



After the Fall: The Future of Global Cooperation

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After the Fall: The Future of Global Cooperation

ICMB Geneva Report 14

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Chapter 1

Introduction: Past Imperfect, Present Tense, Future Conditional

The world economy faces its most serious test since the 1930s. The financial crisis that began in 2007 has yet to run its course: in most of the OECD, the recovery is at best halting, while much of the European Union has collapsed into a second recession and faces a daunting sovereign debt burden. Emerging markets have done better, but their fortunes remain closely connected to trends in the developed world. The immediate future of global economic activity is not promising.

The longer-term future of the international economic order is also in doubt. Even if the principal economies were to resolve their current financial problems without major disaster, the world economy would eventually confront substantial challenges. The macroeconomic imbalances that led to the crisis are likely to recur, and with them the danger of a new round of debt accumulation and potential debt crises. The international financial system has demonstrated a fragility that threatens the global economy more generally. Even as more and more developing countries turn to exports to drive their economic growth, the appetite of the developed world for these imports seems to be waning. International financial flows remain at an extraordinarily high level, but there are

enduring questions both about whether they contribute as hoped to a more efficient allocation of resources, and whether they can be sustained without creating another round of bubbles and crashes.

Most, if not all, of these problems appear to require concerted international efforts to address them. Calls for greater “global governance” reflect the accurate perception that global markets seem to have exceeded the ability of national governments, or *ad hoc* international cooperation, to address the problems to which they may give rise.

And yet the structure of international cooperation on economic issues seems seriously deficient. On some dimensions, such as central bank cooperation, it appears to have worked reasonably well in difficult times.¹ But this relative success is almost entirely limited to monetary policy. On virtually every other important global economic issue, international cooperation is stalled, flawed, or non-existent.

We do not think the very limited successes of attempts at greater global economic governance are surprising. There are major barriers to expanding the realm of international cooperation. This is especially true in the very difficult circumstances of the aftermath of the greatest economic crisis in several generations.

The immediate future path of international economic affairs will indeed be complicated by the fact that the major centers of economic activity are likely to spend

¹ Although some emerging-market governments, such as those of Brazil and China, have complained that excessively loose monetary policy in the OECD was “exporting inflation” to the rest of the world.

much of the coming decade absorbed in difficult attempts to clean up the refuse of the financial crisis, and to find new patterns of economic growth. As North America, Europe, and Japan struggle with their own domestic economic and political problems, they are unlikely to be willing or able to expend much effort to deal with matters outside their borders. Past experience and common sense show that domestic political support is a prerequisite of meaningful international engagement. A government that cannot count on its constituents to support its foreign policies will soon either change its policies, or cease to be in government. And there appears to be limited public support for the measures necessary to expand the network of international economic cooperation.

Another major problem is that the number and character of the relevant international economic actors is changing. It is hard to imagine serious discussions about trade, finance, or exchange rates without including China, Brazil, and other emerging economies. However, the major emerging economies are at very different places on the path to global economic and political engagement. Generally, it is not clear that such countries as China, India, and Brazil will be willing or able to contribute much to the management of international economic problems – for one thing, their interests and perspectives are likely to be very different from those of the current incumbents. The expanding number of systemically important nations both increases the need for substantive cooperation to include those nations, and the difficulty of achieving consensus among ever more disparate international actors.

As the world emerges from the most serious crisis since the Great Depression of the 1930s, then, we must also think about the more distant future. What are likely to be

the principal issues facing the international economy over the next decade? What could a realistic analysis hope for in the way of progress in confronting the problems of the future? What are the constraints imposed by the realities of international and domestic politics? And, most directly for our purposes, what forms of international economic cooperation are most important to pursue, and most likely to be achieved?²

In what follows, we speculate on these matters. We start, in Section 2, with a quick summary of some of the lessons of previous experiences with an integrated international economy. In Section 3, we move to an overview of the current situation. We outline the major dangers facing the world economy in the near term, and the political and economic stumbling blocks to their resolution. Section 4 summarizes the recent experience of cooperative ventures in a world made more complicated by the entry of new major players, and the persistence of conflicts of interest and perspectives among the principal powers. Despite continued rhetorical commitments to economic cooperation – many falling far short of any meaningful global governance -- the recent history of actual attempts to implement such cooperation is very checkered, and largely disappointing.

² Two previous Geneva Reports have focused closely in related issues in international cooperation: José De Gregorio, Barry Eichengreen, Takatoshi Ito, and Charles Wyplosz, *An Independent and Accountable IMF Geneva Report on the World Economy 1* (Geneva: ICMB, 1999); and Peter B. Kenen, Jeffrey Shafer, Nigel Wicks, and Charles Wyplosz, *International Economic and Financial Cooperation: New Issues, New Actors, New Responses* Geneva Report on the World Economy 6 (Geneva: ICMB, 2004).

Section 5 analyzes some of the domestic economic and political obstacles that explain the limited scope of cooperative ventures. It also argues that the major players are likely to face continuing domestic political constraints over the coming decade. All governments require support from their constituents to undertake potentially costly international initiatives; without this support, such international initiatives will face grave difficulties. In Section 6, we discuss what normative theory would suggest might be desirable in the way of governance structures to address the global problems outlined in the previous sections. We ask what sorts of international cooperative measures, institutionalized or otherwise, might be advantageous, assuming they were attainable. