establishing the flow of goods and electricity between conflicting parties.[19] However, Tokyo's aid agenda never included the projects directly related to the conflict regions.

Russia is not the only factor, Japan has been taking in consideration when pursuing its SC policy. Tokyo is reluctant to get involved in any international action, which potentially bears incoherence with the Western interests in the region. This halted Japan's aid allocation to Armenia's North-South road corridor project.

In the late 2000s landlocked Armenia initiated a large scaled infrastructural project, aimed to establish connecting road between Georgia and Iran. This road has greater importance than just an infrastructural entity. As Davtyan stresses, the road facilitates "the transit role of Armenia and becoming the major highway corridor between Europe, Iran and Central Asia, thereby softening the dual blockade, imposed by Turkey and Azerbaijan."[20] Iran strongly supported the project, while it was causing certain fears amid the Western politicians. Iran was under the U.S sanctions due to the disagreements over Teheran's nuclear projects. Thus, a highway project facilitating flow of goods between Iran and Armenia, where Russian military bases are stationed, was not welcomed in the west.

17 The author himself has participated in several these sorts of events.
18 European Union External Actions, "EU relations with Georgia," accessed September 23, 2015, http://eeas.europa.eu/georgia/index_en.htm
19 For ex. EU financed rehabilitation of the Enguri Hydropower plant, or railway station in Tskhinvali and so on. See: Popescu, 2009, 198.
20 Davtyan, 2014, 34.

The Author obtained a document, which shows that Armenian government officially requested Tokyo for the loan to fund the project.[21] Japanese company Padeco, which is consulting JICA-funded Georgia's East-West Highway construction, had already made a feasibility study in Armenia and as Padeco representative told the author; they had high expectations that Japan would provide funds for North-South project as well.[22] According to Armenian Official, interviewed by the author, initially Japan agreed to fund the Iran-linking southern part of the road, but "due to America's pressure" Tokyo reconsidered the aid allocation and would most likely fund the northern part of the road.[23] As a result neither the northern part was funded by Japan. Later Armenia raised necessary funds from international banks and organizations, whereas the major donor is Asian Development Bank (ADB). The sanctions against Iran have been lifted, but certain fears over farther developments remain, as alongside to the road, Armenia is working on establishing a railway access to Iran. If Armenia succeeds in implementing the railway project and Georgia restores its railway over Abkhazia to Russia, as Ivanishvili's new government declared after sweeping elections in 2012, then Russia will gain direct and fast overland access to Iran.

As we can see, Japan has been endeavoring not to challenge or upset neither Russian, nor Western interests in the region. Maintaining low posture in such complicated region has its merits in terms of pursuing other international goals. However, it demonstrates Tokyo's inability to make independent moves on international arena and follow its declared goals, which inevitably extends negative effect on Japan's long-lasting leadership ambitions.

## 3. Low Interference

This chapter presents the insight of Tokyo's traditional reluctance to cooperate with civil society groups of a developing country. Stressing the importance of civic culture[24] for a state's democratic development, we point out the ineffectiveness of Japan's policy in the context of democratization process.

### 3.1 Importance of Civic Culture and Georgia's Case Study

Lack of freedoms, corruption, unconsolidated democracy and underdeveloped civic culture are among the major problems, the SC states have been facing. In terms of civil liberties Georgia has made relative progress, notably since the Rose Revolution, whereas Armenia did not advance much and Azerbaijan is dropping backwards (see chart 1). According to Transparency International, within last 10 years Georgia improved its position in CPI (corruption perception index) world ranking from being 133rd in 2004 to 50th in 2014, outstripping such European countries as Italy, Czech Republic, Croatia and so on. In the same ranking of 2014 Armenia ranks 94th and Azerbaijan126th. According to World Bank's ease of doing business ranking of 2105, Georgia ranks 15th out of 169 economies, whereas Armenia and Azerbaijan hold respectively 45th and 80th positions.[25]

The score is based on two numerical ratings—from 1 to 7—for political rights and civil liberties, with 1 representing the most free and 7 the least free.

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21 Request of Japanese ODA Loan to Armenia North-South Road Corridor Project, May 20, 2010.
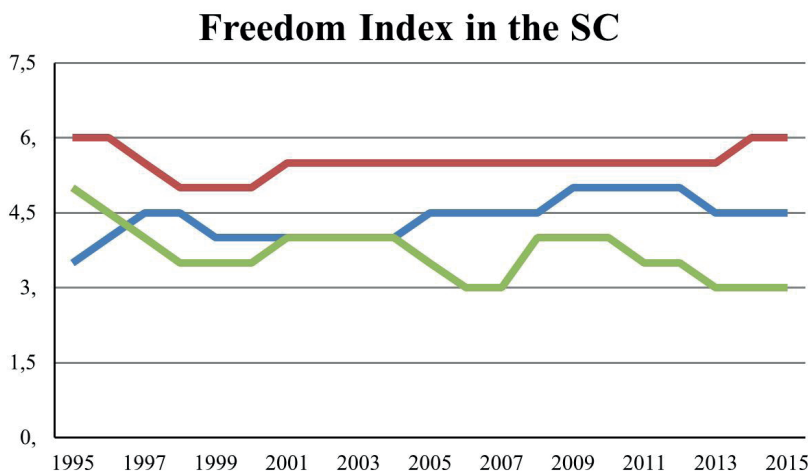22 Padeco representative, Tbilisi, August 14, 2012.
23 Armenian official, Yerevan, August 22, 2012.
24 Civic Culture as it was defined by Almond & Verba, 1963.
25 The World Bank, 2014, 4.

**Chart 1**

## Freedom Index in the SC



Based on the data of Freedom House organization.

Georgia's progress was largely facilitated by rapidly developing civil society and civic culture in general. According to Almond and Verba civic culture refers to the level of the society's involvement in the political processes, such as delegation of political power to the government – so called input, and how the government exercises the power it is endowed with – so called output. The highest level of civic culture (participatory type) is generally inherent to democratic societies, in which the citizens manage to influence the government in various ways and are actively involved in both input and output. The concept of civic culture still remains amorphous and leaves a lot of room for scholarly debate, notably for the specialists of comparative politics. Although, despite its "deliberately vague conditioning concepts" this theory still enjoys considerable popularity among specialists of political science and finds certain implications among historians as well.[26]

Basing on Almond and Verba's classification, it can be argued that most of the post-communist societies fall under the definition of subject political culture, where the citizens are well aware of the political institutions and actors, and display significant interest in government's output of power, but at the same time reluctantly participate in the process of formation of administrative political bodies. Societies, in which the whole generations were shaped within the Soviet Union, do not have a tradition of participating in formation of the governmental bodies, not to speak about active civil societies.

However, the beginning of the 21st century marked a breakthrough in the development of Georgia's civic culture. The civil society groups (notably the movement "Kmara"- Serbian "Otpor's" Georgian counterpart, nongovernment organization "Georgian Young Lawyers' Association" etc.), which enjoyed strong financial support from Western international foundations, emerged as substantial political actors and eventually played a crucial role in the mobilization of politically active parts of the society in order to overthrow Shevardnadze's corrupt regime.[27] Proactive civil participation in political life resulted with the revolution, which subsequently

26 For the review of a scholarly debate on the political culture see: Formisano, 2001, 393-426.; Lehman, 1972, 361-370.
27 For the role of civil society during the Rose Revolution see: Agley E., 2010.

led to progressive reformation of Georgia. The new government which largely was formed by the representatives of the civil society groups made immense progress in decreasing the crime rate and corruption, and increasing the doing business rate, freedom rate and so on.[28] Later, in 2012, because of the unprecedentedly proactive and wide participation of Georgian society in the political processes, the country made the first historical precedent of a peaceful regime change by elections. At the same time it is a rare case in the whole region and is widely evaluated as a breakthrough towards more consolidated democracy.[29]

Non-government organizations and other civic groups largely contributed to the rise of social awareness of political participation on individual, as well as segmental level of the society. Large number of civic activities became possible mainly due to the proactive foreign support and international cooperation, which was not limited to financial aid only. Logistic cooperation, consulting activities and diplomatic support on intergovernmental level as well were crucially important for the significant breakthrough in the civic culture of Georgian society.

## 3.2 Japan and Democratization in the SC: self-help philosophy vs. good governance

The core philosophy of Japan's aid policy, so-called Jijodoryoku (self-help effort) fully corresponds with the very idea of cooperation the civil society. If the first ODA charter (1992) focused solely on the socioeconomic aspect of Self-Help philosophy, the second charter (2003) stressed that "ODA is to support the self-help efforts of developing countries based on good governance, by extending cooperation for their human resource development, institution building including development of legal systems, and economic social infrastructure building, which constitute the basis for these countries' development."[30] As above-described example of Georgia's civic culture shows, civic participation is crucially important for development of good governance and institution building. However, unlike the Western countries' approach, Tokyo has been reluctant to cooperate with politically active civil society groups. Japanese official documents, as well as diplomats and officials often stress that "Japan respects the ownership by developing countries,"[31] whereas Western type of cooperation is perceived as interference in the domestic issues of a recipient state, which can jeopardize humanitarian aspect of the cooperation. One of the chief dimensions of the Western policy in the SC, namely democratization and promotion of civil society, is not always attractive to local elites. Particularly, Azerbaijan took repressive measures against the civic groups. In 2000 Azerbaijan adopted a new progressive, liberal law on NGO activities. Major pipeline projects to transfer Caspian energy resources to the Black Sea, Turkey and farther to Europe, were still underdeveloped and Baku was searching for stronger ties with the West in order to secure its economic and diplomatic goals. However, later in the late 2000s and 2010s the law has been revised several times; first creating more obstacles for NGO registration and then restricting foreign aid flow for civic groups. The new amendments to the NGO law caused heavy criticism of the Western organizations.[32] However Baku gained strong financial background and maintains the position of an important energy supplier for the West, which "overrides concern for the poor state of democracy and human rights."[33] Economic

28 For Georgian reforms after the Rose Revolution see: Burakova, 2011.

29 For ex. see the reports by Freedom House for the previous and the following years of the elections.; For the evaluation of the civil society's role in elections see: Goginashvili, 2013, 71-86.

30 Japan's Official Development Assistance Charter, 2003.

31 *Ibid.*

32 For detailed description of the amendments and their international evaluation see: Bilkova, Clayton, Thorgeirsdottir & Van Dijk, 2014, 4-5.

33 Raik, 2011, 5.

and Geopolitical conditions allow Azerbaijani elites to develop rather confident internal as well as external policy. Despite the heavy criticism, the West has been reluctant to impose any type of conditionality on Azerbaijan. Kobzova and Alieva claim, that "this conditionality-free approach has brought Europe few benefits and continues to discredit the EU in the eyes of Azerbaijani society."[34]

Energy security was the main incentive to strengthen the relations with Azerbaijan for Tokyo as well. In the Second half of the 1990s such Japanese corporations as Itochu and Mitsui started large-scale investments in Azerbaijan. After Hashimoto declared his Eurasian Diplomacy, Japan's foreign minister Komura visited Baku (the fist and the only minister level visit to the South Caucasus) and farther cooperation was facilitated by long term, low-interest loan agreements.[35] At the same time Azerbaijan was the first country in the SC to host Japanese embassy. Later despite the proclaimed Value-Based Diplomacy towards the Arc states, Japan remained reluctant to take position over the deficit of democracy, hence the economic interests prevailed. In fact, the wealthiest SC state, with allegedly the least developed democracy remains the largest beneficiary of Japanese foreign aid in the region (see chart 2). Although aid allocation has been the main foreign policy tool for Tokyo, Aso's proposed policy never found its implications on Japan's aid disbursement in the SC.[36]

**Chart 2 Japan's aid disbursement in the SC according to each year. Denomination – Million USD.**
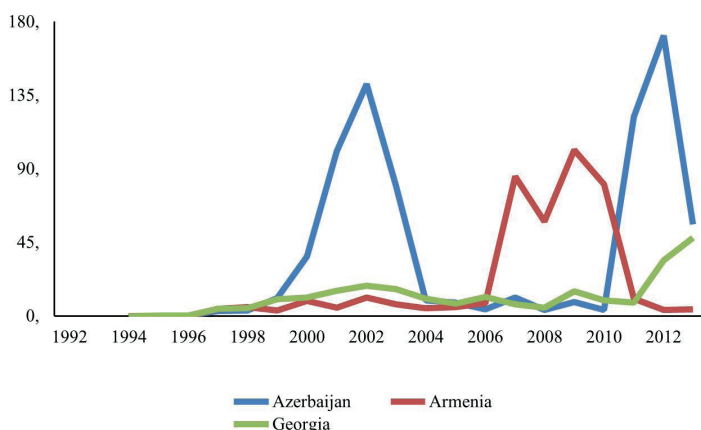


Based on official data of MOFA.

### 3.3 Incident over 2KR Project

Japan has been maintaining conditionality-free approach, with clear reluctance to engage in development of civil society. At the same time Tokyo refrained from making critical statements over the state of democracy, human rights, civil liberties or transparency, even if it directly concerned the projects involving Japan. The incident over the tractors provided by Japan to Georgia is another blatant example.

In 1996, in the framework of Grant Aid for the Increase of food Production (also called 2 Kennedy Round or 2 KR project) Japan took responsibility to allocate 2 560 million yen worth of aid for development of Georgia's agricultural sector. Part of the fund was spent on purchase of 367

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34 Kobzova & Alieva, 2012, 2.
35 For rather detailed analysis of Japans first steps in Azerbaijan see: Dekmejian & Simonian, 200,146-148.
36 Total amount of Japan's aid to Azerbaijan exceeds 774 million USD, while total aid disbursement to Armenia and Georgia is respectively 406.8 and 237.23 million USD. See MOFA's official data.

tractors. Unofficial conversations with Georgian diplomat and an official of Georgia's ministry of agriculture revealed that part of the tractors went missing. One of JICA representatives neither denied nor confirmed the case of misappropriation as well.  However, during all other interviews, none of the officials of JICA and/or MOFA confirmed the incident. At the same time, Georgian side failed to allocate the part of the fund, which it had taken the responsibility to provide. In fact the incident halted Japan's farther engagement in 2KR project. The author obtained the copies of notes exchanged by the two governments, which discussed the terms of continuation of the project. Japanese side requested Georgian government the reimbursement according to taken obligations, however dispute continued until 2008. Meanwhile no large-scaled project was implemented in the frames of Japan-Georgian cooperation, but Tokyo did not halt grants, grassroots projects and technical cooperation.

Georgia's post-Rose Revolution government representatives, namely the Prime Minister Gilauri, deputy minister Tsintsade and the minister of agriculture Kvezereli, who were actively involved in negotiation process, successfully reestablished friendly relations with Japan.  The tractors were said to have been stolen during the Georgia-Russian war in 2008, which appeared to be fully acceptable explanation for Tokyo. At the donor conference held in Brussels, Japan, together with the western governments took responsibility to provide large aid funds in order to help the post-war rehabilitation efforts, and became the second largest donor following the USA. The negative impact of 2KR project's failure was overridden by the importance of maintaining favorable bilateral relations.

## 4. Low Risk

The case studies discussed in the previous chapters demonstrate certain mismatch between Japan's stated policy and practical actions in the region. It can be argued that, on the scale of priority goals, preservation of favorable intergovernmental relations with the SC states and consideration of interests of the region's powerful actors prevail, whereas support of democratization, as well as boost of Tokyo's political presence in the region ranks the least. Policy based on political factor-free ODA does facilitate those goals, but at the same time inflicts considerable portion of criticism both internally and internationally.

Pursuing non-political ODA based policy minimizes the risks for Japan's international policy, economic interests and humanitarian purposes. On bilateral level, Japan maintains the image of an unconditional supporter, ensuring the counterparts pro-Japanese attitude. While on international level, Japan's SC policy doesn't jeopardize relations with its Western partners and leaves extensive room for adjusting its Russia policy. While Russia has been traditionally perceived as a country, which occupied part of Japan's northern territories, the two countries did succeed to elaborate mutually lucrative economic ties. Moreover, Japan places significant focus on partnership with Russia in terms of diversification of energy import sources. Promotion of Russo-Japanese bilateral partnership is seen by Tokyo as a strategic step towards solving the territorial issue, however, in fact, the problem of islands is being overridden by the importance of economical factors. Such prioritization in turn plays furthermore impeding role to Japan's political engagement in Russia's backyard.

Building favorable bilateral relations through the ODA policy facilitates advancement of Japanese companies in the region, since most of the grant projects are tied to Japanese companies. Even though long-term yen loans are not officially tied, practically most of the projects are partly or fully implemented by Japanese companies. Encouraged by the ODA projects the companies are expected to extend their activities in the region, thus strengthen bilateral economic links and promote internationalization of Japanese companies. For ex. Padeco gained ground in Georgia

through JICA funded East-West highway project, what later served as base for advancement to Armenia as well. Being one of the first companies on the ground and timely investing in the feasibility study of Armenia's North-South road construction allowed Padeco to engage in non JICA funded project as well. Mitsui & co. ltd., which was the main contractor for JICA funded Shimal Gas Combined Cycle Power Plant construction project (2004),37 successfully extended its activities to Armenia, obtaining contract for implementation of Yerevan Combined Cycle Co-generation Power Plant project (2006) as well. Crucial factor for successful engagement was knowledge of the region, namely needs and development trends, as well as political situation between Armenia and Azerbaijan, given the condition that a company operating in one country is not always welcome in another, thus some preliminary work is needed to avoid various impeding factors.

On the other hand, the beneficiary states are motivated to facilitate stronger presence of Japanese companies, given the importance of public-private relations in the ODA allocation process. As Arase argues, the distinguishing characteristic of Japanese ODA "is the structural inclusion of private sector actors in policymaking and implementing structures and this is the point that needs emphasis."38

Along with bilateral political and economic relations, Japan places great importance on humanitarian motives in its foreign aid policy. Despite well-founded criticism over Tokyo's mercantilist objectives underlying its ODA policy, element of altruism plays significant role in shaping the aid design as well.39 It is especially visible in such region as the SC, where Japan's political and economical motives are constrained by geopolitical hindrances.

If Azerbaijan and Georgia are often seen as important access to Caspian energy sources, for Japan Armenia has less importance as a resource exporter and even less importance as a transit corridor. However, Japan has been developing highly responsive aid policy to Armenia's infrastructural or human security needs as well.

It can be claimed, that one of Tokyo's main objectives is to secure the humanitarian effect of its assistance. As Japanese high-ranking diplomat Sunaga Kazuo stresses, Japan develops intergovernmental relations in order to alleviate concerns over the aid projects, "because what ultimately matters is how to best grasp and respond to the actual needs of developing countries".40

## Conclusion

Japan's foreign policy has often been criticized to be faceless, pursuing so-called Checkbook Diplomacy and lacking consistency with the stated goals. At the same time, due criticism has been addressed to the mercantile motives behind the ODA projects. However, politics-free ODA has significantly contributed to establishing a foothold of Japanese diplomacy in the SC. Nevertheless, the positive potential has not been exploited due to above-mentioned geopolitical hindrances. Japan places greater importance on coordination of its policy with the US interests, which are strongly presented in the region, avoid countering Russia's interests and upsetting bilateral relations, rather then boost of its political presence and international importance.

Tokyo is still reluctant to introduce political agenda in the region of Russia's high interests. Despite Abe's hawkish policy on certain foreign dimensions, he is endeavored to re-approach Russia in order to keep his vow to solve the long-lasting territorial issue. Although Japan did follow its G7 counterparts and imposed sanctions on Russia, it was rather an outcome of an external

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37 For details see external evaluation of the project: Katagiri, & Itoh, 2007.

38 Arase, 1994, 172.

39 For ex. see: Sunaga, 2004.; Tuman & Strand, 2006, 61-80.

40 Sunaga, 2004, 16.

pressure, than Tokyo's voluntary act. Japan's sanctions are the weakest among G7 members. Tokyo targeted bonds of 5 Russian banks,41 which did not have any considerable representation on Japanese market. Import-export transactions related to arms or military technologies were sanctioned as well,42 however Japan-Russian military cooperation was heavily underdeveloped from the beginning, thus no significant harm was inflicted on Russia. Sanctions against individuals are limited only to people involved in self-proclaimed governments of Crimea and Eastern Ukraine, and several members of Yanukovich's regime.43 In fact, the sanctions did not target any Kremlin official. Despite relatively harmless sanctions, Russia responded with angry statements and increased the number of military flights near the border.44 Japan avoided any farther actions antagonizing Russia. However, In October 2015 Moscow announced farther build up of military presence on Kuril Islands,45 which could have been taken as a failure of Japan's Russia policy. Nevertheless, Abe is less likely to abandon his balanced policy toward Russia and endeavor to boost Japan's political presence in the SC.

Georgia's example of civil society's development and following progressive reforms do prove the effectiveness of the Western policy to support civic groups, contributing to elevation of civic culture in the society. Raising the awareness of Political participation and providing the platform for intellectual search for the governance knowhow spurred remarkable progress in Georgia. We do not intend to make a worldwide generalization of Georgia's case study, since, cooperation between civil society and foreign donors covers wide range of aspects regarding the positive and negative effects of such interference in a developing country's political life and needs deeper scholarly debate. However, considering cultural and socio-political background of the SC countries, development of civic culture is vital for democratization process. Hence, Japan's policy of non-cooperation with civil society and sole focus on bilaterally lucrative economical projects promoted by the ODA at least do not lead to promotion of democracy and at most facilitate non-democratic processes in the beneficiary state. It can be claimed that announced "value-based" approach has not found reflection in actual policy. On the other hand, Tokyo doesn't undermine Japanese business in a recipient country and minimizes the risk of deterioration of bilateral relations.

Comparing the three SC states, Azerbaijan enjoys the highest level of cooperation with Japan. The argument of Tokyo's resource oriented foreign policy is relevant, however not sufficient enough, since, according to JETRO the share of Azerbaijani oil in overall Japan's oil import is extremely low and according to year, sometimes equals to zero. Analyzing through the concept of Low Relevance and High Purpose, it can be argued that Baku's geopolitical conditioning, namely well preserved balance amid clash of the influential powers in the region, as well facilitates development of Japan-Azerbaijani bilateral relations. Despite the announced value based policy, democratization level of a counterpart state hardly influences on Tokyo's decision making, hence neither Georgia, nor Armenia introduce more favorable conditions for Japan's farther engagement than Azerbaijan.

Allegedly poor strategy of Japan's foreign policy in fact provides essential maneuver space for Japanese diplomacy in the SC and keeps the risks low, as it was shown in the case studies. Overall, Japan is pursuing pragmatic and well-balanced policy under extremely sensitive circumstances of Japan-USA-Russia triangle in the region of extreme political complexity, with additionally

41 Ministry of Foreign Affairs of Japan, September, 2014.
42 Ibid.
43 Ministry of Foreign Affairs of Japan, August, 2014.
44 Reynolds, 2015.
45 BBC, October 22, 2015.

emerging China factor. However, the policy of Low Relevance and High Purpose, explained in this work has significant mismatch with Tokyo's certain goals such as international leadership, strengthening political presence and promotion of democratization processes in the region.

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# Predict the Ruture Returns of Shares.
# CAPM vs Multifactor Approach

## Carlo Mastrosimone

**Abstract**   The Capital Asset Pricing Model is a milestone of the forecasting process of the company's returns by allowing investors to make a prediction of the returns of their investments. However, this model is based on several assumptions that are deemed to be unrealistic, such as the true market portfolio which is impossible to observe in the financial market, and for this reason financial researchers have tried to find other methods with the purpose to overcome the limits of the Capital Asset Pricing Model. Nowadays the alternatives are the Arbitrage Pricing Theory and the Multifactor Approach. The first one affirms that it is possible to predict the expected returns of a securities by analysing the responsiveness to disparate macro-economic factors. The latter allows to consider other factors which can affect the returns' trend such as the size of the firms, the earnings – price ratio (E/P), the book to market equity ratio (BE/ME) or the cash flow – price ratio (C/P). The main advantage of the Multifactor Approach is that the market portfolio or index is not considered the main source of information, but other accounting features can be introduced in the forecast process of the returns. Nevertheless, it seems impossible to say which is the best models that can explain in a proper way the stocks' returns.

The Capital Asset Pricing Model (CAPM) was made public for the first time in 1964 with the aim of creating a model for predicting the future return of an asset in relation to its risk. Of course, this model is based on the investor's choice regarding risky assets and all the possible combinations in order to create an optimal portfolio. The CAPM is rooted in Markowitz (1952), who declares that by matching different risky assets, their risk will not increase because they are not characterised by a positive correlation. By following the Markowitz's research, an investor must create his optimal portfolio by depicting his personal efficient frontier where the investor will allocate his preferred portfolio (Hillier et al., 2012). However, Sharpe (1964) has overtaken the model designed by Markowitz, by stating that the future return on a single stock depends on the return of its financial index and this index can be associated to a portfolio of securities. According to Hillier (2012), unsystematic risk, known as diversified risk, is the risk

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that comes from the portfolio but often it can be defeated by adding securities. On the other hand, the diversified risk is generated by the fluctuations in the financial market and financial operators often define it as market risk (Hillier, 2012). Unfortunately, these components cannot be defeated by diversifying the portfolio (Galagedera, 2007). Moreover, the investor, by combining a risk-free asset with the risky assets will find the optimal portfolio, which is denoted by the tangency point between the Capital Allocation Line with the Efficient Frontiers. In addition, the majority of the investors will choose this portfolio, and by definition, it is known as market portfolio, which embodied all the assets available in the market (Bodie et al., 2014). What is more, the CAPM presumes that all the investors are risk averse and they are worried about the mean and the variance of the return on their investments, and often the investors tend to select the mean-variance efficient portfolio in order to reduce the portfolio's variance and magnify the future expected return (Bodie et al., 2014).

However, in the literature it is possible to find out that other factors can affect the reliability of the CAPM and for this reason other models have been developed, as the Arbitrage Pricing Theory (APT) and the Multifactor Approaches, which are able to intercept other elements which can explain in a better way the returns.

## 1. Assumptions of the CAPM

The CAPM is able to estimate the security's returns in relation to its risk that is measured through its beta (β), and the traditional formula of the model is

$$E(Ri) = Rf + \beta[E(Rm)\text{-}Rf]$$

where E(Ri) represents the expected return of one security (i), Rf stand for the risk-free rate, β represent the risk of the security and [E(Rm) – Rf] stand for the difference between the expected return on the market and the risk-free rate.

The CAPM is a hypothetical model and in order to work it needs several assumptions and often they have been deemed as simplification and unreliable. The first assumption is that all investors follow a rational behaviour in their financial choice and the majority of them will choose a mean-variance portfolio (Bodie et al., 2014). This assumption is clear unfounded because their financial choices are often affected by other elements that can alter the final decision. These elements recall another assumption, that is known as single-period horizon (Bodie et al. 2014), because in a short period all the threats are eliminated. Other assumptions are related to the composition of the market, which is characterised by the possibility for the investor to short sell securities, although often there is a lack of available securities for this kind of trading (Bodie et al., 2014). What is more, in the CAPM the market is considered efficient. In the modern financial system operators and investors can access all the available information useful for their business and the stock prices will be a consequence of those information (Brealey et al., 2013). Thus, the market cannot be defeated. However, the real financial world shows that investors cannot access all the information and for this reason securities are traded in the market. This means that the assumption of the homogeneous expectation cannot be respected. On the other hand, the financial market has its own costs, but in CAPM taxes and costs due to the financial transaction are excluded (Bodie et al., 2014). Finally, it is known that the CAPM uses an index portfolio as benchmark, and the assumption is that this represents the true portfolio, which is mean variance. This hypothesis has been the subject of a severe critique by Roll (1977) which precisely criticises the fact that the actual portfolio is not observable.

## 1.1 Criticisms against the CAPM

According to Roll (1977) the CAPM can be tested only if the market portfolio corresponds with the mean-variance portfolio. Moreover, it is known that the CAPM function is a linear function and the future returns of a security are dependent on the market portfolio, which must be efficient (Roll, 1977). What is more, Roll (1977) affirms that the CAPM can be tested if and only if the market portfolio is visible because by definition the market portfolio should include all the securities which are possible to trade within the market. However, in the reality as component of the testing measurement it is possible to use only a proxy because of the difficulties in having the true market portfolio. Furthermore, the CAPM, to be tested, must respect other two important assumptions such as all the investors must be characterised by homogeneous expectations and the market portfolio must be efficient (Roll, 1977). A model without this two characteristic cannot be verified (Roll, 1977). From this point of view, the CAPM is a hypothetical model and Roll (1977) emphasises the physical limitation that in the real financial world it is often impossible to create a true market portfolio, thus testing the CAPM can produce untrustworthy outcomes.

The severe critique made by Roll (1977) is an important milestone of the CAPM theory. However, Brown and Brown (1987) affirms that by creating different portfolios what makes the difference is the relevance and the quality of each elements by obtaining a good approximation of the future returns.

By reviewing the literature, financial researchers have discovered the presence of other factors which can affect the security returns. For instance, Basu (1977) discovers that exist a relation between the returns' risk and the price-earnings ratios, thus the financial market is not completely efficient.

On the same wave, Banz (1981), by analysing twenty-five portfolios of common stocks in the NYSE and the returns during the years 1936 – 1975, discovers that small companies have returns' risk that is higher than the common stock which include big companies. It seems to be that there are other elements that affect the returns. The result is that the CAPM is unable to predict the large returns that the small companies earned and what is more, there is no relation with their risk. In this case the size of the company can be considered as an additional factor that affect companies returns (Banz, 1981). The main limitation of this research is that there is a lack in the theory in order to define this effect, and it is almost impossible to declare whether the size effect should be considered as real effect or a proxy (Banz, 1981).

Yonezowa and Hin (1992) have also questioned why the CAPM is not an effective method in order to predict the returns by analysing stocks that are traded in the Japanese Tokyo Stock Exchange from January 1952 to December 1986. Several critics are made regarding the nonexistence of the market portfolio in accordance with the characteristics of the Japanese investors that often tend to reduce portfolio diversification (Yonezowa and Hin, 1992).

## 1.2 Enhancement of the CAPM. The Arbitrage Pricing Theory

The CAPM is rooted on several unrealistic assumptions which make this model sometimes too stiff and uncorrelated with the real financial world, because of the presence of other factors that can affect the fluctuation of the asset's returns. It seems to be unrealistic that the returns depend only on its sensitivity to the market portfolio.

An extension of the CAPM can be represented by the Arbitrage Pricing Theory (APT), created by Ross (1976), who affirms that it is possible to predict the expected returns of a securities by analysing the responsiveness to disparate macro-economic factors. What is more, the considered portfolio must contain heterogeneous securities in order to maximise its diversification power for the purpose of eliminating the company specific risk (Ross, 1976). In addition, the APT

requires that the stock market has to be efficient in order to avoid any opportunity of arbitrage, based on the law of one price, and the tradable securities are almost infinite in quantity (Bodie et al., 2014 - Ross, 1976). An advantage of the APT is that it is created by considering only a portfolio that is well diversified and not the true market portfolio (Bodie et al., 2014), and for this reason it is possible to use different indexes. Moreover, by using a well-diversified portfolio, all the investors can have the opportunity to overtake any possibility of arbitrage opportunity and it seems possible to leave out residual risks because of the diversification (Bodie et al., 2014).

## 1.3 APT and CAPM

In the APT, what is more important for the operators is that the factors are unveiled and valuated in a proper way. However, as every theoretical model there is some limitations that obstruct the practical application, such as the incalculable quantity of securities and the observable factors that can alter the returns.

However, as stated by Connor (1984) it is possible to delete the assumption of the infinite number of securities because if the market is competitive and in equilibrium the relationship between price and nature of the factors has no effect on a proper constructed market portfolio. This statement has been confirmed by Chen and Ingersoll (1993), by analysing the fact that an optimal portfolio could exist and could be chosen by investors that want to maximize their utility. Moreover, the APT approach can be enhanced and it seems to be possible to reach an alternative model which overcomes the necessary assumptions of the proper diversification of the portfolio by adding, as a new factor, the market portfolio itself, in order to find a true relationship between asset and prices (Wei, 1988). As demonstrate by Wei (1988), often it is possible to remove some factors from the APT model, which have an explanation power of the assets' returns, and the final findings is that by following these procedures the theory collapses into the CAPM. Another observation of Wei (1988) is that the market portfolio, and its relevance in the asset pricing model depends on the quantity of the factors that can be excluded and that the APT is an approximation. Finally, as showed by Wei (1988) by combining together the research of Connor (1984) and Ross (1976), it is possible to obtain a new model, that include as an additional factor the market portfolio, as an alternative true asset-pricing connection.

At the first look CAPM and APT seems to be two parallel worlds with nothing in common because one of the aim of the CAPM is to minimize the specific risk of the firm and on the other hand APT tries to leave out part of the systematic risk. However, Khan and Sun (1997) try to study whether exist a model that allows to combine the CAPM and APT. As stated by Khan and Sun (1997), one way could be by investigating the market risks and the main risks come out by planning the market portfolio. Nevertheless, this approach often can be limited because by applying the APT in the real world is almost impossible to remove all the risks linked to the firms as well as the correlation between the market factors (Khan and Sun, 1997). A way to overcome these limits it seems to be the creation of a model that contains internal factors, generated from the returns (Khan and Sun, 1997). The aim of this model is to identify a formula that focuses its attention on the different factors which affect the financial environment, but the main limit is that there is no practical demonstration (Khan and Sun, 1997).

An empirical work on the APT and CAPM has been conducted by Ostermark (1990) in order to understand which is the best model between APT and CAPM to predict the returns of the Finnish market and Swedish as well. Ostermark (1990) uses daily data from the Helsinki Stock Exchange from February 1970 to December 1987, and from Stockholm Stock Exchange from 1977 to 1987, by creating twelve portfolios. Overall, in these specific markets, the APT can explain and predict in a better way the stock's returns than the CAPM, but CAPM works better in the Swedish market, describing almost 50% of the returns (Ostermerk,1990).

## 1.4 Multifactor Approach

The APT is based on the fact that the future returns of security are predictable by looking at only one factor, but in the real world the returns can be altered by several factors. Thus, the APT can be enhanced by adding different factors that are part of the business life, but the trouble is to identify them. The well-known model used is the Fama-French three factors model that consider three main factors in order to explain the stock returns (Bodie et al., 2014). The main advantage of this model, but in general of the multifactor approach, is that the market index is not considered as the main source of information and each factor is characterised by a specific beta (Bodie et al., 2014). The three factors model created by Fama and French (1992) considers as important elements the size of the company and the book to market ratio.

As described by Fama and French (1996), by reviewing the literature it seems to be that other factors can affect the returns' trend such as the size of the firms, the earnings – price ratio (E/P), the book to market equity (BE/ME) or the cash flow – price ratio (C/P). Moreover, the model described in Fama and French (1993) is able to understand the relationship between the above factors and the expected returns. The formula that discloses the relationship between the expected returns and the three factor model is

$$E(Ri) - Rf = bi * [E(Rm) - Rf] + Si*E(SMB) + Hi*E(HML)$$

where E(Ri) -Rf represents the future return of the portfolio less the risk-free rate, SMB stand for return of the portfolio formed by small stocks less portfolio made by large stocks, HML stand for the return of a portfolio characterised by high book to market stocks less portfolio with low book to market stocks and finally bi, Si and Hi represent the incline of the regression model (Fama and French, 1996). The main advantage of the Fama and French's (1996) model, by analysing twenty-five portfolios constructed on NASDAQ, AMEX and NYSE, is that it is possible to forecast the portfolios' returns which are constructed by including the size of the firms and their book to market equity ratio as well. Moreover, the model is able to depict the trend of portfolios' return characterised by E/P ratio, C/P ratio and expansion of sales as demonstrated by Lakonishok et al. (1994).

The three factors, which characterise the Fama and French three factors model, have been used in order to test the relationship between the Southwest Airlines' returns, calculated from monthly prices1 (28th February 1973 - 30th September 2015), with the model. The analysis considers a multiple regression model to understand whether the explanatory variables, Rm-Rf, SMB and HML2, can explain the company's returns.

The regression model between the Southwest's returns (Ysa) and the three factors is represented as:

$$Ysa = β1+β2(RmRf) + β3(SMB) + β4(HML) + ε$$

under the null hypothesis that β2=β3=β4=0. It is observable that all the factors have a small P-value, which means the null must be reject at significance level of 0.05, so they have an explanatory power of the Southwest's return. Moreover, the P-value of the F-statistic, which describe the overall regression model, is extremely low, and this is consistent with the low P-value of the factors. What is more, it is possible to analyse the value of $R^2$ and adjusted-$R^2$, which tell that 23.58% and 23.13% of returns'change is explained by the three factors. By rejecting the null at least one beta is different from zero, observing a joint effect of the explanatory variables. The regression model between Southwest's returns and each factor shows that HML has no explenatory power (Appendix – Table 3).

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1 Data obtained from Datastream
2 Data available from the K. R. French data library website

**Table 1 Coefficient of the regression model between Southwest' returns and all the factors**

|              | Estimate | Std. Error | T value | P-value  |
|--------------|----------|------------|---------|----------|
| **Intercept** | 0.80968  | 0.42420    | 1.909   | 0.05686  |
| **RmRf**      | 1.05969  | 0.09677    | 10.950  | <2e-16   |
| **SMB**       | 0.40583  | 0.14909    | 2.722   | 0.00671  |
| **HML**       | 0.37190  | 0.12572    | 2.958   | 0.00324  |
| **R²**        | 0.2358   |            |         |          |
| **Adjusted R²** | 0.2313 |            |         |          |
| **F-statistic** |        |            |         | <2.2e-16 |

Note: Data obtained by using the statistical program R-studio

However, the three factors model has some limits and the main one is that this model is not able to describe returns of all portfolios. In an implicitly way it seems to recognise the Roll's (1977) critique of the CAPM where the true market portfolio does not exist. In addition, this model is not able to explain the returns generated in the short-terms because of the reasonless behaviour that investors assume in the short-term (Fama and French, 1996).

An evolution of the three factors model is used by Lam et al. (2010) by analysing the Hong Kong stock market and by using a four factor model which is based on the Fama-French three factors model plus a fourth factor that is the momentum, which declares that a company with good past performance will continue to have high performance in the near future. Moreover, Lam et al. (2010) investigate the security market from July 1981 to June 2001, regarding 689 companies which are part of the Hong Kong Stock Exchange, by creating twenty-five portfolios. According to Lam et al. (2010), this model is still valid during strong fluctuation of the market place. For this specific case the four factors model is a good financial tool.

A really new and innovative approach is the five factors model of Fama and French (2014) which is based on the previous three factors model enhanced by the factors RMW, which represents returns of mixed portfolio composed by stock with strong profitability, and CMA, which expresses the relation among stocks of weak and strong attitude of firms to invest. Although not perfect, this model can predict around 71% and 94% of the trend of the future returns (Fama and French, 2014).

## 1.5 Other empirical research on the multifactor approach

Often the real financial world and investors' behaviour do not allow the CAPM to work in a proper way, due to the different ways in which the investors can react to the announcement of good or bad financial information (Lakonishok et al., 1993). For a good approximation of returns in presence of risk the best alternative is to use the multifactor approach because it allows to consider and add several parameters useful for detecting which are the factors that can explain in a better way the stock returns. The first step in order to decide about the goodness of a model is to detect the economic conditions, after that it is possible to decide which is the best model (Mackinlay, 1994).

A recent research, conducted by Bertholdy and Peare (2004), compares the performance of the CAPM and the Fama-French three factors model and discovers that for an individual stock the CAPM can forecast only 3% of the returns. Conversely, in this specific case, the three factors model can achieve the 5% of forecast of the return of the underlying stock (Bertholdy and Peare,

2004). The result is obtained by analysing the daily prices between the years 1970 – 1996 from the Center for the Research in Security Prices (CRSP), and are considered only stocks that have been traded more than 96% of the period in question (Bertholdy and Peare, 2004). Moreover, Bertholdy and Peare (2004) focus their attention on six likely market portfolios, by choosing four from CRSP, Standard and Poor's Composite Index, Morgan Stanley Capital World Index and Economy Index.

An additional prove that the CAPM is not a proper method in order to predict the stock returns come up from Gonzàles (2001) that analyses the stock market of the capital city of Venezuela, by detecting eight different portfolios during the year 1992 - 1998. The final result reports that for the Caracas Stock Exchange the CAPM is not a good tool because of the nature of developing country of Venezuela, thus the stock market is not well constructed and also because it is affected by the trend of the oil price (Gonzàles, 2001).

## Conclusion

To sum up, this article analyses the main characteristics and limitations of the CAPM trying to understand how the APT and Multifactor Approach can help this model in predicting securities' returns. Although several researchers have criticized the goodness of the CAPM and its assumptions, often deemed to be unrealistic and unreliable, by analysing the literature it seems that it is often difficult to find a model that can predict the returns but it is clear that the Multifactor Approach is able to depict in a more reliable way the future stock's returns. The APT also has limitations such as the incalculable quantity of securities and the observable factors that can alter the returns' trend. Often, the latter are unknown and difficult to predict in advance. In addition, the limit of infinite number of securities can be defeated by making the market as efficient as possible. On the other hand, the main advantage of the Multifactor Approach is that the market portfolio or index is not considered the main source of information any more, but other accounting features can be introduced in the forecast process of the returns. Like any model, even the Multifactor Approach has some limits and the main one is that this model is less reliable in the short-terms because of the reasonless investors' behaviour. Evolutions of the three factors model are described by Lam et al. (2010), who adds the momentum effect. It does not seem possible to give an indisputable conclusion on the poor quality of the CAPM and this area is still field of study, as demonstrate by the recent research of Fama and French (2014) but it is possible to say that other models can explain in a better way the stocks' returns.

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## APPENDIX

### Fitting regression model between Southwest Airlines returns and each factor

By fitting the regression model between the company's return and each single factor, under the null hypothesis that the beta of each factor is equal to zero, at significance level of 0.05 the null hypothesis is rejected because the explanatory variables, RmRf and SMB report a P-value of <2e-16 and 1.09e-07 respectively. Thus, the two factors have an explanatory power of the company's returns. Moreover, by looking at the value of R2, RmRf and SMB can explain 21.32% and 5.237% of the changes in the Southwest' returns respectively.  However, the HML factors records a high P-value of 0.62423 and in this case, at a significance level of 0.05 the null hypothesis must not be rejected, thus the HML factor has no explenatory power. In addition it is observable that the value of its R2 is extremely low, reaching the figure of 0.04718%.

### Table 1 Coefficient of the regression model between Southwest' returns and RmRf

|           | Estimate | Std. Error | T value | P-value |
|-----------|----------|------------|---------|---------|
| Intercept | 0.99678  | 0.42649    | 2.337   | 0.0198  |
| RmRf      | 1.08719  | 0.09256    | 11.745  | <2e-16  |

Note: The result are obtained by running a regrassion model between the Southwest's returns and RmRf. The R2  of the model is 0.2132, meaning that 21.32% of the changes in Southwest' returns are explained by the RmRf. The null hypotesis Ho: β=0 is rejected because P-value is less than 0.05 significance level.

### Table 2 Coefficient of the regression model between Southwest' returns and SMB

|           | Estimate | Std. Error | T value | P-value  |
|-----------|----------|------------|---------|----------|
| Intercept | 1.3820   | 0.4664     | 2.963   | 0.00319  |
| SMB       | 0.8368   | 0.1578     | 5.304   | 1.09e-07 |

Note: These outputs are obtained by running a regrassion model between the Southwest's returns and SMB. The R2  of the model is 0.05237, which indicates that 5.237% of the changes in Southwest' returns are explained by SMB. The null hypotesis Ho: β=0 is rejected because P-value is less than 0.05 significance level.

### Table 3 Coefficient of the regression model between Southwest' returns and HML

|           | Estimate | Std. Error | T value | P-value  |
|-----------|----------|------------|---------|----------|
| Intercept | 1.55848  | 0.47916    | 3.252   | 0.00122  |
| HML       | 0.06896  | 0.14068    | 0.490   | 0.62423  |

Note: These figures are obtained by running a regrassion model between the Southwest's returns and HML. The value of R2 is 0.0004718, which means that 0.04718% of the changes in Southwest' returns are explained by HML. The null hypotesis Ho: β=0 is not rejected because P-value is higher than 0.05 significance level.

PAPER

# Sovereignty and International Engagement:
# Could China Intervene?

## Nicusor-Sever-Cosmin Florea

**Abstract** The current article attempts to identify the most relevant dimensions which shaped China's involvement with the international community and law. I contend that these dimensions should include the Chinese reading of "sovereignty" as a legal concept and China's increasing willingness to commensurate her dramatic economic development with an adequate position in the international system. Finally, I will analyze whether China is willing to read her mainstay of foreign policy, the Five Principles of Peaceful Co-existence, in a new key, that is to intervene in order to protect her growing interests abroad.

The first part of the article will review the historical developments as well as the main theoretical considerations regarding China's Five Principles. The second part sets to provide some insights into China's evolution from perhaps the most notable absentee of the international system to one of the most assertive ones. Finally, I will move on to analyze whether, in the light of China's evolution and guiding principles of international engagement, China could witness another major change in her relationship with the world. I will, in other words, assess whether China could, at some point in the foreseeable future, leave behind her sovereignty stance and intervene, if needed, in order to protect her interests overseas.

**Keywords** China - Five Principles of Peaceful Co-existence - Humanitarian intervention
International Law - non-intervention

## 1. China's Five Principles of Peaceful Co-existence: From Foreign Policy to Principles of International Law

China has undergone dramatic changes in her international relations practices since the proclamation of People's Republic of China on October 1, 1949. Provided the economic reform and opening up, China came across a significant array of transformations, with a distinct turn since the end of the Cold War. Coming all the way from the periphery of the global stage, China is now a fully engaged actor in world affairs.

The Five Principles of Peaceful Coexistence ("Five Principles") represent not only a Chinese foreign policy guideline but one of the country's major contributions to the development of international law[1]. According to some, the Five Principles are China's first mark on the

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1 Tieya WANG, *International Law in China: Historical and Contemporary Perspectives*, 221 Recueil Des Cours, The Hague Academy of International Law, Brill Nijhoff, 1990, p. 263

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international law and order[2] though others see them as a reiteration of the Westphalian norm of sovereignty and non-intervention[3]. Finally, some have attributed them the legal status of jus cogens[4]. During his key-speech at the Central Conference on Work Related to Foreign Affairs of the Central Committee of the Communist Party of China, in November 2014, President Xi iterated a comprehensive plan for China's new diplomacy while stressing the importance of the Five Principles:

> *"...Chinese diplomacy must insist on the democratization of international relations. We adhere to peaceful co-existence, the sovereign equality of all States. (...) We oppose hegemonism and power politics..."[5]*

Initially declared in the Preamble of the Agreement between the People's Republic of China and the Republic of India on the Trade and Intercourse between the Tibet Region of China and India of April 29, 1954, the Five Principles stated that both countries agree to adhere to the following principles while conducting their bilateral relations:

a. mutual respect for each other's territorial integrity and sovereignty;
b. mutual non-aggression;
c. mutual non-interference in each other's internal affairs;
d. equality and mutual benefit;
e. peaceful coexistence."[6]

Two months later, on June 28, 1954, the Prime Ministers of China and India agreed that the Five Principles "should be applied in their relations with countries in Asia, as well as in the other parts of the world (…) in international relations generally."[7]

The following day, in the joint statement signed by the Prime Ministers of People's Republic of China and the then Union of Burma, the two countries agreed that "if these principles could be observed by all countries, then the peaceful existence of countries of different social systems could be assured."[8] The Five Principles thus made the first step towards international recognition. Given the Chinese history of Western semi-colonialism and the iteration of the Five Principles, in a slightly different shape, at the very Proclamation of People's Republic of China, it becomes clear that we are looking at the ultimate denouncement of infringement upon a country's sovereignty and, at the same time, at a stern declaration that such an infringement will never be performed by China[9].

Not only did China foster the Five Principles internally or bilaterally, but it also sought to proclaim

2 Shishi LI (李适时), President of Chinese Society of International Law, Enrich the Connotation of the Five Principles of Peaceful Co-existence in the New Era, remarks at the International Colloquium on the Five Principles of Peaceful Co-existence and the Development of International Law, Beijing, May 27, 2014
3 Amitai ETZIONI, G. John IKENBERRY, *Point of Order: Is China More Westphalian Than the West?*, Foreign Affairs, Vol. 90, No. 6, 2011, pp. 172-176
4 Edward McWHINNEY, *The Renewed Vitality of the International Law Principles of Peaceful Co-existence in the Post-Iraq Invasion Era: The 50th Anniversary of the China/India Panchsheel Agreement of 1954*, Chinese Journal of International Law, No. 3, 2004, pp. 379, 382
5 It should be noted that the Central Conference on Work Related to Foreign Affairs was the second such conference since the establishment of People's Republic of China. Orig. in Chinese, my transl.,中国外交必须具有自己的特色——论贯彻落实中央外事工作会议精神 *(Chinese Diplomacy Must Have its Own Characteristics: Comments on How to Reflect the Spirits of Central Conference on Work Related to Foreign Affairs)*, article available at http://news.xinhuanet.com/world/2014-11/30/c_1113462155.htm, accessed on October 8, 2015
6 For the full text of this agreement (which entered into force on 3 June 1954, following exchange of notes), see *UN Treaty Series*, vol. 299, UN, pp. 57-81, available at http://treaties.un.org/doc/publication/unts/volume%20299/v299.pdf, accessed on October 8, 2015
7 Ibid.
8 *Treaty Series of the PRC (Treaty Series)*, Vol. 3, 1954, p. 13, quoted in WANG, *op. cit.*, p. 263
9 For an excellently documented approach of the role semi-colonialism played in shaping China's national narrative, The Five Principles included, see WANG, *op. cit.*, pp. 205-263

them internationally. In the first treaty concluded by People's Republic of China, namely the Sino-Soviet Treaty of Friendship, Alliance and Mutual Assistance of February 14, 1950, it was stipulated that the relations between the two countries are to be conducted

> *"... in accordance with the principles of equality, mutual benefit, mutual respect for national sovereignty and territorial integrity and non-intervention in the internal affairs of the other party"[10].*

In the advent of the official proclamation "The Five Principles of Peaceful Coexistence" were embodied in bilateral and multilateral treaties and agreements, declarations of governments, resolutions of international bodies and official speeches[11]. Another major international development of the Five Principles was achieved during the Bandung Conference of 1955, when the Ten Principles of Bandung embodied the Five Principles, extending them to 29 Asian and African participant countries. McWhinney notes that "The Five Principles of Peaceful Coexistence has an obvious imprint upon the 1955 Asian-African Conference at Bandung and Its Ten Principles."[12] Perhaps the crux of the international affirmation of the Five Principles was achieved in 1970, when the "Declaration on Principles of International Law concerning Friendly Relations and Co-operation between States in Accordance with the Charter of the United Nations (UN)" was adopted by acclamation in the 20th Session of the General Assembly[13]. Initially proposed by 12 Asian, African and Eastern European countries during the 16th Session of the General Assembly in 1961, the item "Consideration of Principles of International Law concerning Peaceful Coexistence among States" has met objection on behalf of several Western countries, given the use of "peaceful coexistence among States." The phrase was later changed to "friendly relations and co-operation among States in accordance with the Charter of the UN" and a special committee was set up to codify the guiding principles in 1963. Following seven years of deliberations, the Principles were eventually adopted in 1970[14].

The importance attached by the Chinese government to the Five Principles cannot be stressed more. Inspired by the torment of the Chinese people during the "century of humiliation" and proclaimed since the very foundation of the People's Republic of China, they have made their way into international law in less than two decades. It should also be noted that the Five Principles also served as a doctrinarian must for China, since, as a non-member of the UN until 1972[15], it did not formally adhere to the UN Charter and consequently needed a programme to conduct its foreign policy[16]. The long international saga of the Five Principles continues to this

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10 Art. 5 of the *Sino-Soviet Treaty of Friendship, Alliance and Mutual Assistance*, signed on February 14, 1950, Treaty Series, Vol. 1, 1949-1951, p. 2, quoted in WANG, op. cit., p. 264

11 According to an early inventory in 1963, various instruments of affirming the Five Principles were signed by Afghanistan, Burma, Cambodia, Ceylon (Sri Lanka), People's Republic of China, India, Indonesia, People's Republic of Korea, Laos, Mongolia, Nepal, Saudi Arabia, Thailand, United Arab Republic and Vietnam (in Asia), Dahomey, Egypt, Ethiopia, Ghana, Guinea, Liberia and Sudan (in Africa), Albania, Austria, Belgium, Bulgaria, Czechoslovakia, Finland, France, German Democratic Republic, Hungary, Poland, Romania, USSR and Yugoslavia (in Europe) and the United States of America (in North America). See Ian BROWNLIE, *International Law and the Use of Force*, London, 1963, Part. I, Chapter VI, Appendix I, Instruments affirming the Five Principles of Peaceful Coexistence, pp. 123-126

12 Edward McWHINNEY, *The "New" Countries and "New" International Law*, American Journal of International Law, Vol. 60, 1966, p. 2

13 *Resolution 2625*, adopted without vote, UN Yearbook, 1970, pp. 784-788

14 See the *United Nations Yearbook*, 1962, pp. 487-488 and the *United Nations Yearbook*, 1963, Resolution 1963, p. 518

15 See *Note 30*

16 This argument was stressed in a personal discussion with Prof. Li Juqian, to whom I remain grateful for the pertinent remark and kind supervision.

day when the Principles are still appealed to[17] with a frequency that recommends them as the mainstay of Chinese foreign policy. It is in this context that Xue Hanqin notes:

> *"...political wisdom of the Five Principles and the Bandung spirit has stood the test of State practice and the change of times."[18]*

Behind their rhetorical aspects, the Five Principles have known a sinuous dynamic as Chinese foreign policy practice, if not international law principles. Though constantly reaffirmed on a political level, their interpretation, as reflected by China's conduct in the international arena, leaves room for discussion. Whether the Five Principles deterred or catalyzed China's integration in the international community in the advent of its membership in the UN will be elaborated in the following chapter.

## 2. Towards a Liberal Foreign Policy: From Absence to Major Power

The Chinese foreign policy dynamics have been ascertained both by Chinese[19] and Western[20] authors. China's spectacular rise generated a multitude of international reactions academically, arguing for containment, the so called "China Threat Theory"[21]. The current chapter, argues, however, that China is moving towards a more participative approach of international relations, even if such an approach may come at some costs for China's heavily promoted sovereignty approach. Given the existent rhetoric of Beijing, namely the sovereignty approach, in the shape of the Five Principles, it is expected that China will not dismiss it in the foreseeable future. The rise of China, however, corroborated with the reaffirmation of the sovereignty theory, should be interpreted as an emerging Asian-centric international system.

In addition to being one of the five permanent members of the U.N. Security Council, China has rapidly increased its political influence worldwide, downplaying views on diplomatic matters yet unwilling to force other countries to accept her position. A Chinese influence is obvious in Southeast Asia, South Asia, Central Asia, Middle East, Latin America, and, perhaps most notably, Africa[22]. Using data on bilateral trade between China, on one hand, and Africa and Latin America, on the other hand, two Cornell University scholars concluded that the more states trade with China, the more likely they are to converge with China on issues of foreign policy[23]. Such an influence, however, shall not be associated with the penchant of Western powers to engage in military and political interventions beyond their borders, under justifications ranging from the "standard of civilization" (permitting "civilized" states to intervene against "uncivilized" nations) to the doctrine of humanitarian intervention, principles of human rights and, most recently, the responsibility to protect. The Chinese reemphasis of the Five Principles should be interpreted as a tendency to resist such interventionist tendencies and arguably a shift

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17 See *Note 7*

18 Hanqin XUE, *Chinese Contemporary Perspectives on International Law,* 355 Recueil Des Cours, The Hague Academy of International Law, Brill Nijhoff, 2012, p. 69

19 See XUE, *op. cit.*, pp. 186-218

20 Justin S. HEMPSON-JONES, *The Evolution of China's Engagement with International Governmental Organizations: Toward a Liberal Foreign Policy?*. Asian Survey, Vol. 45, No. 5, 2005, pp. 702-721

21 See, inter alia, Joseph NYE, *The Challenge of China*, in Stephen Van EVERA (ed.), *How to Make America Safe: New Policies for National Security*, Cambridge Massachusetts, Tobin Project, 2006, Kenneth WALTZ, *Structural realism After the Cold War*, International Security, Vol. 25, No. 1, 2000, Zbigniev BRZEZINSKI, John MEARSHEIMER, *Clash of the Titans*, Foreign Policy, No. 46, 2006

22 Chang-fa LO, *Values to Be Added to an "Eastphalia Order" by the Emerging China*, Indiana Journal of Global Legal Studies, Vol. 17, No. 1, p. 15

23 Gustavo A. FLORES-MACIAS, Sarah E. KREPS, *The Foreign Policy Consequences of Trade: China's Commercial Relations with Africa and Latin America, 1992-2006*, The Journal of Politics, Vol. 75, No. 2, April 2013, pp. 357-371

of power and influence everywhere these principles have been mutually reaffirmed by China and its international partners. China's tenets, however, are not purist in their nature and allowed, at times, a partial cessation of the rights of sovereignty on behalf of some states, as we will discuss later.

Such tendencies are accurately described in Xue's three-phase analysis of China's multilateral relations[24]. Between 1949-1971, China was largely absent from the international relations. Though China saw the UN in a very positive light, her attitude was dramatically reshaped by the standing of the United States in the Korean War, the deployment of US forces in the Taiwan Straits and the US decision to block People's Republic of China accession into the UN. Under these circumstances, China took the view that the UN has been instrumentalised as a US tool of imperialism. People's Daily, the mouthpiece of the Communist Party of China, best summarized this attitude in 1965, by asking rhetorically:

> *"What kind of thing is the UN? It is the tool of US imperialism, number one overlord, and the Soviet revisionist ruling clique, number two overlord, to press ahead with neo-colonialism and big-nation power politics."[25]*

China, however, conducted multiple activities with other socialist countries and took part in the World Democracy Alliance, International Students Union and International Women's League. It took part in the 1854 Geneva Conference on Indo-China and, as shown earlier[26], recorded a major success at the 1955 Bandung Asia-Africa Conference. During the 1971-1978 period, China maintained its attitude towards US which it perceived as controlled by the major powers. Following Chairman Mao's "three worlds" theory, China ardently called for the third world countries to closely work together and cooperate with second world countries in order to counterbalance the first world countries (largely seen as USA and USSR). China held strong reservations towards human rights, disarmament and international law and never took floor in the International Law Commission of the UN. Most importantly, China took a stern stance against foreign intervention in internal conflicts under Article 2 (7) of the UN Charter and refused to take part in the voting. Between 1971 and 1976, China was absent 46 times out of 156 voting sessions of the Security Council. The post 1978 stage saw a move from a selective approach to a full partnership with the international institutions. China's candidate, Ni Zhengyu, was elected to the International Law Commission in 1982 and, in 1988, China formally applied to join the United Nations Special Committee to Peace-keeping Operations. In 1990, China sent, for the first time, five military observers to the United Nations Truce Supervision Commission (UNTSO) and it 1992 it dispatched an engineering corps to the United Nations Transitional Authority in Cambodia (UNTAC). As of September 30, 2015, China is the 9th largest contributor to the UN peace-keeping missions and the largest contributor among the permanent members of the Security Council with 3040 Police, UN Military Experts on Mission and Troops deployed[27]. China voted for the establishment of the UN Transitional Authority in Cambodia (UNTAC). Unlike the peace-keeping missions previously approved by Beijing, UNTAC ran a rudimentary national administration, supervised elections, returned refugees and demobilized the warring factions. The Chinese Ambassador to UN Li Zhaoxing praised UNTAC for its peaceful means of

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24 The current paragraph is based on Hanqin XUE, *op. cit., Chapter V: Multilateralism and Regional Co-operation*, pp. 186-218

25 *Renmin Ribao (People's Daily)*, July 8, 1967

26 *See the paragraph on Bandung conference*

27 ***, *Contributors to the United Nations Peace-keeping operations*, as of September 30, 2015, table available at http://www.un.org/en/peacekeeping/contributors/2015/sep15_1.pdf, as accessed on October 15, 2015

resolving regional conflicts[28]. In the same year, China supported the Resolution 751 setting up the UN Mission in Somalia (UNOSOM) and the Resolution 794 supporting the Unified Task Force (UNITAF), "to use all necessary means to establish as soon as possible a secure environment for humanitarian relief operations in Somalia"[29]. It should be noted that UNITAF interfered in Somalia's internal affairs and violated the state's sovereignty; the Chinese Ambassador to UN however claimed that such an intervention occurred on an exceptional basis "in view of the unique situation"[30]. The trend continued with China's support for the UN Mission in East Timor (UNAMET, tasked only with election monitoring), the International Force for East Timor (INTERFET) and the UN Transitional Authority (UNTAET). The last was mandated with a wide range of attributes ranging from issuing postage to signing international treaties[31], yet it benefited from Beijing's active support in the Security Council. It should be noted that, along with Russia, China did not attend the "Friends of Syria" conference organized by the Arab League in Tunisia which in turn generated the Kofi Annan Peace Plan for Syria, one of the objectives of UN Resolution 2043[32]. Similarly, People's Republic of China vetoed any sanctions imposed upon Federal Republic of Yugoslavia (on Kosovo), Sudan (over Darfur crisis) and, more recently, Syria.

This indicates, behind an undeniable pragmatism which does not make the object of the current article, that Beijing followed an independent line, not necessarily positioning itself according to the objectives prioritized by Washington, as some suggested[33]. China's attitude toward the UN peacekeeping missions in Cambodia, Somalia and East Timor showcases a hardline defense of absolute sovereignty which has given way to a pragmatic stance which sanctions, to a certain degree of extent, a level of interference.

Interestingly, Carlson finds China's dynamic foreign policy doubled, in real-time, by the academic argumentation of sovereignty. Not only that a softer stance on sovereignty was showcased in the Chinese academia but the number of articles dedicated to the issue of sovereignty increased[34]. Foot suggests that such a change should be explained in a three-folded approach: firstly, many Chinese elites have come to accept the legitimacy of multilateral approach to resolve humanitarian interventions; secondly Beijing's new Security Council voting precedents set during the 90s have created a new foreign policy standard; finally, given Beijing's increasing military might, a response was necessary to reassure the international community that China should not be regarded as a threat[35].

The UN integrative involvement and the dynamics of economic interaction were also mirrored on the political level. In the early 1990s, in the advent of the Cold War, China normalized its relations with Indonesia, Vietnam, Singapore and Republic of Korea. It began the dialogue with the Association of Southeast Asian Nations (ASEAN) and joined the Asia-

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28 M. TAYLOR FRAVEL, *China's Attitude toward UN Peace-keeping Operations since 1989*, Asian Survey, Vol. 36, No. 11, 1996, p. 1110

29 *Resolution 794 (1992)*, available at http://www.un.org/en/ga/search/view_doc.asp?symbol=S/RES/794(1992), as accessed on October 8, 2015

30 Ambassador Li Zhaoxing quoted in FRAVEL, *op. cit*, p. 1113

31 James TRAUD, *Inventing East Timor*, Foreign Affairs, Vol. 79, No. 4, 2000, p. 74

32 Resolution 2043 (2012), available at http://www.un.org/en/ga/search/view_doc.asp?symbol=S/RES/2043(2012), as accessed on October 8th, 2015

33 Allen CARLSON, *Helping to Keep the Peace (Albeit Reluctantly): China's Recent Stance on Sovereignty and Multilateral Intervention*, Pacific Affairs, Vol. 77, No. 1, p. 14

34 *Ibid.*, p. 18

35 Rosemary FOOT, *Chinese Power and the Idea of a Responsible State*, The China Journal, vol. 45, 2001, pp. 1-21

Pacific Economic Cooperation (APEC). It also founded the ASEAN Regional Forum and lead to the formation of eight major regional mechanisms[36]. After previously lying the grounds for the Shanghai Five, China founded in 2001, along with Russia, Kazakhstan, Kyrgyzstan and Tajikistan, the Shanghai Cooperation Organization with the Secretariat in Beijing. Mooted by President Xi on September 2013, the "One Belt One Road" initiative is expected to become a multi-continental platform for outward investments, economic exchanges, regional development and political stability. Adjacently, 2014 saw the announcements of several international financial institutions with China as a leading founding partner: the New Development Bank (NDB), the Asian Infrastructure Investment Bank (AIIB) and the Contingent Reserve Arrangement.

Be it on economic or political level or on participation in peace-keeping missions, it is a matter of common sense that cooperative interaction between states and other international political actors is more likely to occur in a liberal setting rather than a realist state-centered outlook. What is particularly noticeable here is China's exponential growth within the international arena. As Kenneth Waltz predicted "China will emerge as a great power even without trying very hard so long as it remains politically united and competent."[37] The evidence above suggests that China competency resided in moderating its realist paradigm approach and slowly moving towards a more liberal, yet little predictive, international engagement model. China's use of international cooperation to garner acceptance and economical support partially discarded its absolute view on sovereignty and established new foreign policy practices. To which degree of extent these new practices are prone to further dynamics and where are they mostly likely to geographically occur will be answered in the following chapters.

## 3. Could China Intervene?

The purpose of this Chapter is to establish whether China could intervene in another state's affairs, to what extent and to which political costs, given its previous stance on foreign policy as expressed by the Five Principles and, as shown above, even earlier since the very proclamation of People's Republic of China. First, I will try to briefly define intervention, as distinct from interference in another state's affairs[38], and showcase how it is sanctioned by the international law, taking into account both doctrine and substantive law. Secondly, I will attempt a brief historical review of intervention in the Chinese setting, however incomplete my account might be. Lastly, I will try to examine whether China could intervene, under which circumstances and to which political costs.

In a broad sense, intervention could be used to define an action of a person, organization or state aimed at another, person, organization or state. Sensibly, the current article deals with interventions as undertaken by foreign actors of international law, precisely states, in an organizational setting (such as an international organization or an ad-hoc "coalition of the willing"), aiming at another state. In this sense, James N. Rosenau defines intervention as "any

36 Namely ASEAN Community, ASEAN and China-Japan-Republic of Korea partnership, ASEAN with each of the three partners, East Asia Summit, ASEAN Regional Forum, Greater Mekong Sub-region Economic Cooperation and Asia-Pacific Economic Cooperation. For further information on China's regional integration efforts see Yaqing QIN (ed.), *East Asian Cooperation: 2009*, Economic Science Press, 2010, pp. 27-141

37 Kenneth WALTZ, *Structural Realism After the Cold War*, International Security, Vol. 25, No. 1, 2000, p. 32

38 It is the author's view that "interference" is too vague a concept to indicate whether and at which times it occurred, beyond the shadow of a doubt. I would leave that task to other scholars, more knowledgeable and academically wise than myself.

action whereby one state has an impact upon the affairs of another"[39]. For Wolfgang Friedman, an intervention is "almost any act of interference by one state in the affairs of another"[40], even if, apparently, it generates little or no impact. Ramses Amer distinguishes between "behavioural" and "traditional" school in the academic debate on intervention. While behaviouralists would have a systematic take on interventionary behavior, traditionalists would rather provide discussion with a general perspective[41]. For the purpose of the current study, the author understands intervention as a military action of one or more states, within the confines of the respective state, which may or may not alter the internal affairs of the respective state and is performed at or against the will of the incumbent government of that respective state.

The international legal order, as we know it today, underlies two equally consistent foundations, though, as we will see later, subject to dynamics. Firstly, the principles of sovereignty and non-intervention, ideas that paved the way of the modern state system since the Treaty of Westphalia in 1648. Secondly, the obligation to refrain from the use of force in international relations, as established by the Article 2 (4) of the United Nations Charter. Under two exceptions, however, the use of force is allowed: firstly, under Article 51 of the Charter states are allowed to use force for self-defence, secondly, under Chapter VII of the Charter, the United Nations Security Council may authorize the use of force to restore or maintain the international peace. It should be noted that the Security Council has only authorized two[42] such use of force in the past fifteen years.

It should be noted that the wording of the whole Charter was based on a series of compromises reached by the original member-states, seeking to accommodate each other's views and, consequently, has sometimes been interpreted as "ambiguous" and "unclear"[43]. Such is, inter alia, the wording of Article 2(4), which could be interpreted in a double folded manner: firstly, "force" could be restrictively interpreted as "armed force" being used against the territorial integrity of a state, secondly, "force" could be extensively interpreted as any action undertaken against the territorial or political integrity of a state. Similarly, a restrictive interpretation of Article 51 would argue that the use of force is only permitted when an "armed attack" occurs, while an extensive read of the same article would render a "pre-emptive" or even "preventive"[44] use of self-defence legal[45]. The interventionary experiences of the past decades indicate a recurring

39 James N. ROSENAU, Intervention as a Scientific Concept, Journal of Conflict Resolution, Vol. 13, No. 2, 1969, p. 153

40 Wolfgang FRIEDMAN, Intervention and International Law I, in Louis G.N. JAQUET (ed.), Intervention in International Politics, Netherlands Institute of International Affairs, Martinus Nijhoff, Hague, 1971, p. 40
41 Ramses AMER, *The United Nations' Reactions to Foreign Military Interventions*, Journal of Peace Research, Vol. 31, No. 4, p. 426
42 Resolution 678 (1990), Adopted by the Security Council at its 2963rd meeting, on 29 November 1990, also available at http://www.refworld.org/cgi-bin/texis/vtx/rwmain?docid=3b00f16760, and, more recently Resolution 1973 (2011), Adopted by the Security Council at its 6498th meeting, on March 17, 2011, also available at http://www.un.org/News/Press/docs//2011/sc10200.doc.htm, both accessed on October 10, 2015
43 See, among others, Ian BROWNLIE, *The Use of Force in Self-Defence*, British Yearbook of International Law, Vol. 37, 1962, pp. 223-233
44 For a discussion among the differences between the two terms, see Bob HOWARD, Intervention and Prevention: How Dangerous?, AQ: Australian Quarterly, Vol. 77, No. 4, 2005, p. 24  Of at least equal importance in assessing the right to self-defence is the "Caroline Test", excellently detailed in Thomas M. NICHOLS, The Coming Age of Preventive War, University of Pennsylvania Law Press, Philadelphia, 2008, p. 2-4
45 AMER, op. cit., p. 429

legal justification grounded on humanitarian principles[46] protection of nationals[47], pre-emptive force[48], treaty-based intervention[49] or the more recently-coined "responsibility to protect"[50]. The current article, however, will only deal with intervention as justified by humanitarian principles and only marginally approach the issue of treaty-based intervention.

In a refined doctrinarian analysis, Bhikhu Parekh defines four attributes of intervention, as follows:

- The State that is the object of intervention must be widely acknowledged to be sovereign;
- It implies that the act is designed to influence the conduct of the internal affairs of a state, and not to annex or to take it over;
- If the country concerned is opposed to it. Otherwise, Parekh continues, it becomes a case to a willing support of a party. Under this point, the scholar seems to elaborate too little on who is qualified to ask for such a support in a difficult situation, such as, for instance, civil strife.
- Immigration, trade, fiscal, foreign and other policies could be easily and with profound effects influenced by other states. Bribing politicians or journalists, secretly funding political factions or infiltrating the ranks of dissidents does not constitute intervention for Parekh[51].

Jack Donnelly[52] suggests three models of normative status of sovereignty, each corresponding to a different degree of accepting humanitarian intervention, at the expense of sovereignty yet to the purportedly higher end of defending human rights. Firstly, statism[53] involves full responsibility of the perpetrating state and allows no right to intervene. The model is therefore deemed conservative and leads to impassivity in the humanitarian intervention debate. Internationalism[54] acknowledges the centrality of states and their respective sovereignty yet stresses on the international social practices that regulate interstate relations. Intervention is not unilaterally permissible, but only when it is sanctioned by the society of states. Donnelly argues that the statist model was valid before the World War II, while the internationalist model prevails nowadays. Lastly, cosmopolitanism[55] assumes that the international system consists of individuals rather than states. Sovereignty is totally dismissed and the real issue is centered upon meeting the needs of the world's citizens. The burden of proof does not lie on the states initiating humanitarian

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46 It is the author's view that humanitarian intervention is of military action and involves maintaining or recreating peace and order with the aim of relieving suffering. Humanitarian aid distinctly seeks to relieve suffering, not necessarily creating peace and order. Political intervention seeks to impose a specific structure of civil authority, while refraining to use military intervention on behalf of another state.

47 Employed, inter alia, by the United Kingdom in the Suez intervention (1956), Israel in Entebbe (1976) and the United States of America in the Dominican Republic (1965), Grenada (1983) and Panama (1989).

48 Most recently employed by the Unites States of America in Iraq (2003) but rejected by the International Court of Justice since the *1986 Nicaragua v The United States of America* case.

49 Used by Turkey during the 1975 invasion on Cyprus and justified through the 1960 Cyprus Treaty of Guarantee. For a comprehensive and authoritative view on the effect of consent to intervention and international treaties to settle internal conflict, see David WIPPMAN, Treaty-Based Intervention: Who Can Say No?, The University of Chicago Law Review, Vol. 62, No. 2, 1995, pp. 607-687

50 Most recently used in Libya (2011) and Central African Republic (2013).

51 Bhikhu PAREKH, *Rethinking Humanitarian Intervention*, International Political Science Review, Vol. 18, No. 1, 1997, pp. 53-54

52 Jack DONNELLY, *State Sovereignty and International Intervention: The Case of Human Rights*, in Gene M. LYONS, Michael MASTANDUNO (eds.), John Hopkins University Press, Baltimore, 1995

53 Ibid., pp. 120-121

54 *Ibid.*, p. 121

55 *Ibid.*, p. 121

intervention but on the bystander-states. In a sublime rhetoric spin, Donnelly adds that the norm of sovereignty, that is as vested in the individuals, can be violated not only by outside powers but also by indigenous use of force. The brief doctrinarian views presented above saw not only a wide and largely debatable variety of views over what is "intervention" and what is "humanitarian". It opens endless moral iterations of the necessity of preserving sovereignty or, on the contrary, of counter-balancing it for higher, human rights aims. It also allows one to ponder that, while humanitarian intervention has a strong element of ethical reasoning, the decision to eventually intervene in a particular situation can be easily hijacked into a political debate.

If the theoretical views appear to differ among each other to a large degree of extent, the legal practice, however, seems to leave little room for doubt. The use of human rights as grounds for humanitarian intervention has been fully dismissed by the International Court of Justice in the Nicaragua v United States of America case, as it follows:

> "With regard more specifically to alleged violations of human rights relied on by the United States, the Court considers that the use of force by the United States could not be the appropriate method to monitor or ensure respect for such rights, normally provided for in the applicable conventions."[56]

It is for this reason that Rodley observes that the doctrine of humanitarian intervention has been no longer invoked, not even in the formal legal justifications, though, in certain cases, it would have been expected. Among such cases, the scholar invokes India in respect of Bangladesh, Vietnam in respect of Kampuchea, Tanzania in respect of Uganda and the United States in respect of Grenada[57].

The balance between state sovereignty and humanitarian demands has, however, evolved, if not in the case law of the International Court of Justice, in the opinion of the most highly qualified international lawyers. Under this regard, for instance, the former Secretary General of the United Nations, Javier Perez de Cuellar has mentioned:

> "We are witnessing what is probably an irreversible shift in public attitudes towards the belief that the defence of the oppressed in the name of morality should prevail over frontiers and legal documents."[58]

Regarding the Chinese interventionary practices it should be noted that, despite the Five Principles discourse, the early history of People's Republic of China saw several instances in which the principles of sovereignty and non-intervention have been interpreted so they could fit the pursuit of either socialist-nurtured solidarity or national interest[59].

In 1955, for instance, immediately after iterating the Five Principles, China considered mandated to bring further clarifications to the principles in accordance to the proposition made by Stalin that intervention could occur militarily, economically or subversively. Chou Keng-Sheng therefore considered "indirect aggression" the refusal to interfere in the Spanish Civil War and consequently allowing the overthrow of the Republican Government. United Nations' instrumentalisation of international law to suit imperialistic purposes became evident, for China, in the UN's refusal to

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56 *Case Concerning the Military and Paramilitary Activities in and against Nicaragua (Nicaragua v United States of America)*, paragraph 268, Judgment of June 27, 1986, summary of the judgment available at http://www.icj-cij.org/docket/index.php?sum=367&p1=3&p2=3&case=70&p3=5, accessed on October 9, 2015
57 Nigel S. RODLEY, *Human Rights and Humanitarian Intervention: The Case Law of the World Court*, The International and Comparative Law Quarterly, Vol. 38, No. 2, 1989, p. 332
58 *Diplomatic World Bulletin*, Nol. 22, 1991 quoted in Christopher GREENWOOD, *Is There a Right of Humanitarian Intervention?*, The World Today, Vol. 49, No. 2, 1993, p. 35
59 As shown earlier during the second part of my study, China has known a dynamic passage from a purely realist view to a more liberal-oriented foreign policy.

interfere in South Africa's treatment of its Indian population and in France's control of Algeria[60]. The class character of humanitarian intervention was also sanctioned by the Chinese scholars:

> *"Imperialism considers as "inhumane" those countries in which the proletariat has political power and establishes a dictatorship over the reactionary forces. It considers as "inhumane" the punishment and suppression imposed by the people of a country upon conspiratorial elements who engage in rebellion and subversive activities supported by imperialism."[61]*

Whether intervention at the request of a government is lawful or not, does not receive a consistent reply on behalf of the Chinese scholars of the time. Chen Tichang, one of China's most prominent legal scholars at the time, wrote that "Acts of intervention in a state with the consent of the government of that state cannot be considered [illegal] intervention."[62] Two years later, however, in the context of the American intervention in Lebanon, at the request of the incumbent Chamoun government, the Chinese scholars held the view that USA has undertaken an "armed intervention in the Lebanon's internal affairs"[63]. In line to the new international developments, Beijing reiterated its standards of intervention, shifting from the previous "consent of the government" to "the genuine desires of the people"[64]. Such a discourse allowed China to decide on what is foreign intervention on the grounds of political expediency and to consequently and similarly condemn the aggression of the United States in Vietnam. It should be noted that China sought to reconcile the dictum of the Five Principles with the Marxist views on intervention[65] and noted that "the old international law jurists, who still adhere to the purely legalistic viewpoint", fail to recognize that international law is "simply a legal instrument in the service of a country, socialism and peace, to be used when useful but discarded when disadvantageous"[66].

With regard to the Soviet suppression of the Hungarian revolt and the invasion of Czechoslovakia, China deemed the former consistent "with the spirit of solidarity and cooperation between brother countries", yet condemned the second as "revisionist social-imperialist aggression"[67].

Concerning the Korean War, China held that the support granted was both humanitarian and self-defensive, as "action not only to assist a neighbor, but to protect our country."[68] During the Vietnamese War, China held the view that aggression against the Democratic Republic of Vietnam "means aggression against China" and sent up to 50,000 regular members of the People's Liberation Army to North Vietnam, where, with the consent of the government of the

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60 Keng-sheng CHOU, The Principle of Peaceful Coexistence From the Viewpoint of International Law, Cheng-fa ten-chiu, Vol. 6, 1955, pp. 37-41 quoted in Jerome Alan COHEN, China and Intervention: Theory and Practice, University of Pennsylvania Law Review, Vol. 121, No. 3, 1973, p. 479

61 Hsin YI, *What Does Bourgeois International Law Explain About the Question of Intervention?*. Kuo-chi Wen-t'I yen-chiu, Vol. 4, 1960, pp. 47-49, quoted in COHEN, *op. cit.*, p. 480

62 T'i-ch'iang CH'EN, *The Hungarian Incident and the Principle of Non-Intervention*, Kuang-ming jih-pao, April 5, 1957, p. 1, quoted in COHEN, *op. cit.*, p. 482

63 ***, *The Chinese Government Demands Withdrawal of U.S. Forces From Lebanon, Withdrawal of British Forces from Jordan*, Peking Review, July 22, 1958, p. 7, quoted in COHEN, op. cit., p. 482

64 ***, *Refuting the Loud Western Outcry Over the "Hungarian Issue"*, People's Daily, November 14, 1956, p. 1, quoted in COHEN, op. cit., p. 483

65 See Note 101

66 Li-lu CHU, *Refute Ch'en T'i-ch'iang's Absurd Theory Concerning International Law*, People's Daily, September 18, 1957, p. 1, quoted in COHEN, op. cit., p. 485

67 COHEN, op. cit, p. 488

68 Hsiu-ch'uan's WU, *Speech Regarding the American Aggression on China*, December 16, 1950, Chung-hua jen-min kung-ho-kuo tui-wai kuan-his wen-chien chi 1949-1950, 1957, pp. 219-237, quoted in COHEN, *op. cit.*, p. 490

Democratic Republic of Vietnam engaged in construction work and manned anti-aircraft defenses until 1969[69]. In line with the Five Principles' tenets, China mainly refrained from endorsing wars of national liberation in the Third World countries and did not export revolution nor terrorism[70]. The low profile attitude within the international arena continued under Deng Xiaoping, both due to the non-interventionist, sovereign-holding tenets of the Five Principles and as part of the "taoguang yanghui"[71] and "bu chu (sometimes dang) tou"[72] principles for guiding China's foreign policy[73].

Taking into account both the Chinese foreign policy transition from a realist perspective to a more liberally-guided integrative foreign policy of international cooperation and China's economic interests vested abroad, as shown in the previous chapter, the debate over the principle of non-intervention and, implicitly, the resilience of the Five Principles in China's foreign policy has been reignited. Pang Zhongying, Professor of International Relations at Renmin University, notes the strain posed by the Five Principles to China's foreign policy, provided its increasing engagement with the outside world and indicates China's long-held tenets of foreign policy as perhaps one of the country's largest security dilemmas[74]. In an earlier article, the Professor even argues that *"China should declare clearly that China intervenes globally, regionally, and multilaterally, but conditionally", and that "a global China . . . has to intervene"*[75]. Other Chinese scholars do not ask for a complete overhaul of the Chinese foreign policy, instead proposing an alternative interpretation of the principle of non-intervention. Cui Hongjian, researcher at the China Institute of International Studies (CIIS), argues that the mechanism and actions prescribing the principle of non-interference need to be amended, as the current understanding does not provide sufficient security guarantees for China's current level of engagement with the world[76]. It is expected that, given China's continuous economic growth and ever-increasing engagement with the inter-twined global economy, such voices claiming to revisit the Five Principles or, at least, to provide a different interpretation for some of them, would continue to raise.

The new National Security Law of People's Republic of China was passed on July 1, 2015, at the 15th meeting of the 12th National People's Congress[77], seems to echo the arguments above. Art. 33 of the Law reads: "The State takes necessary measures in accordance with law to protect

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69 WHITING, *How We Almost Went at War with China*, Look, April 29, 1969, pp. 76-77, quoted in COHEN, op. cit., p. 491

70 For very illustrative examples on China's non-interventionist conduct in this regard, see COHEN, *op. cit.*, pp. 494-497

71 Literally, hide brightness and nourish obscurity, meaning hide one's capacities and bide one's time.

72 Literally, don't raise one's head, meaning don't play a leadership role.

73 Quansheng ZHAO, *Interpreting Chinese Foreign Policy*, Oxford University Press, Oxford, 1996, pp. 53-54

74 Zhongying PANG, *China's diplomatic and economic influence is limited (orig. in Chinese, my transl.)*, Caogen,
August 25, 2013, article available at http://www.caogen.com/blog/infor_detail/52241.html/, accessed on October 10, 2015

75 Zhongying PANG, *Through Chinese eyes. Part 1*, Lowy Interpreter, December 22, 2011, article available at http://www.lowyinterpreter.org/post/2011/12/22/Through-Chinese-eyes-Pang-Zhongying-(part-1).aspx, accessed on October 10, 2015

76 Hongjian CUI, *It is time to update the security concept based on noninterference (orig. in Chinese, my transl.)*,
Huanqiu Shibao, July 28, 2012, article available at http://opinion.huanqiu.com/1152/2012-07/2961005.html, as accessed on October 10, 2015

77 For an unofficial English translation of the Law, see http://chinalawtranslate.com/2015nsl/?lang=en, as accessed on January 7, 2016

the security and legitimate rights and interests of overseas Chinese citizens, organizations and institutions; and ensures the nation's overseas interests are not threatened or encroached upon." Such a provision seems to legalize "necessary measures" to be performed by China, possibly abroad, in order to protect her "overseas interests", bringing into question an alternative reading of the Five Principles. It is yet to be established whether such "measures" would be conducted upon the agreement of the respective states or against their will.

The stance of non-intervention has met, as shown above, various forms of acceptance in the international relations. Though limitedly accepted by the International Law, humanitarian intervention, remains one of the most used vehicles for intervention. Varying according to national rhetoric and international circumstances, it has been successfully used and set precedents. However, a customary law on the matter is yet to be defined. China's stance, though largely compliant with the Five Principles, saw several episodes when their interpretation was finely tuned to correspond certain foreign policy interests. While such interests are currently evolving, it is expected for the Five Principles to be accommodated with China's current level of engagement with the world. Such a dynamic could discard the Five Principles completely, in the light of an overhauled foreign policy, or could see a reinterpretation of the principle of non-interference or even in the tenet of non-aggression. Provided China's complex dynamics and the past experience of incremental changes, the former scenario seems to be more likely.

## Conclusions

The current study has multiple drawbacks. First of all, it lacks comprehensiveness; the wide variety of state-actors behavior in the international arena corroborated with the large spectrum of formal legal justifications for non-intervention, or, on the contrary, in favour of, is simply overwhelming. Secondly, it is, perhaps, less accurate than expected. A better analysis could have been iterated following more active debates with the local scholars and decision-makers. The primary source of research, has been, however the existing international and domestic literature, especially the English-language scholarly articles. Thirdly, it is narrow in scope. It offers chiefly a review of the international relations and legal literature and consequently a standpoint based exclusively on these disciplines. A multidisciplinary approach, recalling perhaps more aspects related to the Chinese economics or military affairs would be desirable. It is the author's view, however, that the above mentioned downsides do not render the study futile, though they may narrow its conclusions. Further research is therefore advised.

Far from claiming predictability, the study notes that the complexity of the Chinese foreign policy dynamics denotes a well-anchored pragmatism in the interest of the Chinese people as a nation, a pragmatism that will most likely continue to inspire Beijing's international conduct. Navigating the waters of international affairs and, implicitly, international recognition, has sometimes been a sinuous mission for China, yet it came a long way to be accepted not only as a full member of the international community and a permanent member of the UN Security Council, but as a credible partner for regional and global dialogues. Such a status owes largely to China's Five Principles.

In the light of upgrading its security and foreign policy interests in accordance to the ever-growing engagement in the world affairs, China may, at some point, feel strained by the principles of non-interference or, perhaps, non-aggression, and consequently offer an alternative reading in which the interventionary paradigm becomes justified. Shall such a change occur under the auspices of liberal foreign policy of international cooperation, i.e. in a multilateral format largely accepted by the international community, China will continue to advance on its long established road of peaceful development. If, on the other hand, a breach of the Five

Principles would occur in a unilateral setting or will be backed by little international support, China risks to lose its credibility and its status of persistent objector to interventionary practices and sovereign-violating power politics. One thing, however, becomes obvious: more than sixty years after the iteration of the Five Principles, China has come to the point where the Principles are no longer used to claim sovereignty and to reject external interference. It is the author's view that China has acquired, without the doubt, the military might needed to protect itself from foreign intervention without necessarily appealing to rhetoric. Whether China's attitude towards international law will avail of its current consolidated status in the international affairs to react to other states or, on the contrary, will continue to use the Five Principles, even if under an upgraded form, to take regional and global initiatives, it is yet to be seen.

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PAPER

# The EU Food Police

# Its Lessons for Taiwan

## Der-Chin Horng

**Abstract**   Food police emerged as a key role for legal implementation following a series of food scandals in Europe and Taiwan which began in the 1990s. Proper institutional control has been recognized as an essential element in protecting consumers with respect to food, and so, following the adoption of Regulation 178/2002, the EU acted to establish an effective food control system converting all the food chain from farm to table. The EU applied a separation principle for risk assessment and risk management in food safety. In line with the European Commission responsible for risk management, the food police in the EU and its Member States play a critical function in auditing food products and cracking down illegal activities. The EU food police would enhance the EU's food safety governance and promote the implementation of EU food law. This food police system thus facilitates the Europeanisation of food inspection at the European level and provides a multilevel institutional protection for food safety and consumer interest in the EU. This paper examines EU food control jurisprudence and the associated implement framework on food police, and compares these with corresponding institutions and practices in Taiwan. It also offers some proposals for food police reform in Taiwan to enhance the food law implementation in general.

**Keywords**: EU - Food safety - Food control - Food police - Consumer interest - The Act Governing Food Safety and Sanitation

## Introduction

### Background and Importance of Food Safety in the EU

Since the 1990s, European countries, the U.S. and Taiwan have been plagued by major food safety crises and scandals, such as mad cow disease (BSE), foot-and-mouth disease (Aphtae epizooticae), dioxin poisoning, plasticiser additives, and tainted oil, etc. These scandals have put public health and consumers' interests at serious risk. The reoccurrence of food fraud and poisoning leads to what sociologist Ulrich Beck terms a postmodern and post-industrial "risk society" (Beck 1992). One of the prominent sources of risk in a postmodern and post-industrial society is a very basic, but now distant need—food (WHO 2015). The formation of the EU food safety system came in direct response to such food crises. This system is intended to establish high-standards of food safety for EU citizens, to ensure the free flow of food

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products and the proper functioning of the internal market, and to restore consumer confidence in European food (Vos, 2000). Regulation 178/2002,[1] passed by the EU on 1 February 2002 and put into force on 21 February, is the basic EU legal framework for food safety. It establishes the general principles, responsibilities, and basic requirements concerning risk-safety institutions, traceability, food businesses, emergency measures, and risk management. More importantly, Chapter III of the Regulation establishes the official risk safety institution—European Food Safety Authority (EFSA). Additionally, under Regulation 882/2004[2] passed on 29 April 2004, Article 32 and Article 33 respectively establish the EU food Reference Laboratory (EU-RL) and national reference laboratories which are responsible for the analysis and control of food safety. To facilitate inspection and compliance with food safety law, Europol and numerous Member States have also set up food police divisions. The establishment of all these institutions are responsible for effectively implementing food controls and regulations. Institutional change, legal reform and policy transformation are thus important factors ensuring the soundness of food safety in the EU.

In Taiwan, the plasticiser additive scandal of 2011 and the tainted oil scandal of 2014 dramatically undermined the credibility of food businesses, weakened consumer confidence, and stained Taiwan's reputation as a kingdom of delicacies. The social cost and medical expenses that might accrue cope with public health problems are considerable. The reoccurrence of food safety breaches shows that Taiwan has much room for improvement compared to the EU with respect to food control regulations, food safety institutions, law implementation and food crisis management, etc. In Taiwan, the Act Governing Food Safety and Sanitation was put into force 28 January 1975. Between 10 June 2011 and 20 January 2015, the Act went under six amendments incorporating such measures as emergency alerts, labelling, traceability, self-governance, market monitoring, imported food origin certification, and border inspections, etc. The most recent three amendments focused on increasing administrative penalties, but failed to touch upon establishing risk analysis and management institutions that are key ingredients in a food safety system. Also contributing to delays in addressing the food safety crises was a lack of coordination and separation of duties among the various responsible government agencies, including the Ministry of Health and Welfare, Council of Agriculture, Environmental Protection Administration, and the Ministry of Economic Affairs.

Although the Act has undergone frequent amendments, food safety breaches and scandals have not abated, indicating that the food safety law is not being executed properly. Therefore, in attempting to improve current regulations, the government must establish an integrated system governing risk analysis, laboratories, and auditing to enable proper execution of food safety laws. An integrated and robust domestic system is also crucial in bridging international food safety standards which would, in return, foster exports of domestic food products.

EU food safety law is an excellent reference point for the Taiwanese government in strengthening the food safety system. In the three amendments during 2013 and 2014, the government made reference to the concept of "from farm to table" in the EU law. However, other institutions and mechanisms, such as a risk management system based on risk assessment and analysis, national laboratories, and food safety police, should also be incorporated to facilitate substantial execution of food controls and restore the government's credibility in food management.

1 Regulation 178/2002 laying down the general principles and requirements of food law, establishing the European Food Safety Authority and laying down procedures in matters of food safety, OJ 2002, L31/1, as amended by Regulation 1642/2003, OJ 2003, L 245/4.
2 Regulation 882/2004 of 29 April 2004 on official controls performed to ensure the verification of compliance with feed and food law, animal health and animal welfare rules, OJ 2004, L165/1.

This paper adopts the methodologies of legal and policy analysis, and a comparative perspective to investigate official documents, specific articles and case studies of food safety related legal reform and enforcement construction in the EU and Taiwan. In hope to shed light on food safety reform and innovation in Taiwan, this paper attempts to analyse the objectivity, justifiability and suitability of food safety policies in the EU, and implements a critical approach to comment on food safety law and practices in Taiwan. This paper focuses on food police in the EU and its implications and inspiration for policies and practices in Taiwan.

### *Jurisprudence for Food Police Formation*

According to the United Nations Food and Agriculture Organisation (UNFAO), the components of food control and food safety system are (FAO, 2004):

1. Food safety regulations and standards;
2. Risk assessment and risk management institutions;
3. Laboratories;
4. Official enforcement unit including food police;
5. Risk communication;
6. Coordination mechanism of food safety related institutions;
7. Food safety crisis management and alert system in case of emergency; and
8. Education, training and international cooperation.

Law and regulation are infrastructure crucial to the implementation of food safety. Regulations are even considered elements of industrial competence and national competitiveness to the extent that sovereign states enter regulatory competition (Trachtman, 1993).

Food control is a series of compulsory actions implemented by the government to enhance food safety standards in each and every stage of the food supply chain, including production, processing, transportation, storage and sales recall, among other things. It would have positive spill over effects on areas such as consumer interest, public health, the development of the food industry and fair competition. Designing regulations, policies and implementation on the national level is indispensable to integrating diverse resources. Built on such a framework, a system composed of risk assessment and management mechanisms, food safety standards and processes, food safety laboratories and food police would emerge to meet the basic food safety needs of the general public (FAO, 2003).

Food safety has its origin in government control theory, particularly the theory of public interest (Peltzman, 1980). Accordingly, food control is necessary because it protects consumer interest, public health, fair competition and the proper functioning of the market, and deters businesses from engaging in illegal activities. In addition, food controls also effectively prevent food businesses from engaging in unfair competition practices that would trigger a race to the bottom scenario and worsen public health. In case of malfunctioning food controls, businesses would compete by lowering safety standards, and engage in rent-seeking and arbitrage activities, with the ultimate result that the entire food safety system would be disordered (Siles-Brügge, 2014).

Information asymmetry also poses problems in building a food control system. Pesticides, additives and other chemicals are common in the production and processing of food products, but detailed information is often not easily available to consumers. In this case, the role of government is essential to ensuring the quality and safety of food products by, for example, restricting the use of pesticides and additives and requiring businesses to reveal pertinent information on product labels (Greenwald, Stiglitz and Weiss, 1984).

Article 14 of the EU Basic Food Safety Law of Regulation 178/2002 stipulates that food shall not be placed on the market if it is unsafe. The definition of unsafe food include injurious to health and unfit for human consumption. In determining whether any food is unsafe, regard shall be had:

1. to the normal conditions of use of the food by the consumer and at each stage of production, processing and distribution; and
2. to the information provided to the consumer.

Furthermore, in determining whether any food is injurious to health, regard shall be had:

1. to the probable immediate, short term and long term effects of food on the health of a person and on subsequent generations;
2. to the probable cumulative toxic effects; and
3. to the particular health sensitivies of a specific category of consumers where the food is intended for that category of consumers.

In determining whether any food is unfit for human consumption, regard shall be had to whether the food is unacceptable for human consumption according to its intended use, manner of contamination, whether by extraneous matter or otherwise, or putrefaction, deterioration or decay. Consumer interests, public health, and general trust in the food markets and the government's authority would be endangered if food businesses, especially large-scale firms, take advantage of the freedom to operate and engage in illegal activities such as food fraud and food crime (Popper, 1945). In Taiwan, repeated major food crises have put at risk the health of consumers and damaged the integrity of Taiwan's food markets and food culture. The companies involved in adulterating food products and other food-related crimes should be regarded as inimical to an open society and the general public. Protecting consumers' interests is thus the core objective of food controls, according to UNFAO and WHO (FAO, 2004). The major task of food law in the EU, according to Article 1 of Regulation 178/2002, is to provide assurances of a high level of protection of human health and consumers' interests, and ensuring the effective functioning of the internal market.[3]

In the EU, the protection of consumers' interest enjoys constitutional status. Article 169 of the Treaty on the Functioning of the European Union (TFEU)[4] provides that "In order to promote the interests of consumers and to ensure a high level of consumer protection, the Union shall contribute to protecting the health, safety and economic interests of consumers, as well as to promoting their right to information, education and to organise themselves in order to safeguard their interests". Article 12 of TFEU[5] also stipulates that "consumer protection requirements shall be taken into account in defining and implementing other Union policies and activities". Article 38 of Charter of Fundamental Rights of the European Union[6] provides that consumer protection should be among the highest guiding principles of EU policies. According to Article 6 of the Treaty on European Union (TEU)[7], Charter of Fundamental Rights of the European Union shall have the same legal value as the TEU and TFEU. Consumer protection not only serves as an interest, but also constitutes a basic constitutional right. Therefore, the EU shall carry out

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3 Article 1 (1) Regulation 178/2002, provides that: The Regulation provides the basis for the assurance of a high level of protection of human health and consumers' interest in relation to food, taking into account in particular the diversity in the supply of food including traditional products, whilst ensuring the effective functioning of the internal market.

4 OJ 2010, C83/47

5 Article 12 TFEU, provides that: Consumer protection requirements shall be taken into account in defining and implementing other Union policies and activities.

6 OJ 2010, C83/389

7 OJ 2010, C83/13

policies to protect consumers' interests; failure to do so might violate constitutional treaties (Benöhr, 2013).

The Court of Justice of the European Union (EUCJ) in *1979 Cassis de Dijon* confirmed that consumer protection is a compulsory requirement in the functioning of the internal market.[8] At the same time, the EUCJ proposed that the principle of public interest could serve as a justified reason to limit the free flow of products and services in the internal market. In the judgement of other cases[9], the EUCJ also ruled that the EU and its Member States may, based on reasons of public interest or public health, institute regulations and laws with regard to labelling, information disclosure or other compulsory measures. Labelling is an important part of the food safety chain. In the food industry, the components and ingredients of food products are usually fairly complicated. Thus labelling, which informs buyers of correct information and characteristics of food products and assist consumers to make informed choice[10], becomes an important policy instrument for the EU and Member States to strengthen food safety.

Although the autonomy of private law implies that consumers are not usually the minority in society, the choices they make are limited due to the complexity of food processing procedures and industry structure. Therefore, based on the theory of public authority interventionism, labelling is justified to balance the information asymmetry between consumers and producers of food products.[11] Food safety, due to its wide range of influence on consumers, is a collective right that deserves the attention from governments all over the world (Brownsword, 2008).

Since 2002, the EU, USA and Japan have used the term "food safety" as the official legal term for basic law governing food products. These regulations, based on the shared interest in safeguarding consumer interests and public health, and fostering robust development and fair competition in the industry, include EU Regulation 178/2002, which established EFSA and other food control procedures, the Food Safety Basic Law[12] of Japan and the Food Safety Modernization Act[13] of the USA.

In Taiwan, during the 6th Legislative Yuan session in 2014, several legislators and scholars proposed to add to Article 1 of the Act Governing Food Safety and Sanitation, the principle of "consumer protection" as its founding philosophy. The proposed line of content, according to proposal No.1722 of the Legislative Yuan, read that "this Act is enacted to regulate and govern food safety, to ensure food quality, consumer interests and the health of citizens, and to promote robust development and fair competition in the food industry." The proposition nevertheless failed to pass. Currently, Article 1 of the Act only provides that "this Act is enacted to govern food sanitation, safety and quality, and protect the health of citizens".

As indicated by the FAO, there are international norms making the protection of consumer interests the centrepiece of food law (FAO, 2006). In Taiwan, the Grand Justices interpretation No. 577 also requires that the government take action to control food safety in order to protect such public interests as consumer interest and public health. Constitutionally speaking, consumer protection and public health are important components of basic rights, justice and public reason (Rawls, 1993). Therefore the inclusion of consumer protection still should remain a priority in future amendments of the Act Governing Food Safety and Sanitation.

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8 Case 120/78, *Rewe-Zentral AG v. Bundesmonopolverwaltung für Branntwein* [1979] ECR 649.

9 Case C-448/98 *Guimont* [2000] ECR I-10663.

10 Case C-12/00 *Commission v Spain* [2003] ECR I-459.

11 Case C-383/97 Van der Laan [1999] ECR I-731. Cf Stuyck (2000); Howells and Wilhelmsson (2003).

12 Food Safety Basic Law is passed on 23 May 2003 as Law no. 48, and amended on 11 June 2003 as Law no. 74.

13 FDA, FDA Food Safety Modernization Act (FSMA), Public Law III-353, January 4, 2011, 124 STAT. 3885.

The importance of the institution lies in its capacity to initiate regulations, establish an organisation and enforce laws. It provides the rules of the game for all participants in the functioning of politics and economy. Douglass North, recipient of 1993 Nobel Memorial Prize, adopts an economic historical perspective to analyse the impact of institutions on economic growth and explains the reasoning, processes and consequences of institution change. According to North, institutions organise and regulate social economic relationships, establish order, stimulate the accumulation of knowledge and innovation, and promote market functioning and government efficiency; in the long run, institutions govern the development trajectory and economic performance of a country (North, 1990).

Institutions, such as food laws, risk assessment and management mechanisms, test laboratories, food police and law enforcement personnel, are the cornerstones for establishing a strong food control system characterised by public confidence and trust (Hood, Rothsteinm and Ballwin, 2001). These organisations and policy instruments should be directed by works conducted by professional scientists and functional experts who enjoy a certain degree of independence and who have clear lines of responsibilities (Majone, 1997). A robust institutional framework including food police can therefore maintain the efficient execution of food law, ensure the legality and justifiability of food policies, and increase the credibility of food safety for consumers at large. The food safety system of the EU exemplifies a comprehensive and robust institution, and serves as a great point of reference for Taiwan to modernise its food governance and facilitate the execution of food safety laws.

## Food Police in the EU

In order to strengthen the implementation of food safety laws in the EU and Member States, a multi-level food safety police system has been established within Europol and the police departments of Member States.

### *Food Police within the Europol*

According to the EEC Treaty in 1958, a common market, in which goods, persons, services and capital could move freely, was established. To counter potential criminal activities induced by the four freedoms in common market, a non-official police network within the Member States was established in the 1970s. In the 1991 Luxemburg Summit, then Chancellor of Germany Helmut Kohl advocated for a European criminal police force making reference to the FBI of the US. The 1992 Maastricht Treaty K1(9) stipulates that the police forces within the Member States should cooperate with one another. The Europol Convention was passed in 1995 according to K3 of the Maastricht Treaty, and put into force on 1 October 1998. The Council of the European Union, on 6 April 2009, passed a decision, based on the EU Treaty 30(1)(b), 30(2) and 34(2)(c), to establish Europol as a permanent institute; the decision became effective on 1 January 2010.[14] The headquarters of Europol is located in The Hague, the Netherlands. In 2015, it recruited about 900 staff whose professions include criminal, border and customs police, and included about 100 scientists with expertise in criminal analysis. In terms of its budget, in 2011, Europol was allotted about 84 million euros as part of the EU annual budget. According to Article 2 of its founding decision, Europol has legal personality which significantly raises its legal status within the EU and Member States.

Since its founding as a permanent institution within the EU on 1 January 2010, the responsibilities and tasks of Europol have been expanding to include preventing cross-border criminal activities. Other targets include those listed in the Annex of 2009/371/JHA Decision: drug smuggling, money laundry, immigration, human trafficking, murder, organ trading, ethnic

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14 Council Decision Establishing the European Police Office (Europol), 2009/371/JHA, OJ 2009, L121/37.

extremisms, organised robbery, fraud, environmental crimes, corruption, computer crime, weapon smuggling, Internet attacks… etc. Europol would decide whether to investigate the aforementioned criminal activities according to their scale, impact and consequence. Since 2010, Europol has been investigating approximately 18,000 cross-border cases each year. Some include cross-border food fraud and criminal activities.

The primary tasks of Europol, according to Article 5 of Decision 2009/371/JHA, are:

4. to collect, store, process, analyse and exchange information and intelligence;
5. to notify the competent authorities of the Member States without delay via the national unit referred to in Article 8 of information concerning them, and of any connections identified between criminal offences;
6. to aid investigations in the Member States, in particular by forwarding all relevant information to the national units;
7. to ask competent authorities of the Member States concerned to initiate, conduct, or coordinate investigations, and to suggest the setting up of joint investigation teams in specific cases;
8. to provide intelligence and analytical support to Member States in connection with major international events; and
9. to prepare threat assessments, strategic analyses and general situation reports relating to its objective, including organised crime threat assessments.

Additional tasks of Europol are:

1. to develop specialist knowledge of the investigative procedures of the competent authorities of the Member States and to provide advice on investigations;
2. to provide strategic intelligence to assist and promote the efficient and effective use of the resources available at national and Union levels for operational activities and the support of such activities;
3. the training of members of their competent authorities, where appropriate, in cooperation with the European Police College;
4. the organisation and equipment of those authorities by facilitating the provision of technical support between the Member States;
5. crime prevention methods;
6. technical and forensic methods and analysis, and investigative procedures.

According to Article 11, Europol shall maintain the Europol Information System (Europol, 2014). In the beginning of 2013, Europol indicated that about 3,600 criminal Organisations in 28 Member States had engaged in food criminal activities. The percentage of criminal activities involving food products, cosmetics, medicines, and toys has risen from 14.5% in 2010 to 28.6% in 2011. A specific case Europol has investigated is the horse meat scandal of February 2013 (Europol, 2014; Fox News, 2013).

### Horse Meat Scandal

In February 2013, it was found that the beef sauce in frozen spaghetti products sold in Tesco, a Britain grocery franchise, contained up to 60% horse meat. This discovery immediately triggered a scandal. According to food law in the U.K., horse meat is forbidden food products. In addition, the EU stipulates that food products that contain more than 1% horse meat should be appropriately labelled.[15] Due to the international nature of the horse meat supply chain, on 15 February, the EU approved taking samples to examine all beef-related products in the EU in order to restore consumer confidence.

The EU Standing Committee on the Food Chain and Animal Health and the Member States

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15 Commission Recommendation 2013/99, OJ 2013, L48/28.

together conducted the sampling tasks. The mission lasted two months and cost 2.5 million euros – an expense shared between all 28 Member States. In total, 2,250 samples were examined, with between 10 to 150 samples taken from each Member State. In addition, to detecting in the horse meat possible residues of phenybutazone, which is harmful to human health and therefore prohibited by the EU, the plan requires an examination of one sample out of every 50 tons of horse meat, and each Member State had to carry out a minimum of five tests (European Commission, 2013). On 15 April 2013, the EU published the test results: 193 samples contained more than 4.5% horse meat and 19 samples contained more than 0.5% of phenylbutazone. Due to the harmful effect of phenylbutazone to human health, the horse meat scandal was not only a food safety event, but a food fraud one. In reaction, the EU notified the Member States through the Rapid Alert System for Food and Feed (RASFF) of the need to implement appropriate measures to address the crisis (EFSA and EMA, 2013). In fact, the Food Safety Authority Ireland (FSAI), upon the discovery of horse meat adulteration on 8 February 2013, utilized the RASFF to notify other Member States of the problem (European Union, 2014).

The role that Europol played in the horse meat scandal was to trace and investigate food fraud. The Food Standards Agency (FSA) of the UK also shared files relevant to the horse meat investigation with Europol to engage in investigation at a pan European level (BBC News, 2013). Therefore, Europol has become the primary institution of official control at the European level, conducting food safety related tasks that involve information exchanges, law enforcement, and cross-border investigations.

## Food Police within the Member States

### Food Police in Some EU Member States

In a number of EU Member States, there exist food safety police or other institutions whose missions are to curb food crime. An example of which is the food crime enforcement unit in France under the OCLAESP, Ministry of Interior France. This unit is the police authority responsibility for carrying out on-site investigations of food factories and enterprises. In 2013, the unit has a 3 million euro annual budget (H M Government, 2014).

In Italy, the food crime unit, Carabinieri, is empowered to investigate food crime and fraud, react to emergencies, and arrest and detain related personnel and goods. The food safety enforcement units in France and Italy exemplify cross-border efforts to curb food crime, and have developed into a European and international intelligence network that meets for one week every year to discuss key missions.

Food safety enforcement units in Germany used to function on the level of Lander. After the horse meat scandal, the government has begun to establish food safety and fraud enforcement units at the federal level. In Denmark, the food crime agency, established in 2005, enjoys investigatory and enforcement power and has revealed illegal activities practiced by food businesses. The agency is able to carry out 16 major investigation missions (H M Government, 2014).

In the Netherlands, where agriculture accounts for a large part of its economic output, food crime authorities have existed in different forms for more than 60 years. Currently, the Dutch food crime competent authority enjoys full police authority and especially targets organised food crime activities. In 2012, the food crime agency investigated 246 food crime signals, and successfully prosecuted 77 criminal charges in 24 major investigations. The agency confiscated assets worth more than 6.5 million euros. In 2013, the agency conducted three investigations regarding the horse meat scandal, and arrested a businessman who mislabelled and sold 300 tons of horse meat as beef.[16]

16 European Commission, DG Health and Consumers-Food and Feed Safety. Report missione DG(SANCO)/2011/688 di aggiornamento del Country Profile Italia. September 2012, p. 64.

In reaction to the horse meat scandal, the British Food Safety Authority, FSA, was assisted by other government agencies, including the Police Department, Home Office, Ministry of State for Agriculture and Food, National Fraud Intelligence Bureau, and Intellectual Property Office. Different government institutions share food safety related intelligence on the Government Agency Intelligence Network (GAIN). During the cross-border food fraud mission, the government confirmed that a professional and independent food safety unit is indispensable to ensuring food safety within and beyond national borders.

On behalf of the UK government, Chris Elliot, Professor at Queen's University Belfast, conducted an independent investigation and reported on the framework for food crime prevention. The report showed that the annual cost of establishing a new food safety police or food crime prevention institution ranges from 2 million to 4 million pounds. In the initial recruitment stage, the cost should not exceed 2 million pounds. As the institution begins to function and expand, the budget should increase to perhaps 4 million pounds. In response, the FSA indicates that if the new food safety unit is set within the FSA, its consumer protection and business support teams should be able to support its founding (H. M. Government, 2014). The report clearly shows that the new food safety police unit, an innovative agency of government policy and a food safety institution in the UK, should play an important role in supporting the implementation of food safety laws in the future.

### The Carabinieri

Food products and agriculture are important industries in Italy. The founding of the Carabinieri food safety police was intended to foster the development of the agricultural sector, ensure food safety, and protect Italy's culinary image and protect its interests in international trade and tourism. The Carabinieri food safety police has 1,200 staff and is headquarters is located in Milan (European Commission, 2012).

To carry out the regulations specified in EU Regulations 852/2004, 853/2004, 854/2004 and 822/2004, the Italy government, in its Decree 193/2007, stipulated that the competent authorities on food safety are the Ministry of Health and local health bureaus, and the Trento and Bolzano provinces. The Ministry of Health was founded, according to the Decree 172 on 13 November 2009. On 3 November 2011, the President of Italy passed Decree 108 establishing the Department of Veterinary Public Health, Food Safety and Collegial Bodies for Health Protection (DVPHNFSCBHP) within the Ministry of Health. Under the department there are three bureaus—animal health and medicine, food safety and nutrition, and consumer protection—responsible for ensuring food safety, the proper functioning of the food chain, and consumer protection at the national level. Enforcing the food safety law is the responsibility of 146 Local Health Units (AUSL) at the local level.

The Ministry of Agriculture Foodstuff and Forestry Policies (MIPAAF) is responsible for controlling plant health, food and feed quality, and pesticides and fertilizers.

The responsibilities of the aforementioned government agencies are to coordinate, guide, supervise, audit and investigate food safety events within the nation. However, exports of food products and international trade are the duties of the DVPHNFSCBHP and the Carabinieri Healthcare Command.

The Healthcare division, under direct guidance and supervision of the Ministry of Health, is a special and professional unit within the Carabinieri. The Healthcare Command is a central control system composed of three field offices and 38 territorial inspection units; it is in charge of examining and controlling adulterated food products, food fraud and smuggled medicine products. In addition to following the guidance of the Ministry of Health, the Health Command of the Carabinieri can actively carry out investigatory missions, including on-site

investigations of food businesses, voluntary examinations, product samplings and analyses. Staff of the Healthcare Command, upon completing the special training in food safety and healthcare techniques, have the duties and powers of official auditors and judicial police, and engage in food safety examination tasks (European Commission, 2012).

In July 2007, the Italian government established a cross-department conference to improve communications between government agencies on animal health and food safety. The key missions are:

1. to ensure the cooperation between government agencies to support the National Food Safety Committee;
2. to establish the operation procedures of national, territorial and local governments, and set up internal and external auditing standards;
3. to develop information systems at all levels of government to facilitate food safety management; and
4. to develop a robust network of food safety laboratories.

Regarding the legality of the aforementioned food safety operations, Article 13 of Decree 689/1981 stipulates that competent food safety agencies have the power to investigate. In addition, Articles 17 and 22 of Decree 441/1963 and Criminal Law No. 357 provide that law enforcement personnel at all levels of government enjoy the status of public servants and the judicial polices. Article 3 of Decree 283/1962 states that investigators, in the course of conducting their mission, may request assistance from the police. According to Decree 112/1998, Decree 283/1962 and Presidential Order 327/1980, the Ministry of Health, in addition to authorizing territorial authorities to control and investigate, also has the right to implement on-site investigations and to examine related documents.

The law on administrative penalties is founded on Decree 689/1981. In addition, a number of regulations target specific food businesses. These include: Decree 190/2006 (Article 18, 19 and 20 of Decree 178/2002), Decree 193/2007 (Decree 852, 853 and 854/2004), Decree 151/2007 (Decree 1/2005), Decree 142/2009 (Decree 183/2005) and Decree 198/2004 on animal welfare.

Most cases of proven illegal activity can be punished through administrative penalties, except for those subject to criminal penalties specified in Articles 5, 6 and 12 of Decree 283/1962, Decree 281/63 and Criminal Law No. 515 and 516. Nevertheless under the precautionary principle, investigators can recommend that prosecutors review a case based on criminal law though the case has been already processed with administrative penalties.

The amount fines levied depends on the gravity of crime and financial conditions of the charged. Other punishments include detention and seizure (Article 24 of Decree 689/1981), confiscation (Article 19), and forced business termination (Article 8 of Decree 30/12/1999 and Criminal Law No. 507 and 517). The ruling should also take recidivation into consideration. According to Decree 462, released on 7 August 1986, the Ministry of Health shall publish a list of fixed base operations that had engaged in selling low quality food products or food fraud products (European Commission, 2012).

In conclusion, the Italian government's emphasis on the enforcement of food safety law is embodied in the establishment of the national food safety police system. At the 2015 World Expo in Milan, food safety was one of the seven listed topics: agricultural product supply chain, biodiversity and agriculture, food education, cooperation on food safety issues, food that makes life better, and world culinarians. The Italian government again shows that food safety is not only a local issue, but is gradually evolving into a global problem (Milan Expo 2015, 2015).

**Lessons for Taiwan**

*The Implementation of the Food Safety Law in Taiwan*

According to Article 41 of the Act Governing Food Safety and Sanitation, competent municipal, county, or city authorities may take the following actions to ensure that foods, food additives, food utensils, food containers or packaging and food cleansers are in compliance with the provisions of this Act:

1. enter the place of manufacturing, processing, preparation, packaging, transportation, storage and sales, perform on-site examination and conduct sampling and testing;
2. in the course of conducting the duties referred to in the preceding paragraph, authorities may require food businesses in the place referred to in the preceding paragraph to provide the source, and amount of raw materials or products, information on processing, quality assurance, sales counterpart, sales volumes, and other supporting information, evidence or records, and such may be reviewed, detained and copied;
3. seal foods, food additives, food utensils, food containers or packaging and food cleansers found to be not in compliance with the provisions of this Act according to the examination and testing results;
4. order food businesses to suspend operations, or cease sales, when those businesses violate Paragraph 1 of Article 8, Paragraphs 1 or 4 of Article 15, or Article 16, or the standards prescribed by the central competent authority pursuant to Articles 17, 18 or 19;
5. upon receipt of reports of food poisoning accidents, authorities may order the relevant food businesses to make corrections within a prescribed time period or send the relevant food personnel to participate in a food poisoning prevention seminar at least four hours long at agencies (institutions) certified by the competent authorities at all levels. During the investigation, the businesses may be ordered to suspend operations, cease sales or undertake disinfection and seal suspect products.

Where necessary, the central competent authority may also execute the measures described in the preceding paragraph.

It is stated in the Act that when needed, the central competent authority may take the necessary action. However, it is not mandatory that the central competent authority take action. In August 2009, the Executive Yuan set up a Board of Food Safety whose mission was to consult in support of the Executive Yuan's food safety policies. A month after the plasticiser scandal in May 2011, the Executive Yuan established the Board of Food and Medicine Safety with the goal of promoting exchanges and discussions of information. Both lacked the mechanism necessary to trigger actions and execute. The addition of copper chlorophyll to cooking oil, discovered on 16 October 2013, and the tainted oil scandal which erupted on 4 September 2014, testify to the inefficiency of the Executive Yuan's execution of food safety law.

In response to the 2014 tainted oil scandal, and in an effort to restore consumer confidence regarding food safety in Taiwan, the government specified the mission of the Food Safety Board: "To enhance the coordination, monitoring, promotion, and inspection of national food safety affairs, the Executive Yuan shall establish the Food Safety Board. The Premier of the Executive Yuan shall serve as the convener with the participation of the heads of other relevant ministries and commissions, experts, scholars, and representatives of non-governmental organisations to take charge of inter-agency coordination for food safety risk assessments and management measures, as well as to establish the alert and auditing system for food safety and sanitation. The Food Safety Board shall meet once at least every three months. When necessary, a temporary meeting may be convened. The convener shall appoint a Minister without Portfolio or a ministry

head to act as the Chief Executive of the Food Safety Board, and the central competent authority shall be in charge of staff affairs.

Each municipal/county/city government shall establish the Food Safety Board; the head of the municipality/county/city shall serve as the convener to take charge of inter-departmental coordination for the food safety management measures. A meeting shall be convened once at least every three months.

Decisions made by the Food Safety Board in Paragraph 1 shall be carried out and implemented in compliance by relevant ministries and commissions. Each quarter the Executive Yuan shall announce the supervision results included in its administrative policies report to the Legislative Yuan every year.

The regulations governing the formation, tasks, parliamentary procedures and other matters to be complied with for such Food Safety Board in Paragraph 1 shall be prescribed by the Executive Yuan."

On 13 February 2015, the government laid out the principles governing the establishment of the Food Safety Board. Accordingly, the Board shall include 22 to 28 members and be composed of the Premier, Minister of the Ministry of Health and Welfare, three to five experts, representatives from related civil Organisations, five to nine representatives from consumer groups, and officials from the Ministries of Finance, Education, Justice, Economic Affairs, Foreign Affairs, Interior, Health and Welfare, Environmental Protection Administration, Mainland Affairs Council, National Communication Commission, National Police Agency and Fair Trade Commission. In 2015, the membership of the Board consisted of 14 governmental officials and 14 professionals and civil representatives. The Executive Secretary is headed by the Minister of Health and Welfare. The Board meets every three months and emergency meetings are held if necessary.

The Board is beneficial to government integration and the execution of food safety as Articles 2(1) and 3 of the Act stipulate that the Executive Yuan shall announce the supervision results, including in its administrative policies, and report to the Legislative Yuan every year. However, it might lack substantial contribution as the Board meeting is held every three months and the Board's mission is merely to negotiate among ministries. Therefore, the government should further establish a food safety police, food safety laboratories, and risk assessment institutions to ensure that food safety regulations and on-site examinations are implemented.

### Food Police Reforms in Taiwan

According to Article 41 of the Act, the municipal or county/city competent authority is responsible for food product examination and control. In fact, before the addition of Article 42(1) on 18 November 2014, responsibility to inspect food products was assigned to nurses in local health bureaus. The employee turnover rate was high because the position lacked police authority and workload was relatively high. Therefore, the performance of food safety examinations was relatively poor in Taiwan. For the police, food safety related tasks are not considered part of their assigned tasks, so there is no incentive to safeguard food safety. Although Article 42(1) stipulates that the police are responsible for cooperating in food safety related missions, the specific degree of cooperation still needs to be clarified and the police do not have the power to act in this regard. Furthermore, the competent authority that governs food safety does not have a police force. Therefore it lacks the power to initiate missions to curb illegal activities regarding food safety.
In addition, the lack of a clear boundary between food safety authority and the police force results into the inability to respond promptly to emergency cases. Therefore, the government must establish a permanent food safety police force to conduct professional food inspections and audit missions daily and promptly. The Executive Yuan, in particular, is responsible for

establishing a food safety police force under the Ministry of Health and Welfare so that it meets the requirements laid out in Article 2(1) of the Act

In December 2013, the number of police officers in Taiwan was 73,959. Among these were the following Special Forces: 269 National Park Police; 1,401 Highway Police; 635 Railroad Police; 1,456 Aviation Police; and 146 Environmental Police and 170 Forestry and Preservation Police within the First Special Police Corp (National Police Agency, 2013).

As a result of the 2014 restructure of the Executive Yuan, National Park Police, Special Force Police, Environmental Police, Preservation Police and Gaoping River Police were merged into the Seventh Special Police Corp, amounting to totally 957 officers. Before 2014, there was no sign of establishing food safety police.

The government was made aware of the food safety issues as a consequence of the 2014 tainted oil incident. On 24 October 2014, the National Police Agency initiated the "Cleansing Project" with the aim of cooperating with the Ministry of Health and Welfare to conduct examination missions throughout Taiwan (National Police Agency, 2014). The Project lasted one month and targeted only underground food businesses. Without a permanent food safety police, the government is incapable of guarding food safety in a regular, systematic and integrated way. In fact, the Legislative Yuan, when reviewing the restructuring of the Ministry of Health and Welfare, did recommend establishing a food safety police force, but this recommendation was not adopted in the end (Official Announcement Office of the Legislative Yuan, 2014).

Being that food safety has evolved into a national security problem, the government should be doggedly determined to establish a food safety police force. It is recommended that a food safety police force be set up under the Ministry of Health and Welfare with an initial size of about 300 officers, and that this number be gradually increased to 600.

Establishing a professional food police force would allow for:

1. consolidating the professionalism in food safety inspection and analysis;
2. strengthening the implementation of daily and on-site inspection;
3. developing methodologies and technical standards around investigating food fraud and food criminals;
4. establishing an information system on illegal food safety related activities to further assist systematic and regular tracking mission;
5. establishing a cooperation network between the central and local authorities that are in charge of food safety;
6. developing the prosecution standard of food safety crime and respond to cases of emergency;
7. integrating the responsibility and power of food safety inspections and risk management; and
8. developing international exchange of food safety police practices, analytical technology, and cross-border inspections, and bridging the practices and standard of food safety to international norms.

It is recommended that the Act Governing Food Safety and Sanitation include an Article stipulating that a food safety police force be established within the central competent authority. The police force should have the power and responsibilities of judicial police and engage in the inspection, control and prevention of food safety incidents. This should resolve the lack of regularity and professionalism in efforts to curb food safety breaches.

Ronald Dworkin, in *Taking Rights Seriously* (1977), argues that if government authorities do not treat consumer interests and public health seriously, then as a consequence the public would not treat food law and law in general with respect, thus rendering food safety policies

futile (Dworkin, 1977). It is through to the establishment of independent national food safety laboratories, food police, and food safety risk assessment committees that the government is able to demonstrate its determination to resolve food safety problems (Prosser, 2010). In addition, the government needs to constantly revaluate changes in the external environment in order to redistribute resources and reconstruct the institutional framework so that such organisations as national laboratories, food police and risk assessment committees are capable of responding to emergent food safety related risks and problems. It is through such efforts that consumer interests and public health are rightly protected, and that the general public benefits from having in place a sustainable food police framework (Dworkin, 1986).

## Conclusion

Since the EU food safety law passed in 2002, official food safety control has been marked by a multi-level institutional framework that includes the EFSA, EU-RLs and food safety police. The diverse institutional arrangement demonstrates that this Europeanisation of risk assessment, food inspection and auditing would significantly benefit the implementation of food safety law in Taiwan. Through high standard food controls, these institutions are the key to building a food safety mechanism that bases and focuses on consumer protection.

This paper reveals that the unit of food police in the EU and Member States would benefit from auditing food products, cracking down on illegal activities and serious implementation of food safety regulations. One of the prime goals of food police in the EU is to enhance legal enforcement and restore consumer confidence in the EU food market.

Since the breakout of major food crises concerning plasticiser additives and tainted oil, food safety in Taiwan has developed into a multi-facet issue in which individuals, families, industries are actively involved and affected. In a macroeconomic sense, this affects consumer interests, public health, food industries, tourism, international trade and the environment, among other issues. It is recommended that the Taiwanese government take reference to EU laws and practices, and establish a professional food police unit. By enforcing the domestic food police, Taiwan would be able to enhance its food law and policy enforcement while providing a sound standard of consumer protection for the general public.

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PAPER

# Higher Education ERP Systems: Setting the Right Price

**Prem Prakash Dewani • Sameer Mathur • Jagmeet Singh Suri • Piyush Srivastava Varun Bansal • Vivek Tiwari**

**Abstract**    The case is about NYSA, selling Education software, which is planning on moving into Education ERP software business. The firm's major concern is to how to price the software services and to justify the prices they charge from different clients depending on client's size, complexity of project, intensity of services and client's history and competition.  They have observed that customizing the product as per the requirements of the client is never-ending and there is no solution available to this till date. NYSA's other concerns include how to reach the masses and since it is a mid-size organization, they have limited human resources which keep shifting from one project to another.

## Introduction

It was a pleasant January morning, Yadwinder Mittal, GM Nysa, a small segment IT firm selling Education software in that Domain, collected all the relevant material to present a case to higher management to move into the Education ERP software business. It had more market potential as well as profitability.

But exploring into a new segment was not an easy task and he knew that challenges were aplenty. To present a case he has to cover a lot of ground in the coming three weeks and he was visibly worried. He is being preparing for this presentation for a while and collected a lot of data regarding the domain, client, competitor and financial details. He had concluded empirically that the most important factor will be pricing the software and services. With the given intense competition he had found a sweet spot in terms of firms positioning that educational institutes with low budget are not served properly by any of the competitor. He

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remembered a professor telling him about the bestselling book by C.K Prahlad, Fortune at the bottom of pyramid in his MBA course. He is now contemplating to buy that book to understand more about his customer their need and how to enter into the market but right pricing. He thought he would need to bundle the services with the actual ERP solution, he also needs to pitch in with value based pricing rather than a standard industry practice of pricing software and service differently.

Next three weeks are going to be very exciting as he would expand himself into a different horizon, he is hopeful and confident and thanking his decision to take up the pricing course during his MBA.

## Company Background

NYSA running successfully was into its 5th year in business, with turnover of RS 15 crore (Exhibit 1). It has grown from 5 employees to current strength of 105 employees and the CMD Puneet is talking to GM Yadwinder Mittal on how to take it forward.

It all started when Puneet an Indian Institute of Technology (IIT) alumni working in education sector and into IT hardware was joined by one of his friends Rajat, a consultant to the education board in the state Of Rajasthan.

At that time Rajat was working on a solution to manage admissions in engineering colleges. As this was the peak of IT boom in the country, engineering colleges were opening everywhere flooded with students most of whom were aspiring to get a job in IT and go to dreamland USA. The seats were limited and student had to go through entrance exam in getting admission to these colleges. Lacs of students were applying for engineering, out of which 30,000 students were shortlisted for 15000 seats across 135 colleges in the state. Since demand was high and 90 % of colleges were private and students were ready to bribe their way to get admissions, it became State government's responsibility of mange fair admissions such that only meritorious students should get the chance.

Rajat with experience of more than 15 years in government sector had worked with various state government bodies and helped them in implementing quality IT solutions. He was also known for his support in understanding of E-governance solutions across various departments. He was brought on board to manage the whole process.

When Rajat opened last year files to understand how the process was managed, he was shocked to see that all work was manual and to manage this it took more than 40 people working 75 days, 16 hours a day without any weekend to complete the tasks. On estimating the cost involved he could see that it was more than ten million. On top of this if he needed information he had to search in heaps and bundles of paper.

Rajat was also concerned with the process being followed.  All the candidates who cleared the exam had to come at a central location to fill the form and opt for his choice of course. In most cases up to 1000 candidates were called in a day and on an average 90 % percent would be given a seat and confirmation. Most of the time candidate had to stay for 2 to 3 days for admission process to finish. Some being poor could not afford hotel accommodation and had to sleep on ground at the venue, making the whole place look very mismanaged. Politicians used this opportunity to market themselves and education mafia took the opportunity to misguide and lure student for their personal benefits.

Rajat was not happy and started searching for a resolution to the issue. He was looking for something which could transform the whole process but could not found any readymade solutions. He then called Puneet who had experience in similar territory to work out a solution for him. Puneet and Rajat discussed this over a period of 7 days understanding the problem and came out with a solution which was to take the whole process online.

They prepared proof of concept and same was presented to the CM of the state. The idea was appreciated and got a go ahead from the state and led to birth of NYSA, dedicated focus to provide solution to admission. NYSA performed the task to the satisfaction and earned accolades from all the sections of the government. For the first time students got admissions without even moving out of their home. State could save 50 % on the costs and valuable time of their employees.

Riding on the success of their venture Puneet and his team went to various places with their solution. The solution was readily accepted by various states in the country, providing solution to government education department. As time passed by NYSA came up with ERP solutions and services to various Universities across the country. Thus making ERP solutions a backbone for their success.

## Industry: Market Now

Over the Period of last 5 years markets have considerably changed. Though the market is flooded with many Engineering colleges but not many students want to take up the courses. Even after passing from the institutes the students fail to get good jobs because of global meltdown and reduced job opportunities. Because of Puneet was worried about future of this business but there was a ray of hope in their ERP solutions business which he expected to pick up in next few years. This was because government had relaxed norms for opening new universities and it was anticipated that most of them would require some kind of solutions to run this show.

They also had ERP solutions for which they were already giving services to their clients. The solutions were ready but then they were custom made as per the client requirements. The solutions were tailor made which were built in 6 to 1 year time frame. If they were to target a large volume of clients they need to have a standard solution which could be used as off the shelf and sold to customers.

They called a meeting with the sales to discuss this issue and most of them were not confident about the idea and felt it is not made for their kind of industry. Even one of the Sales managers quoted

*"Our work is like a heart surgeon you can estimate a problem but cannot give the disease a cure unless we open the heart although the problem might be same but the procedure to fix that problem is different. None of our client has same structure and processes. Then how we can create a standard solution "even we try to do so we are going to fail"*

Mittal was confident upon his boss idea and wanted to go ahead with the project so he sat with Mr. Ashish and discussed on what could be done and how the solutions could be developed. Ashish who was the project head (Exhibit 3) for one of the key ERP implementation jumped over the idea and found it to be exciting and was ready to take the challenge. He called his team for discussion. After an hour of discussion and brainstorming team came to a conclusion that a product can be created but it would have to be customized as per the client requirement and that can be a never ending activity and there is no resort visible to this issue till date. Hemant, the senior program manager had a point

"Most of our clients don't have vision, they are completely dependent upon us for delivery, when we go to them for requirement they ask for something else and at the time of delivery they change requirement. Most of these requirements are not confirmed in written so every time we are stuck up in endless loop of customization. The big question was we can create product but how would change the client mindset to use that product.

Another challenge was how to take that project to masses. One of the other major aspects was the kind of solutions available with NYSA. The Education ERP roughly constitutes 25-30

modules and out of these only 5 to 6 modules were enough to serve 80 % of any client requirements, the clients still asked for most of the modules. On an average client would implement around 20 – 25 modules including 5-6 core modules. The requirement of other 15 to 20 modules was different from client to client and NYSA had to gain expertise in developing these modules which might take another 2 years and by that time market would saturate. Moreover at the time of presentation if NYSA was unable to present a desired module client would carry a negative image which might result in losing credibility and that account as well.

Another key concern creeping in Mittal's mind was that since it was a mid-size organization, small teams were working on various projects and resources were continuously shifting from one project to another. There were no bifurcation of projects to individual teams so it would be difficult to estimate the amount of effort spend upon each of clients. Moreover in the absence of activity based costing it was like finding a needle in the haystack if it was required to know the cost spent on each of the task.

Next day in the first half Mittal fixed up the meeting with Mr Das, who was the Vice president of the organization on implementing this idea. Das with his experience immediately agreed that this could be the future of industry but he shares some of his apprehensions related to consumer mindset, he quoted "you know the attitude of our typical Indian customer, when they buy a solution they think they have hired a slave and we have to get everything done for them, most of the time we have to deploy resources at the customer end even when we have not committed and we cannot do anything about it because our payments are linked to delivery." He continued "this is add on cost but how we would manage this when we are going for off the shelf product, he also cautioned that we cannot deny any service to a customer, mind it wrong feedback is like a fire that might burn the jungle faster than you can even think of and this is a small industry once something goes wrong it would be tough to rectify". He shared his experience of the industry and as per him there are two different types of customer one are private colleges and universities and other are government and both of these clients have a  very different set of purchasing pattern and requirement . These need to be assessed before proposing any solutions. Government client may not pay you more than the amount they have committed, but they would ask you to provide everything they have asked in written. Everything that is in between the lines also goes into their favor, whereas the private client would like everything on the platter. They would be much more organized and would look forward for the service which is excellent and may ask for new services in the future like custom mobile app or a helpline. We would then have to be ready before approaching such customer.

After all this discussion Mitta sat with  Sales General Manager Mr Matthew who was in this field for last 3 years and wanted to understand the other factors which can affect their strategy at national level as per Matthew the industry was quiet fragmented (Exhibit 5) and most of the market was captured by the regional players. As per him till date the industry was premature and the current market share was expected to be around 100 Cr and currently growing at a CAGR of 29.5 % and is expected to be triple in next 5 years. As per him people have just started accepting IT solutions and we may see lots of changes in the market.

He was not very positive on idea and had the same concern regarding endless changes asked by the customer and his concern was how would we handle customers who are not in northern India as most of our products and medium ticket value and average product cost is 35 to 50 lac and multiple visits and implementation team deployment would lead a cost to up to 20-55 % of revenue which might make the project unviable moreover if we pass on this cost to client how we could compete with other regional players. But more than this, the major concern was the variation in the ticket size because we had clients ranging from 2 to 30 million. The pricing is

dependent upon the size of the client, complexity of project, expected intensity of services and past history of client and competition. He exhaled "for the same services we are charging 30Rs. per student per month to one client and 90 Rs per student per month to another and if we have to quantify the difference in price we may not be able to justify then how can we standardize".

Other Key focus was the government sector which was expected to be the key factor for growth in times to come. Government spending was at all-time high; Matthew shared some data and figures (Exhibit 4(a), (b) which seemed to be very compelling. But as per him standard pricing for government sector was next to impossible because of their purchasing pattern.

He was also worried about the fact that country one of the biggest IT company PCS systems also have established a new vertical for these solutions and they were taking it very seriously and was expected to huge junk off market in times to come moreover there was another player worth 500 Crore. Maniram group who were into education and printing has acquired a IT solutions firm and wanted to big time in education software so his mix views were that competition would educate the customer and increase willingness to pay but we need to have a plan to take on these giants.

Another Major upcoming expected of this Industry were support services in last few months clients have started asking for Call center support and Mobile based applications. Even in few cases heavy manpower was deployed at client side and there were instances where this cost went up to 25 % of the total project value. But this helped the organization in charging premium over the competitors and most of the High profile customer valued services.

With all the feedback gathered from the different source Yadwinder sat with Puneet to discuss on how to go forward with the project and they task which earlier seemed to be marketing challenge now seemed to be tilting toward the most unexpected factor Pricing which was again supported one of the marketing manager quoted

> *"We are in B2B business we could hardly get any benefits from the marketing and we have to depend upon push and sales strategy or the leads through our sources or clients. Demo is the most important part of conversion for which we need to identify the key stake holder from the client side. But during discussion with most of the stake holders they want to know the cost of the product at the time of first meeting itself and in many instances client create an imagery about the product without even seeing the demo on listening bout the costs of the project and they either think it to be too costly or too cheap and then it is a daunting task to convince them"*

Mr Puneet gave Yadwinder a week's time to come back with solutions and with new role in hand it seems to be a mammoth task for him to justify his offering and what shall be cost and he needs to have an answer for all the issues raised by various stake holders and how can he club the services into the cost model. The Future of the organization lie on this decision as most of the time sales team have to take approvals from the senior management on pricing and closing the deal and this would save the effort and would empower th ¿e sales team in take instant decisions.

**Exhibit 1 Profit & Loss Statement of NYSA Communication for the year 2015 - 16**

|     | Particulars | Notes | 31st March, 2013 | 31st March, 2012 |
| --- | --- | --- | --- | --- |
| I | Revenue from operations | 2.10 | 145,653,521 | 122,001,589 |
| **II** | **Total Revenue** | | **145,653,521** | **122,001,589** |

|  | Particulars | Notes | 31st March, 2013 | 31st March, 2012 |
|---|---|---|---|---|
| III | Expenses: |  |  |  |
|  | Employee benefit expenses | 2.11 | 69,592,015 | 64,592,015 |
|  | Financial Cost | 2.12 | 3,103,867 | 2,703,867 |
|  | Depreciation Expense | 2.7 | 7,517,453 | 6,513,341 |
|  | Other expenses | 2.13 | 49,007,396 | 38,505,398 |
| IV | **Total Expenses** |  | **129,220,731** | **112,314,621** |
| V | **Profit/(Loss) before taxation, extraordinary items and tax** |  | 16,432,790 | 9,686,966 |
| VI | **Tax Expense:** |  |  |  |
|  | Current tax |  | (4,998,541) | (1,975,540) |
|  | Deferred Tax | 2.4 | (982,069) | (322,050) |
| VII | Profit(loss) after tax |  | 10,452,180 | 7,389,376 |
| VIII | Total Profit/(loss) Transferred to Balance Sheet |  | **10,452,180** | **7,389,376** |
| IX | **Earnings per Share** |  | **418.09** | **295.58** |
|  | Basic / Earning /(loss) per share |  |  |  |

## Exhibit 2 Competitor Offering Analysis (Key Modules)

| s.no. | Module name | NYSA COMM. | CAMPUS 123 | SUNTRA Microsystems | BRNACH SOFTECH. | APP-MOB LANE | PCS Eion | Maniram Tech | FEDERER |
|---|---|---|---|---|---|---|---|---|---|
| 1 | Application management | ✓ | ✓ | ✓ | ✗ | ✗ | ✓ | ✗ | ✗ |
| 2 | Student registration | ✓ | ✓ | ✓ | ✗ | ✗ | ✗ | ✓ | ✓ |
| 3 | Student admission | ✓ | ✓ | ✓ | ✗ | ✓ | ✓ | ✓ | ✓ |
| 4 | Fees management | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ |
| 5 | Examination management | ✓ | ✓ | ✗ | ✓ | ✓ | ✓ | ✓ | ✓ |
| 6 | Result analysis | ✓ | ✓ | ✗ | ✓ | ✓ | ✓ | ✓ | ✓ |
| 7 | Time table scheduling | ✓ | ✓ | ✗ | ✓ | ✓ | ✓ | ✓ | ✓ |
| 8 | Library management system | ✓ | ✗ | ✗ | ✓ | ✓ | ✓ | ✓ | ✓ |

| s.no. | Module name | NYSA COMM. | CAMPUS 123 | SUNTRA Microsystems | BRNACH SOFTECH. | APP-MOB LANE | PCS Eion | Maniram Tech | FEDERER |
|---|---|---|---|---|---|---|---|---|---|
| 9 | Attendance management system | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ |
| 10 | Vehicle management system | ✗ | ✗ | ✗ | ✓ | ✓ | ✓ | ✓ | ✓ |
| 11 | Hostel management | ✓ | ✓ | ✗ | ✓ | ✓ | ✓ | ✓ | ✓ |
| 12 | HR management | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ |
| 13 | Assets management | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ | ✓ |
| 14 | Financial accounting | ✗ | ✓ | ✓ | ✗ | ✓ | ✓ | ✓ | ✓ |
| 15 | Alumni management system | ✓ | ✓ | ✓ | ✗ | ✓ | ✗ | ✗ | ✗ |
| 16 | Document management system | ✓ | ✓ | ✓ | ✓ | ✓ | ✗ | ✓ | ✓ |
| 17 | Mobile alerts | ✗ | ✗ | ✓ | ✗ | ✗ | ✗ | ✓ | ✓ |
| 18 | Smart card integration | ✗ | ✗ | ✓ | ✗ | ✗ | ✓ | ✓ | ✗ |
| 19 | E-homework | ✓ | ✗ | ✗ | ✗ | ✗ | ✗ | ✗ | ✗ |
| 20 | Cloud learning | ✓ | ✗ | ✗ | ✗ | ✓ | ✓ | ✗ | ✗ |
| 21 | Training and placement | ✗ | ✓ | ✗ | ✗ | ✗ | ✗ | ✗ | ✗ |
| 22 | GPRS | ✓ | ✗ | ✗ | ✗ | ✗ | ✗ | ✓ | ✗ |

## Exhibit 3 Organization Chart
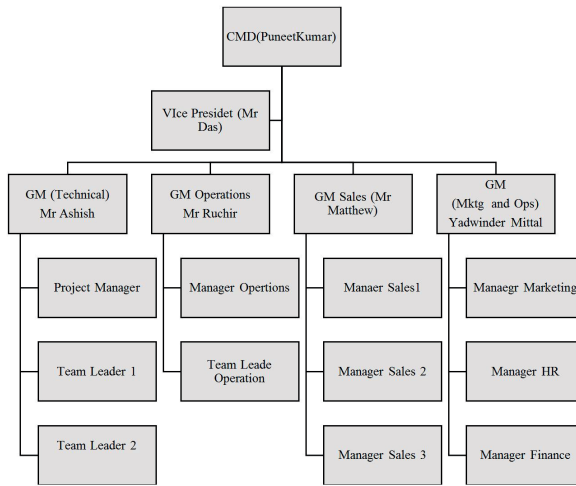


## Exhibit 4(a) Industry Growth from 2007 to 2012

| Category | 2006-07 | | 2011-12 | | Increase | Growth Rate (Per cent) |
|---|---|---|---|---|---|---|
| | Total | Per cent | Total | Per cent | | |
| By type of institutions | | | | | | |
| | 63.38 | 45.8 | 89.63 | 41.1 | 26.25 | 7.2 |
| Cental | 3.10 | 2.2 | 5.63 | 2.6 | 2.53 | 12.7 |
| State | 60.28 | 43.6 | 84.00 | 38.5 | 23.72 | 6.9 |
| Private | 75.12 | 54.2 | 128.23 | 58.9 | 53.11 | 11.3 |
| By degree/diploma | | | | | | |
| Degree | 123.54 | 89.2 | 184.84 | 84.8 | 61.30 | 8.4 |
| Diploma | 14.96 | 10.8 | 33.02 | 15.2 | 18.06 | 10.8 |
| Total | 138.50 | 100.00 | 217.86 | 100.00 | 79.36 | 9.5 |

Source: University Grants Commision (UGC), All India Council for Techincal Education (AICTE), NCTE, Indian Nursing Council (NCTE).

Adopted from Distance Education Council



**Growth of Higher Education Institutions**
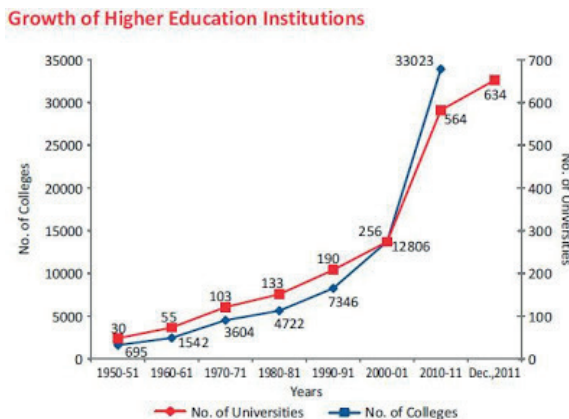
Source : MHRD / UGC

**Exhibit 4(B) Government Spending**

Table-4 Budgeted Expenditure on Education by Education Department of Central Government (Revenue Account) (Rs in thousands)

| S.No. | Sectors | Actuals (2010-11) | | | Revised Estimates (2011-112) | | | Budget Estimates (2012-13) | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | Plan | Non-Plan | total | Plan | Non-Plan | total | Plan | Non-Plan | total |
| | | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 |
| | **University & Higher Education** | | | | | | | | | |
| 1 | UGC | 42225500 | 39035900 | 81261400 | 52445000 | 43708400 | 96151400 | 63511500 | 47941700 | 111453200 |
| 2 | Establishment of Rural University | 44600 | 10700 | 55300 | 50000 | 13700 | 63700 | 60000 | 14300 | 74300 |
| 3 | AIU | 8000 | 3200 | 9200 | 8000 | 3200 | 9200 | 8500 | 3200 | 9700 |
| 4 | Zakir Hussain Memorial Trust Delhi | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| 5 | Setting up of Commonwealth University COL | 0 | 40000 | 40000 | 0 | 40000 | 40000 | 0 | 50000 | 50000 |
| 6 | Shastri Indo-Canadian Institute | 0 | 27700 | 27700 | 0 | 27700 | 27700 | 0 | 27700 | 27700 |
| 7 | IIAS Simla | 41945 | 54500 | 98445 | 48000 | 72500 | 120500 | 55000 | 77200 | 132200 |
| 8 | National Research Professors | 0 | 0 | 0 | 0 | 13000 | 13000 | 0 | 13000 | 13000 |
| 9 | Project of History of Indian Science Philosophy & Culture | 11000 | 0 | 11000 | 11000 | 0 | 11000 | 15000 | 0 | 15000 |
| 10 | Assistance to state govt of degree colleges | 0 | 0 | 0 | 100000 | 0 | 100000 | 100000 | 0 | 100000 |
| 11 | Education Loan Interest Subsidy | 2032800 | 0 | 2032800 | 6400000 | 0 | 6400000 | 8000000 | 0 | 8000000 |
| 12 | ICSSR | 279798 | 571200 | 850998 | 340000 | 439800 | 779800 | 1000000 | 472400 | 1472400 |
| 13 | ICHR | 50999 | 62500 | 113499 | 70000 | 101800 | 171800 | 80000 | 107900 | 187900 |
| 14 | ICPR | 39214 | 33900 | 73114 | 50000 | 41500 | 91500 | 60000 | 44600 | 104600 |
| 15 | Estb of Tribunals,NCHER,NFC etc | 0 | 0 | 0 | 0 | 0 | 0 | 20000 | 0 | 20000 |
| 16 | National Mission on Teachers & Trm | 0 | 0 | 0 | 0 | 0 | 0 | 10000 | 0 | 10000 |
| 17 | Incentivising of States for expansion,inclusion & excellence | 0 | 0 | 0 | 0 | 100 | 100 | 10000 | 100 | 10100 |
| 18 | Refund of Income Tax | 0 | 0 | 0 | 0 | 16400 | 16400 | 0 | 16400 | 16400 |
| 19 | Improvement in salary scales of University & Colleges | 0 | 58500 | 58500 | 0 | 500000 | 500000 | 0 | 22500000 | 22500000 |
| | **TOTAL University & Higher Education** | 44731856 | 39898100 | 84629956 | 59520000 | 44976100 | 104496100 | 72928000 | 71268500 | 144196500 |

**Exhibit 5 Estimated Share of Major Players of the Industry**

## Market Share

PAPER
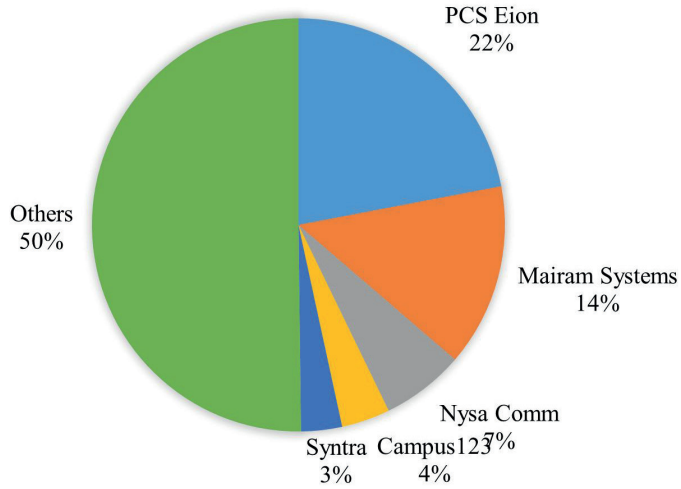
# A Tale of Islamic Financing: Theory Vs Practice

## Muhammed Abdul Aziz Muhamad Saleh Jumaa • Faisal Khan

**Abstract**  The purpose of this study is to understand the basic rules and sources of Islamic financing and to address the reason behind the gap between theory and practice in Islamic financing that violate the Islamic economic principles and why Islamic banks depend mostly in debt instruments more than equity instruments? Perspectives of the early scholars of Islamic management of an account concurred that the arrangement of organization partnership in general and MuÌÉrabah (benefit sharing) specifically is the fundamental technique on which Islamic banks must depend on contributing their money related assets. This study found that financing under the Islamic management of an account has decreased intensely from the methodology created by the early scholars. In reality, these banks have received obligation based on financing techniques and underestimated the routines for financing taking into account benefit and loss sharing. This adjustment in financing technique has perversely influenced the bad name and the desire tied with the monetary part of these banks. The study focused on the reason behind the gap between theory and practice in Islamic finance.  This study examined the practical part by analyzing and evaluating the relative distribution of Islamic financing methods in four famous Islamic banks. The study selected a group of Asian Islamic banks as a model for analysis and evaluation through the period from 2012 to 2014. The study concluded that the gaps result from the misuse of the roles and norms of Maqasid Al-Shariah along with the diversion in the relatively allocation of the financing methods toward debt instruments rather that equity instruments.

## 1. Introduction

Two perspectives shape the relationship in the middle of Islam and account. One is that Islamic law, the Shariah cases to control all parts of life, moral and social, and to envelop criminal as well as common preview. Each demonstration of devotees must adjust to Islamic law and watch moral guidelines got from Islamic standards. These moral standards characterize what is genuine, reasonable and simply, the nature of corporate obligations and the needs to society. Second, not withstanding giving an arrangement of business morals, certain Islamic financial and money related standards have an immediate effect upon monetary frameworks. Initiating looking for other tools which are more profitable and less risky as well as easier application resorted to finance instruments of business for margin profit, which led to the emergence of

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a variety of funding methods such as Murabaha, and Ijara. These operations overshadowed the other and made the practical application of the experience of Islamic banks deviate from the theory which Italians have developed, which still has the support of most of those people who are interested in the Islamic financing system of the modern era.

Does this fact make us wonder about the extent of deviation witnessing practical experience of Islamic banks having a framework for a theory? The question is also about how these banks need to evaluate their career? This is what we will try to answer in this study which aims to shed light on the financing function of sites in the Islamic banking currently by monitoring the experiences of some Islamic banks relying on high-descriptive analytical method which includes the search along with the point of view from issues of the book of Islamic Banking.

From practical side it will focus on analyzing policy of funding in the financial annual reports for some Islamic banks relying on financial statements for being more styles appropriate to the nature of the study and its objective is to evaluate the extent of the gap between the theoretical and practical side of Islamic finance.

## 1.1 A Theoretical Methods of Islamic banking financing

The Holy Quran includes message and command from Allah which has been sent down by Prophet Muhammad peace be upon him to guide people to the right direction. Hadith "Sunnah" is a collection of information, history, account, variation and records of the Sunnah that was created by Prophet Muhammad (P.B.U.H.). Hadith also describes the prophet's behaviour, method of any action, declaration and saying under assortment of circumstances during prophet's life time. Ijma is the unanimity of opinion on agreements of Muslim juries on any problem to determine a special legislation. Qiyas and Ijma are branches of Sharia law, these sources are a solely complete and overall the Sharia law itself has yet to be formulated so as to adjust foreseen consequences and also to overlook Islamic banking system with it.

Gharar (Interest) is not allowed in Islamic banks, but in commercial banks they may use it to Gharar the client and get as much profit as they can from the customer. Gharar transaction occurs when one party can only benefit by the other's loss. Under conditions of uncertainty, commercial insurance is given as an example, since either the insured pays a premium and receives no counter value, or the insurer pays out much more on a claim than was received by way of premium.

However, Islamic finance follows a very pragmatic development that is located within the neo-classical paradigm. Along these lines, in its present state, Islamic account does not appear to share the foundational cases of Islamic financial aspects. "A particular component of the late talks on Islamic managing an account has been the developing wedge between its routine hypothesis and current practice". The outcome, subsequently, has been "the uniqueness between the suspicions, standardizing standards and goals of Islamic financial matters as a framework and Islamic money as an instrument of that framework".

Currently, Islamic fund speaks to half breed monetary results of the worldwide money related framework. In this manner, "the distinction has been decreased to detail, and the worth framework is no more said past quoting so as to portray the disallowance of Reba verses in the Qur'an". Despite what might be expected, Islamic financial aspects' perusing of the same Shari'ah rules underscore social equity, need satisfaction and redistribution, in particular a socio-political perusing inside of a political economy structure. Tolerating the present condition of Islamic money is a trade-off earnestly requiring new models of improvement inside of the idea of Islamic good financial framework. The failure of Islamic finance needs to be urgently moderated. Islamic Finance gives high thought to the Concept of Social Justice and deals with poor people and frail.

## 1.2 Islamic Finance Methods

Murabahais the major channels of financing in Islamic banking because it's a legal commercial transaction in Islamic law; furthermore, it provides customers with finance without Reba since the Islamic bank buys the commodity and sells it to the customer by instalments which meet his cash flows ability. The bank receives an agreed profit in return.

## 1.3 Mudarabah Financing

In any contract of Mudarabah, the Islamic bank will provide the entrepreneur of the capital he ask for, and he should contribute with his management and experience. On the other hand the loan will be borne by the bank while the profit will be shared on agreed base. (AAOIFI) accounting and auditing Organization for Islamic finance institution. Shariah standards for Mudaraba have certain rules, this rules should be adhered from both parties for any finance contract and any contract have to get passed from Sharia compliant any Customer want to involve in Mudarabah finance, who will become Mudarib, the bank or the institution will provide him with Islamic finance service (IFI) and he/she will become (Rab al mal) all of this will be on an agreement between bank and customer and this will be established an executed via Mudarabah contract. Mudaraba financing have two main types; restricted and unrestricted. In restricted contract, the capital of (Rab al mal) will have the authority to manage the fund but with certain restriction. For instant country exposures. However, in unrestricted the Mudaraba contract allows the capital to manage the funds without any restriction, in Mudaraba capital must be intangible asset or cash. In Mudaraba, there are links between Maqasid al-Shariah and Islamic economy. We can say that the bank will be a supplier and the borrower will take the money to start the project, whenever he get the profit it will be shared on an agreed base. In this situation, the bank will take his original money and the profit; furthermore, we can say there are no gap found in Mudaraba.

### 1.3.1 The Practical Dimension of the Islamic Banking Format of the Mudarabah Contract

a. A client who is unable to finance an asset requires financing for that asset and thus approaches the bank.

b. Since the Islamic bank cannot lend the client money In return for Interest, the bank offers to buy the required asset from the seller in order to gain ownership, which is an Islamic pre-requisite for it to be able to sell the asset to the client.

c. The cost of purchasing the asset from the bank is calculated [entailing the cost of the goods + % percentage mark up by the bank]. Other legal and administration costs are then also added in order to calculate the final cost. The % percentage mark-up by the bank varies in relation to the period of repayment and is also determined by Islamic banks in non-Muslim and Muslim countries via the current interest rates of conventional banks.

d. Normally, any up-front payments towards financing the asset sought by the client are deducted, and a mark-up is placed only on the amount financed. For example, in car stuffs the value of any car traded in as part of the sale is deducted from the purchase price of the car that is purchased.

e. If the customer accepts the final and calculated or pre-determined cost of purchasing the asset from the bank, the bank purchases the asset from the seller and sometimes profits through receiving a cash discount. If such discounts are received, the asset cannot be sold on the basis of a Murabaha if the discount is concealed. However, prior to purchasing the asset, the bank also have the client sign a legally binding contract that he will, subsequent to the bank's purchase, purchase that asset himself from the bank for the specified amount. The bank will not buy the asset unless the (potential) buyer's promises to purchase are binding. The asset is either purchased directly by the bank or, as is customary, the client

is asked to act as an agent on behalf of the bank. An agency agreement is concluded in which the client is also authorized to take delivery of the goods. However, the supplier of the goods shall invoice the bank and not the agent for the goods. This requirement has been waived by some banks in order to meet local tax requirements.

f. The bank bears any risks from the date of delivery by the supplier to the bank until the date and time of resale of the asset to the client.

g. Ownership is transferred to the client only after full payment of the purchase price. In the interim prior the bank retains constructive possession.

h. Clients are obliged to insure the assets at their own cost, even though owner-ship may not have been legally transferred to them.

## 1.4 Musharaka (or Sharika) Financing

Musharaka is partnership between the client and the bank as each one of them participate in the contract either on assets or working capital, furthermore the Musharaka contract have no fixed rules, each one of the contracts is dealt with on its own worth, there is no restriction on the contract so it mean one contract might last for couple of weeks or even couple of years. Profit share in the contract is based on the agreement between the parties as they discussed and agreed on. But in some cases of loss it will be shared by the capital provider. So in few words, Musharaka contact is simply, a contract between two partners, each one of them participate in projects in forms of cash or expertise and they share the profit and loss depending on the contract that has been agreed between both of the parties.

In musarkaha finance, there is a gap between the bank and Maqasid al-Shariah as typically the bank has the opportunity to cancel the agreement any time, as soon as the bank finds any fault from the customer or if there are any risk that might affect the bank.

## 1.5 Salam (baie al salam)

Salam is a sale where the seller himself undertakes to supply a specific product to the buyer at a future date, so they can agree on a specific price and a specific delivery time as agreed in the contract. This Islamic type of finance was created to meet the needs of small farmers who required money to grow their crops as they were allowed to sell some of their products in advance and after collecting the new crops they can return the money or profit to the bank. Salam can be used for the type of products where the quality and quantity can be measured in advance. For instance, it cannot be used for vegetables or fruits as there are a probability that the tree might be destroyed before the yield.

## 1.6 Ijarah

Ijarah term means to give something on rent; literally it can be utilized for specific transaction when the service is provided for someone in exchange for something.

For example, hiring (renting) a lawyer or an engineer to provide a service for exchange of money. However, in renting a specific property and there is a third party, the third party will benefit from the profit but the ownership remains the same.

## 1.7 Investment Instruments:

These are vehicles for capital instruments as an association.

- **Mudarabah** (المضاربة): A fund administration instrument could be short, medium or long term, whereby a financial specialist deposits money to operators to attempt a task.
- **Musharakah** (المشاركة): A value organization instrument which could be either medium or long term association, where two or more persons join either their capital or their work to share the profit & losses.

## 1.8 The Sukuk Market

Sukukare investment certificates (Islamic Bonds). Sometime they represent 'ownership' in the assets underlying the issue. Those with variable profits are based for Mudarabah or Musharakah. More pervasive are those with pre-picked, adjusted wage. The most clear of these is the one considering ijarah, i.e., rent or use. A building (or an oil tanker) is procured and leased, the cash capital for the buy offering keeping in mind the end goal to have been established confirmations. Proprietors of these affirmations would be met all pre-requisites for get a touch of the rent. These certificates can be traded in the market.

These assets are sold by the originator to a Special Purpose Entity (SPE) and then are leased back at a specified rent. The SPE securitizes the assets by issuing Sukuk certificates that can then be purchased by investors. There are Sukuk based on Salamor istisna' contracts. Agricultural produce or manufactured goods to be available in the future may form the basis of salam/istisna' bonds. Also there are hybrid issues whose underlying assets are mixtures of these. Murabahah receivables being debt obligations are not considered fit for Sukuk issue, but they have been accepted in such a mixture as long as they are in a minority.

## 1.9 Outline of the basics of Islamic finance

- Usury-Free Practices
- Risk-Sharing
- Divinity of honouring Contracts
- Moral-/Ethical Dimension
- Socio-Economic Background (Empathy, Equity and Fairness)

## 2. Analysis of Islamic Financing Methods by Islamic Banks

It became clear to us that the theoretical side posed by intellectual sources, the initial system is the primary method of posts which must rely upon the Islamic banks and that's because of the positivity of this system on the side of economic conditions. Is the practical application of the way of Islamic banks was in line with this proposal?

To find out the reality of Islamic finance in the practical application, we'll examine the relative distribution of the Islamic financing methods in some Islamic banks, and I have chosen a group of Asian Islamic banks as a model for my study through funds provided by these banks in the period from 2012 to 2014 analysis.

Displayed data in table 1 below has the following explanation:

1. Murabaha and forward sales ranked first in total funds with an average of 60.52%
2. Then comes the leasing, which ends with ownership where weighing as much as an average of 36.20%
3. Mudarabah and Musharakah occupied a very marginal importance of reaching an average of 1.62% for the post of diminishing while the non-existent of Mudarabah, where its only 0.04%
4. Bank did not use the process of Mudarabah in their financing in 2014.
5. The absence of some other financing methods such as al Salam and Istisna during all the years of studies.

**Table 1 Malaysian Bank**

| Years | 2012 | | 2013 | | 2014 | | Mean |
|---|---|---|---|---|---|---|---|
| Financing Methods | Amount RM '000 | % | Amount RM '000 | % | Amount RM '000 | % | % |
| Murabahah & sell on account | 22,427,825 | 56.49 | 27,829,382 | 58.40 | 30,986,549 | 66.65 | 60.52 |
| Ijarah | 15,232,593 | 38.37 | 18,736,382 | 39.32 | 14,373,482 | 30.92 | 36.20 |
| Mudarabah | 30,233 | 0.08 | 25,712 | 0.05 | 0 | 0.00 | 0.04 |
| Musharakah | 1,866,505 | 0.36 | 998,267 | 2.09 | 1,113,863 | 2.40 | 1.62 |
| Selling Loans | 64,696 | 1.36 | 28,754 | 0.06 | 3,004 | 0.01 | 0.48 |
| Other Service | 78,637 | 2.36 | 33,456 | 0.07 | 11,243 | 0.02 | 0.82 |
| TOTAL | 32,175,858 | 100.00 | 36,982,219 | 100.00 | 44,501,242 | 100.00 | 100.00 |

**Table 2 Qatar Islamic Bank**

| Years | 2012 | | 2013 | | 2014 | | Mean |
|---|---|---|---|---|---|---|---|
| Financing Methods | Amount QAR '000 | % | Amount QAR '000 | % | Amount QAR '000 | % | % |
| Musharakah | 58,634 | 0.18 | 49,872 | 0.13 | 55,982 | 0.13 | 0.15 |
| Murabahah | 22,093,837 | 68.67 | 25,983,744 | 70.26 | 30,987,383 | 69.63 | 69.52 |
| Istisna Contract | 3,378,273 | 10.50 | 3,368,374 | 9.11 | 4,983,748 | 11.20 | 10.27 |
| Mudarabah | 583,736 | 1.81 | 682,736 | 1.85 | 1,113,863 | 2.50 | 2.05 |
| Ijarah | 5,982,733 | 18.59 | 6,763,528 | 18.29 | 6,872,834 | 15.44 | 17.44 |
| Other Service | 78,645 | 0.24 | 133,965 | 0.36 | 487,432 | 1.10 | 0.57 |
| TOTAL | 32,175,858 | 100.00 | 36,982,219 | | 44,501,242 | | |

Displayed data in table 2 above has the following explanation:

1. Murabaha comes in the first priority in financing tools by the bank with an average of 69.52%
2. Leasing ended by ownership comes in second, with an average of 17.44%
3. Mudarabah and Musharakah occupies a very marginal importance of reaching an average of 2.05% for speculation while virtually non-existent for the Musharakah as it stood at 0.15% only
4. The absence of some other financing methods such as al slam and Alasisnaa during all years of studies.
5. Note that Murabaha and Alsaomat continues to increase over 3 years and although the rates of increment, there is an indication of growing interest of the bank to these tactics.
6. Mudarabah, leasing and Istisna 'a continuously decline in all years of study.

**Table 3 Jordan Islamic Bank**

| Years | 2012 | | 2013 | | 2014 | | Mean |
|---|---|---|---|---|---|---|---|
| Financing Methods | Amount JD '000 | % | Amount JD'000 | % | Amount JD '000 | % | % |
| Murabahah | 876,376 | 67.84 | 856,767 | 66.00 | 909,873 | 69.06 | 67.63 |
| sell in account | 2,182 | 0.17 | 2,767 | 0.21 | 3,028 | 0.23 | 0.20 |
| Rent end up with owns | 398,298 | 30.83 | 422,873 | 32.58 | 387,873 | 29.44 | 30.95 |
| Musharakah | 14,987 | 1.16 | 15,676 | 1.21 | 16,787 | 1.27 | 1.21 |
| TOTAL | 1,291,845 | 100.00 | 1,298,085 | 100.00 | 1,317,563 | 100.00 | 100.00 |

Displayed data in table 3 above has the following explanation:

1. Murabaha holds the lion's share of the other modes of financing where Murabaha ranked first with an average estimated 67.63%.
2. Comes in second place is the rent ended by ownership with averaging 30.95%.
3. Musharakah weight appeared very weak, where it reaches an average of only 1.21%.
4. The bank did not depend on Mudarabah during the 3-year study.
5. Not only Mudarabah formula is absent from the methods of financing in the bank, but also absence of both the peace and also Istisna'a.
6. Note: Murabaha recorded a steady decline in 3 years, but in very small amount which did not affect the acquisition of this formula on the bulk of the funding plans which did not go down to 80% during these years.

**Table 4-Al Rajhi Bank**

| Years | 2012 | | 2013 | | 2014 | | Mean |
|---|---|---|---|---|---|---|---|
| Financing Methods | Amount SAR '000 | % | Amount SAR '000 | % | Amount SAR '000 | % | % |
| Trading | 44,898,374 | 32.75 | 41,727,342 | 30.15 | 49,873,874 | 32.37 | 31.76 |
| Murabahah& Installment | 90,938,728 | 66.33 | 95,637,872 | 69.11 | 102,983,748 | 66.84 | 67.42 |
| Istisna Contract | 598,940 | 0.44 | 293,892 | 0.21 | 398,273 | 0.26 | 0.30 |
| Other Service | 673,622 | 0.49 | 728,273 | 0.53 | 827,363 | 0.54 | 0.52 |
| TOTAL | 137,109,664 | 100.00 | 138,387,379 | 100.00 | 154,083,258 | 100.00 | 100.00 |

## 3. Literature Review

Utilizing from different studies that follow the year 2000, which presented the subject of Islamic banks notion and highlighted its congruity for Islamic account; clarified the real components of Islamic law and preclusion concerning Islamic account; addressed the utilization of "nominate" contracts and guarantees (or legitimately tying one-sided endeavors) in organizing Islamic monetary issues; discussed the administrative issues an defined administration and social obligation. Also a lot of studies and researches discussed the success factors of Islamic banks and the problems faced by Islamic banks.

Monzer Kahf (2005) study entitled: "The success factors of Islamic banks". Mr Kahf in his study discussed several cases related to the standards of success of the Islamic banking, he selected a sample from famous Islamic banks "Bahrain Islamic banks" in four years from 2001-2004, and concluded a success criteria through basic indicators relating to Islamic banks profit system.

Nasser AlGhareeb (2010) discussed the legitimacy for banking issues and the history of Islamic banking and Islamic funding framework. Also he handled the problems that are faced by Islamic banks and their relationship with the central bank; he discussed the measurement and distribution of profits in Islamic banks and determining the criteria of distributing profits.

Manawar Iqbal (2007) discussed the Islamic banks system in order to bridge the gap in data from 2003-2006. The researcher used multiple hypotheses, experiments, and analytical equations to achieve the goals needed to compare Islamic banks with conventional banks.

## 4. Methodology and Hypotheses

The study will analyse and evaluate different financing methods offered by Islamic banks in Asia. Hypotheses:
- H1: The gap results from the misuse of the roles and norms of Maqasid Al-Shariah only.
- H2: The gap result from the misuse of the roles and norms of Maqasid Al-Shariah along with the diversion in the relatively allocation of the financing methods between debt and equity.

## 5. Study Findings and Evaluation

After studying and understanding the theory and practice of Islamic financing in Islamic banking system, we can summarize our study in answering the three questions below:

### 1. Do Banks misuse the rules and norms of Maqasid Al Shari'ah, and if yes in what ways?

Presently, few Islamic Banks are dedicated in taking after Shari'ah Rules and agreeing to Maqasid al Shari'ah. In any case, the greater part of Islamic Banks are abusing the standards of Maqasid al Shari'ah, by "practically adhering to shallow or poor translation of the all-inclusive statements of Islamic Law, while "shying-endlessly" from the genuine objectives of Islamic Law and the Socio-Economic Values of Islam that are exemplified by Social Justice, Fairness, Empathy, Equity, and so forth".

These Banks are rolling out improvements in the general comprehension of Islamic Rules under the "standard" of modernisation that keeps Shari'ah "adaptable" and utilizable in each time and put. Their "invented" rationale here is that: Islamic Banking could increment hazard because of such elements as the many-sided quality of Islamic credit contracts, restricted default punishments and good peril motivating forces brought about by PSLB (profit sharing and lose bearing) contracts.

The Buy-Back Arrangements, for instance, are broadly utilized as a part of all divisions of the economy including managing an account fund. Be that as it may, there are not kidding reservations among Studiers with respect to the legitimacy of purchase back courses of action. "Such plans may be a minor subterfuge to go around the denial of Reba". Purchasing and offering in the meantime is just another strategy for loaning on hobby. Moreover, offering something which one does not have is abusing another Islamic standard.

Islamic banks are gradually abandoning the ethical Norms of Islamic Finance. The basic principles of Islamic ethical norms elucidate that:
- Islamic Finance supports adjusted exchanges: Lenders must impart benefits or misfortunes to Borrowers.

- Islamic Finance rejects "creating" cash from cash, on the grounds that the part of cash in Islam is "worth characterizing" and a medium for trade.
- Islamic Finance disallows the expansion of credits for securing or putting resources into illegal merchandise, (for example, pork and alcoholic) or serves, (for example, betting, usury, extortion).
- Islamic Finance rejects contracting under high hypothesis ((Gharar)), as this prompts misusing or imperilling "the powerless".
- Islamic Finance rejects deal and buy of obligations at business sector decided costs, as this adds up to regarding them as products and administrations. In any case, they are definitely not. Obligations are aggregates of cash, to be paid at a future date. Accordingly, deal and buy of obligation is similar to deal and buy of money now against money at a future date. That is Reba restricted in Islam for reasons of value and human felicity.

## 2. Who is responsible for the misuse of the rules and norms of Maqasid Al Shari'ah?

Direct responsible for the abuse of the guidelines and standards of Maqasid Al Shari'ah are:

a. The Senior Management of Islamic Banks, due to either:

1. Academic Impatience for implementing a "brisk fix", an "Answer", for the "issues" thwarting the development of the moderately much "more youthful" Islamic Banking in the opposition with the more experienced traditional Banking that controls the worldwide money related markets. This accompanies a "satisfactory" penance of "a few snags" (Maqasid Al Shari'ah); and/or

2. Professional ambition for accomplishment of "eminence" and notoriety for accomplishing high benefits, by any methods; and/or

3. Personal ambitions for fulfilment of "record" results that "entice" contributors and customer base, in this manner bringing about the extension of the base of customers of the bank, and along these lines securing them advancements and rewards.

b. The Members of the Sharia Supervisory Boards, whose capacity is to go about as review and oversight for guaranteeing bank consistence with Shari'ah Law and its dedication to apply Maqasid Al Shari'ah. These tend to side bank administration and acknowledge and "advertise" the "obscured" and contorted sentiment and vision of the administration about the Islamic Law, and 'be permissive' in the support of these perspectives which progressively forsake the quintessence of Maqasid Al Shari'ah. Individuals from these Boards take after their own advantage, really being "remunerated" by the bank to assume a submission part for the reluctant open and potential clients, and for embracing routes for "danger evasion".

c. Indirectly responsible for the abuse of the principles and standards of Maqasid Al Shari'ah are the bank customers, who intentionally incline toward "Islamic-ally un-legitimate" benefits and profits to their religious responsibility and immaculateness of inner voice.

## 3. Why Islamic banks focusing on Murabaha in their financial resources?

Clearly  illustrated by the previous study that Islamic banks goes to sales formats, leads by Murabaha in the recruitment of financial resources and this at the expense of Musharakah formats and this tendency is because of several important reasons as bellow:

1. Lack of risk in Murabaha transaction because of taking guarantees that client well paid, in contrast with the other finance method specially if there weren't any previous deals.

2. Easy processing in  Murabaha contract , where the employee of the bank are not spend any efforts in study or follow or having responsibilities with the owner like Musharakah

3. Financing or resources available to the bank in the Islamic Mostly Come from short or medium-term and that capable with methods of Murabaha, also sale includes fixed return that agreed and signing in Murabaha contract between the bank and the customer.

4. Employee of commercial bank faces same procedure like what they work on in credit department.

5. Customers who have dealt for so with conventional banks on the funding formula have benefit when turn them to deal with Islamic banks that this formula appropriate especially with regard to non-interference by the banking their business after receiving financing and in order to preserve their secrets to their desires and this is what is not available in Musharakah.

6. Murabaha does not require the implementation of the bank, but the existence of a specialized expertise is required and in Murabaha process, the banks do not need to keep or store the purchases item, so the cost is less.

7. Lack of employee experience and expertise in the Islamic banking methods and investment and other formats making them vary of risk taking, especially if the bank has some successful experiences of other banks.

## 6. Conclusion

In this study, we attempted to study the framework and components of Islamic economics, finance and banking, and the financing techniques utilized by Islamic financial institutions.

Twenty five years ago, the "young" Islamic finance had been at cross-roads. Then, in a haste being fuelled by the competition for profit and extensive revenues, it gradually started to move into ethically compromised practices. Thus the operations of Islamic Institutions and their modes of financing have expanded considerably, while individuals have been deprived from "tasting" the fruits of this "enormous growth".Currently, however, its distinctive feature of Islamic finance is the growing controversy between its original theory and current practice.

During these last 25 years, Islamic finance has grown and developed in such a way that it converged towards conventional banking methods, thus becoming, itself, a presenter and producer of hybrid financial products of the "interest-bearing" international financial system. So, the "Grand" operations of the massive international financial markets – those which priorities economic incentives rather than ethical, religious and behavioral norms - have "tempted" Islamic finance institutions to become part of the "usurious" international financial system.

We have addressed in this study, diagnosis and analysis of the reality of the Islamic bank financing in the practical application and this in order to identify the extent of deviation of the Islamic Bank from the theoretical frame and get to know the extent of the need for these banks to reconsider their own way, so our study result to some of the findings and recommendations and that doesn't means to ignore Murabaha but don't rely much on it while they apply it with right contracting terms of legitimacy and without fraud or intentional misuse .

The banks have rights to selling what God has permitted and humans does not deprive it, but if Islamic banks are able to distribute their investments by species, possibly such as Mudarabah, Musharakah and al-slam, leasing with giving preference relative to formats of Musharakah, it will be a best practice between the banks and their clients. Therefore, it has been the divergence between the assumptions, normative principles and aspirations of Islamic economics as a system and Islamic finance as an instrument of that system.

According to the study, the several financing techniques such as Murabaha, Buy-Back transactions, Deferred Sale operations, etc., need to be carefully and thoroughly reviewed from the point of view of the Shari`ah Law and with a backdrop of Maqasid Al Shari'ah.

I do recommend the following steps to stem the gap in Islamic finance:

- Establishing an Islamic Central Banks to monitor and control the Islamic financing methods and match them with Islamic law.
- Shifting toward equity financing methods gradually with a 5 % average annual increase.

## 7. Recommendations

In light of the results obtained previously it is clear that group of banks are almost similar in terms of the degree of dependence on financing methods to apply their resources where we noted that the adoption of the majority of these banks in its funding formulas on sales, particularly to Murabaha is the main reason for the gap between theory and practice which result in negative impact on economic conditions, so the experts and specialist should work together to achieve the following objectives:

1. Activate the Islamic Financial Methods based on participation in the profit and loss of funding tools by the following:
   - Careful selection of client's with new financial records, and who deal in accordance with the financial rules and norms of customary accounting and adhere is sued by standards, so they have to have special department to deal with this issue.
   - Restrict Mudarabah with conditions and restrictions that fit the ownership in all aspects of investment activity because the contract is the foundation upon disclaimer and the speculative or worker should be adhered to it and not violating it.
   - Watching the stages or process before and after the work is done well leads to minimizing of losses or to not complete and achieve the desired profit.

1. Don't rely much on Murabaha to avoid the following negative effects:
   - Reduces the ability of Islamic banks to finance large economic projects that require long-term funding while Murabaha is consider as a short-term approach in general.
   - Murabaha sale contributes in the production of behavioural models that are unacceptable in Islam such as bias to quick profit; avoid the risk, the desire to increase profit margins and lack of attention to the other party in community.
   - Attention to goods imported and ignoring of domestic goods affect the productivity of these countries.

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The Holy Qur'aan, Al-Baqarah, 2: 275

{Those who swallow down usury cannot arise except as one whom Shaitan has prostrated by (his) touch do rise. That is because they say, trading is only like usury; and Allah has allowed trading and forbidden usury. To whomsoever then the admonition has come from his Lord, then he desists, he shall have what has already passed, and his affair is in the hands of Allah; and whoever returns (to it)-- these arc the inmates of the fire; they shall abide in it.}

The Holy Qur'an, Al-Baqarah, 2: 276

{Allah does not bless usury, and He causes charitable deeds to prosper, and Allah does not love any ungrateful sinner.}

The Holy Qur'an, Al-Baqarah, 2: 278

{O you who believe! Be careful of (your duty to) Allah and relinquish what remains (due) from usury, if you are believers.}

The Holy Qur'an, Al-Imran, 3: 130

{O you who believe! do not devour usury, making it double and redouble, and be careful of (your duty to) Allah, that you may be successful.}

The Holy Qur'an, An-Nisa'a, 4: 161

{And their taking usury though indeed they were forbidden it and their devouring the property of people falsely, and we have prepared for the unbelievers from among them a painful chastisement.}

The Holy Qur'an, Ar-Room, 30: 39

{And whatever you lay out as usury, so that it may increase in the property of men, it shall not increase with Allah; and whatever you give in charity, desiring Allah's pleasure-- it is these (persons) that shall get manifold.}

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# Population Growth and Development
# Education as Factors of Economic Growth

## Armine Aghajanyan

Abstract   Human capital includes the accumulated investment in such areas as education, training, migration. The knowledge and skills that the worker has and who acquired them through education and training, including the skill obtained with experience constitute a certain stock of productive capital. The monetary value of the capital stock is defined as the discounted stream of future income from its use during a person's life, that is dependent on the wage rates at which human capital can "rent" employers in the labor market, interest rates and the expected duration of employment. Job migration and extend the value of human capital specific people by increasing its price (wages, paid per unit of time for the use of entrepreneurs the knowledge and skills of the employee).

**Keywords**   Economic growth factors - Population.

**JEL Classification** O-043

## Introduction

Approximately 12 thousand years ago, during the Neolithic revolution, when humanity passed to farming, the world population did not exceed 5 million. From Neolithic to the XVIII century, the population growth rate has been very low, with an average around 0,002% per annum. By 1750, population growth has increased to 0.3% per year, that is increased 150-fold.[1]
By 1950 it rose further by 3 times and amounted to almost 1% per year, and reached a peak in 1970 - 2.3% per year. In the 1980-1990 years it was at the level of 1.7% per year. This phenomenal acceleration of population growth began in XVIII-XIX centuries in England and America, then in Western Europe. Moreover, population growth in Europe and North America was accompanied by an increase in per capita income. The very logical theory developed by T. Malthus, according to which the population growth leads to impoverishment of the majority of its mass and an increase in mortality and per capita income growth of the population leads to an increase in fertility, has not been confirmed in practice and has been abandoned by most economists of the XX century.[2] However, T. Malthus' theory of the logic is used in the

[1] Todaro M.P. Economic development: a textbook. M.: UNITY, 1997, pp 171, 172.
[2] Becker G. S., Glaeser E. L., Murphy K. M. Population and Economic growth. // AEA Papers and Proceedings. 1999. № 2, V. 89. P. 145, 146.

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neoclassical theory of growth as the assumption of declining marginal product of labor with an increase in labor supply. This logic holds for the assumption of the absence of technological and social progress. As noted by many leading contemporary economists, advocates of the theory of human capital, in a modern urban economy, increasing population density, caused by the growth of population, contributes to the specialization of people and a great investment in human capital, as well as to the acceleration of the accumulation of new knowledge. This "increasing returns" from specialization and knowledge increases, per capital income, apparently, to a greater extent than the "diminishing returns" in sectors with limited resources (mining and agriculture).[3]

What factors contribute to the growth of economic performance with growth of population and its density?

Apparently, the most important factor in improving the overall efficiency of the economy with an increase in its scale is urbanization. G. Becker, E. Glaser and C. Murphy noted that the concentration of population in cities is very important for the economy, as in the cities there is extensive division of labor and more human capital and new knowledge is produced. Moreover, the high population density in cities contributes to a highly specialized by occupation, and the production and transmission of knowledge to future generations. As is known, in the neoclassical model it is believed that the rate of return on investment in physical capital is reduced with an increase in per capita stock of physical capital population. The corresponding assumption for human capital is less plausible, since human capital is the knowledge of prisoners in humans. The benefits of the accumulation of additional knowledge in people depend more positively than negatively on knowledge they already have. These assumptions underlie the dominant concept of learning in the educational pedagogy, where the success of learning higher mathematics and other disciplines depends on the degree of assimilation of the functional blocks of the elementary concepts.[4]

Another argument in favor of population growth as a factor for economic growth is found in the textbook of M. Todaro: "Over a large population presents a greater consumer demand, providing economies of scale production and lower production costs, and also increases the supply of low-cost labor in order to achieve large production volumes".[5] Economies of scale achieved by population growth and density, especially in big cities, that is urbanization contributes not only to the accumulation of human capital, but also reduce the production costs of conventional products.[6]

Economists-"revisionists" counterrevolutionary neoclassical school of the 1980s George. Simon and N. Eberstadt argued, for example, that free markets are able to adapt to any deficits arising from population growth ... In the end, free markets and human ingenuity permit all the problems of population growth.

D. Acemoglu tried to theoretically describe the mechanism of occurrence of social increasing returns from investment in human capital. The growth of return on investment, both in human and in physical capital, is connected to the emergence of externalities in the accumulation of human capital as a reserve for the whole country, and per employee. One of these social effects associated with the expectations of investors.[7] If the investment in human capital is considered to increase its stock increasing the number of qualified professionals, firms expecting expansion

3 Becker G. S., Glaeser E. L., Murphy K. M. Population and Economic growth. P. 145, 146.

4 Becker G. S., Glaeser E. L., Murphy K. M. Population and Economic growth. P. 145, 148.

5 Todaro M.P. Economic development: a textbook. P. 191.

6 Becker G. S., Murphy K. M., Tamura R. Human Capital, Fertility and Economic Growth // J. P. E. 1990. Pt. 2. № 5, V. 98. P. 15, 16.

7 Acemoglu D. A Microfoundation for social Increasing Returns in Human Capital Accumulation // The Quarterly Journal of Economics. 1996. VCXI, Issul 3. P. 779–804.

of the labor supply of specialists in the labor market and a corresponding increase in the impact of physical capital, increase investment in physical capital.

This meands that at least part of the external effects occur due to changes in the value of future pairs of physical and human capital firms. These effects increase the impact of both human and physical capital with the growth of the stock of human capital occurring in individual firms, regions and entire countries. Increased return on investment in human capital in the major cities is attracting skilled labor.

Migration flows of specialists - the "brain drain" - also exist in the less developed countries. These facts confirm the existence of externalities in the accumulation of human capital and increasing population density. Therefore, population growth with a corresponding increase in its quality and level of education is an essential factor of economic development and growth of effectiveness. Consider the role of human capital accumulation in the modern world. Human capital includes the accumulated investment in such areas as education, training, migration. The knowledge and skills that the worker acquired through education and training, including the skill obtained with experience, constitute a certain stock of productive capital.

The monetary value of the capital stock is defined as the discounted stream of future income from its use during a person's life that depends on the wage rates at which human capital employers can "rent" in the labor market, interest rates and the expected duration of employment. Job migration and extend the value of human capital specific people by increasing its price (wages, paid per unit of time for the use of entrepreneurs the knowledge and skills of the employee). The wealth of the society as a whole can be viewed as a set of human capital and material (physical) capital, not directly associated with people. The total wealth of the United States in 1991 was estimated at approximately 54.5 trillion dollars, of which 26 trillion (48%) accounted for the human capital.[8]

## Conclusion

According to the World Bank, as part of the national wealth of the United States the main production assets (buildings and structures, machinery and equipment) account for only 19%, natural resources - 5%, and human capital - 76%. In Western Europe, the corresponding figures are 23.2%, 2.8% and 74%, in Russian - 10%, 40% and 50%. The relevance of studies of human capital production and use of machinery is growing rapidly due to the increased role of knowledge and scientific and technological progress in the modern economy. Apparently, the quality of the workforce, level of education and training will be in the XXI century not only an important factor in economic progress, but also the basic condition for the competitiveness of national economies. In practice, public spending on higher education has leveled in 2003 with private, as evidenced by the statistics[9]

The relevance of studies of human capital production and use of the mechanisms intensified due to the increased role of knowledge and scientific and technological progress in the modern economy. In the early 1990s, the share of education expenditures in GDP was in France - 7.1%, Japan - 6.3% in the US - 6.1%, in Germany - 4.5%, while in Russia only 2.7%, which is 2-3 times lower than in developed countries. As part of a person's productive capacity are also present biologically and socially inherited characteristics, such as the supply of health and intellectual capacity, moral and ethical norms, values, etc[.10]

Job migration and extend the value of human capital specific people by increasing its price, that

8 Eisner R. Extended Accounts for National Income and Production // Journal of Economic Literature 1988.
9 Dobrynin A.I. Dyatlov S.A., Tsyrenova E.D. Human capital in transitive economy. P. 107, 108.
10 Dobrynin A.I. Dyatlov S.A., Tsyrenova E.D. Human capital in transitive economy. P. 107, 108.

is wage rates received per unit of time for the use of the knowledge and skills of the employee by entrepreneurs. The wealth of society as a whole can be viewed as a set of human capital and material (physical) that are not directly related to the people.

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# America's Health, Innovation, Technology and the United States Presidential Election

## Eliot Sorel

Addressing America's health and healthcare is one of the challenges for the next president of the United States, since the U.S. healthcare system represents now nearly 20% of America's GDP.

The United States takes great pride in its extraordinary health research and discoveries; excellent academic medical centers; dynamic, innovative information and communication technology sector; and, the surge in technology applications across the healthcare system.
Although the Affordable Care Act has increased Americans' access to care and the aggregate US healthcare budget is now approaching $3 trillion, millions of Americans still do not have access to care.

The United States, the richest country in the world, is the only developed economy where not all of its citizens have access to care. That high (and rising) cost of US healthcare is likely unsustainable, given its current trajectory.
Despite substantial expenditures, the American healthcare system does not rank in the top ten in the world. For those who do receive healthcare, the quality of that care is highly variable.
In the next few years, the U.S. healthcare system will be significantly tested by the following:

- aging healthcare workforce;
- retirement of a sizable segment of practicing physicians;
- on-going (and growing) shortage of nurses;
- burden of non-communicable diseases;
- re-emergence of communicable diseases;
- current minimal emphasis on health promotion and protection, as well as illness prevention;
- lack of health insurance coverage (and thus access to care of millions for Americans); and
- continued care of the uninsured through our hospitals' emergency rooms (the most expensive, fragmented, and inefficient means of care delivery).

Disruptive health and healthcare innovation, along with a judicious and smart use of technology as a tool in service to innovation, will be essential to respond to these American health systems' challenges.

Equally important is the seamless integration of attending to populations' TOTAL health, beginning with the perinatal period by providing incentives for health behavior changes (in

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both care receivers and care providers), promoting and protecting health and wellness, preventing illness, and emphasizing shared responsibility (among care receivers, providers, payers, and policymakers).

All Americans across the life cycle should enjoy access to quality health care in a sustainable system. The next American President will need to address these challenges and opportunities and create the incentives for disruptive innovation that will assure access, quality, and sustainability of health and healthcare for all Americans. Such a mission has intrinsic value and economic value added. Its accomplishment must be one of top priorities for the next US president's agenda for health reasons, economic reasons and for US security.

(The opinions expressed here are solely those of the author)

# The Happy Hellenic Republic:

# Introducing new regulatory framework

## Tigran Hakobyan

**Abstract**  This document presents a proposal for a new regulatory framework for the financial sector of the Happy Hellenic Republic (HHR).  The recently elected government has managed to fully repay its external debt, has abandoned the euro and issued a new currency, the Happy Midas Drachmae (HMD).

**Keywords**  New regulatory framework - Financial sector - International financial convergence Liquidity virtue cycle.

**JEL Classification**  E02, O43

## Introduction

In this context of macroeconomic stabilization, given the high amount of reserves and the nascent Euro Area recovery, it is expected that over the following years the HHR economy will receive a strong capital inflow, which will further boost economic activity and thereby the financial sector. The experience of the international financial crisis has proved that the consequences of a self-reinforcing liquidity crisis can be devastating and has exposed the limitations of the regulatory framework implemented before and during the crisis.  Thus, in order to avoid excessive risk taking by financial institutions over this future expansion period, it is necessary to create and implement a sound financial regulatory framework, in our case a liquidity management framework.

## Scope of regulation

Within the globalized economy, in which financial linkages between countries are becoming more interrelated, the implementation of any new financial regulatory framework should be consistent with the internationally accepted principles for the financial sector. Therefore, in designing a new regulation for HHR, it is necessary to determine a new set of rules, which leads to convergence of HRR financial sector to international standards. In this sense, we base this new framework on the "Principles for sound liquidity risk management and supervision" outlined

by the Basel committee in September 2008 and the subsequent Basel III recommendations.1 We would like to state that the rules that are to be put forward concern banks (credit institutions), however, we recognize the fact that these liquidity management guidelines may also be used to define liquidity risk management protocols for non-bank financial institutions. The rules we propose will deal with the building of a comprehensive risk management framework that is subject to regular review by internal and external supervisors. These rules will seek to avoid the cataclysmic damage that can be caused by a reversal of the liquidity virtue cycle due to unlikely but strong liquidity shock events leading to a downward spiraling liquidity crisis.

## Underlying Risk Methodology and Liquidity Risk Measures

In our proposed guidelines, the Liquidity Coverage Ratio (LCR), as introduced by Basel III, will be replaced by a new LCR based on the Projected Liquidity Exposure (PLE) and the Counter Balancing Capacity (CBC) as proposed by the findings of Fiedler (R. Fiedler, Liquidity Risk Corporation). The definition of High Quality Liquid Assets, as per the Basel III definition, will also be used in the calculation of the PLE. Regarding funding stability over a longer period, the Net Funding Stability Ratio (NSFR) calculation methodology remains the same, however the weights in the Available Stable Funding (ASF) and Required Stable Funding (RSF) calculations may be changed on a situational basis. Precise changes to risk-weights should be discussed in more detail in cooperation with the Hellenic Central Bank and other national competent authorities. In this new framework, the central bank in its supervisory role will be granted further responsibility and authority in order to determine the regulatory accounting standards to be reported by financial entities, financial projection models with different kind of scenarios and which will be subject to stress tests. It is the opinion of the authors of this proposal that the methodology and procedures for these financial models, its forecasts and stress tests be determined by the central bank, who due to its overview of the macroeconomic outlook and its economies of scale is in a better position than individual financial entities to determine which are the relevant variables and likely scenarios.

However, there should be a strong and continuous interaction between the central bank and the risk management representatives of individual entities. On the one hand, this should allow the risk measurement tools to be adapted to specific problems faced by different kinds of banks. On the other, this will generate a learning process where the representatives of individual institutions incorporate the liquidity risk view of the central bank and where the central bank gets to know the risk management challenges and practices that are specific to entities operating in different sub-segments of the financial industry. In this sense, liquidity risk management plans should be designed with respect to the individual bank's liquidity risk tolerance, as well as the bank's systemic importance to the HHD economy. Said risk tolerance should be reviewed and assessed on a regular basis in cooperation with any relevant competent national authorities. In addition, financial institutions should develop a contingency funding plan consistent with their risk preferences and results of stress tests and scenario analysis. Finally, the risk management regulations should be accompanied by the implementation of a Fund Transfer Pricing System to determine the cost of funds to clients based on an incentive compatible mechanism to limit risk taking throughout different banking units.

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1 Basel Committee of Banking Supervision: Principals of Sound Liquidity Risk Management and Supervision, Bank of international settlements bcbs 144, September 2008;
   Basel Committee of Banking Supervision: Basel III: International framework for liquidity risk measurements, standards and monitoring, Bank of international settlements bcbs 188, December 2010

Minimum Requirements (LCR and NSFR) must be reported on a daily basis. On a monthly and quarterly basis financial institutions should report their financial statements following a standardized account breakdown determined by the central bank. Also to be reported on a monthly and quarterly basis are their minimum liquidity requirements and liquidity gap analysis by currency as well as an update of the financial model introducing data of current financial statements update and macro-financial projections provided by the central bank. Financial institutions should develop stress and back tests using the general methodology outlined by the central bank and including specific scenarios agreed on between individual institutions risk managers and the central bank representatives. These results should be accompanied by a document containing an analysis of the results and an evaluation of the strengths and limitations of the contingency funding plan based on these results. Finally, on an annual basis, banks should present annually aggregated version of data presented on a higher frequency basis as well as a report explaining any changes in the business plan and the associated adjustments to the contingency funding plan.  Banks should also report their results to market participants, to a reasonable extent, allowing the participants to assess the soundness of the liquidity risk management plan implemented.

## Impact on the Financil System, the Real Economy and Interactions with other Countries

The proposal aims mainly at directly reducing funding liquidity risk and minimizing the probability of a bank's exposure to stressed liquidity scenarios. However, due to the close linkages between funding and market risk, the proper implementation of this framework will reduce liquidity risk as a whole. As this framework is designed to be consistent with supervisory standards agreed on by the Basel Committee, it will also encourage a convergence of the Hellenic financial system to international standards and norms.

Regarding macroeconomic effects, appropriate implementation of this regulatory framework will limit excessive risk taking and reduce the likelihood of adverse liquidity shocks, which end up affecting the exchange rate and real economy. However, the measures proposed should be discussed in detail with the Hellenic Central Bank and any other relevant competent national authorities, including those in charge of macro policy design, in order to allow coordination of policy implementation, considering its consequences for the financial system and the real economy.

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# STABILITY WITHOUT STATEHOOD

## Lessons from Europe's History before the Sovereign State

### PETER HALDÉN
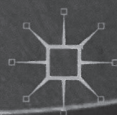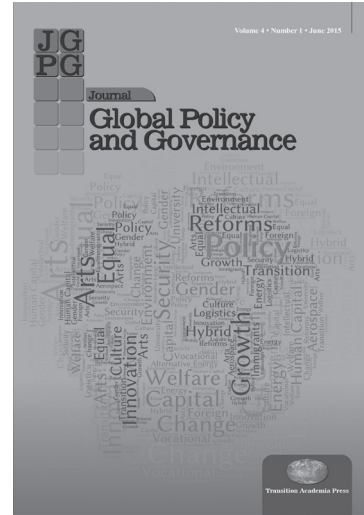
# Journal of Global Policy and Governance
# Aims and scope

Global governance is a challenge of our era and us as human beings no matter where we live and what values we believe in. After a 100 years of development, international relations are so closely and tightly knit. A problem in a community might affect the life of the people in a remote part of the world and its solution might also be in the hands of these people but can't be assumed outside the more global International Relations theories and practices approach, an interrelated already practiced at every policy decision making, economic and financial levels and first of all by the main powers.

How can we manage this complex of various relations matters for our life and common future? It is the time for us to invest our wisdom and energy to make global governance work now and to give a sense to the United Nations already reduced to a zero-sum-game playing on the major emergencies and conflicts due first of all to the obsolete veto system that would be at least extended to all the 15 countries of the Security Council, being them permanent or at rotation, with the weighting of votes bringing less hypocrite the present five Jalta powers partition already 70 years ago. We are talking of the world not existing anymore.

There is no simple way and framework for global governance. Global governance is a general term which means to think globally and act globally. It is complicated because problems might be local. It is complicated because problems might be also global. It is complicated because the solution of problems might be local but also in a global framework global. That is why we need to check issues case by case carefully. We need to sort out what solution is the best choice for the problem. We need to identify who should be the persons of good will taking the challenge and adding their intellectual and scientific capabilities to the human destiny.  We have to take an action worldwide. Global issues are definitely the subjects of global governance. Meanwhile, global governance takes care of issues with local reasons and local solution because we believe the experience might be helpful for people living in other parts of the world.

Interdependence of International Relations with finance, economy, technology, research and

advanced knowledge until a few years ago unimaginable, new military might introduced by innovation must be some of the crucial challenges, where also our Journal Global Policy and Governance intends to contribute opening its pages, issue after issue, to faculty, experts, testimonies, articles and relevant review of books, junior researches working papers. But we know also that traditional conflicts would not have any perspective in the medium term and will bring to the defeat of the ones who are imagining a return to the past.

We intend to embrace and reach all the possible interested colleagues and fellows around the world, as choices and strategies in all the sectors involving public and private governance, nobody excluded, are under questioning and innovative evaluation. Global world is not anymore a provocative statement, a kind of utopian return to realism and the theories dominant up to the German reunification, the end of Soviet Union and the war in the Balkans have now become obsolete by definition.

Middle East, Black Sea, Eurasia, Ukraine, Baltic, Turkey have the capability to reshape the future. Even if they are now in the middle of the fire, soon the devastations and impressive mass killings will be overcome and reconstruction taking the lead in many of these countries.

But why not underline the successful 30 years development and growth of China, a unique case in the last 500 years. China is the third world power, after European Union and USA, and has now similar problems we have encountered and are still facing nowadays, needs to find a political solution to reforming and giving voice to an accountability to its almost 1 billion 500 million inhabitants.

We really have to rethink the International Relations and the theories of Global Governance and Policy Choices, accepting the pluralities of institutional architectures and ways to give voice and accountability to the citizens. The European Union represents a "non Statehood" institutional governance, without even a Constitution and the Sovereignty belonging to the member countries. Do you believe the EU will change its architecture established by the Treaty of Rome in the future? This is an illusion of the antagonists of the different strategies and policies that were adopted right up to the Euro and the high welfare and technologic standards already achieved, even in the face of a crisis on 2008 that from the Atlantic arrived to Europe three years later and is now affecting East Asia. By 2020 we will be out of this tunnel everywhere in the world.

To add a valuable contribution to this scientific debate is our very aim and scope

# *Bodies and Organs*

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# Global Policy and Governance

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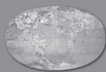Religion-Corruption Nexus in Ghana
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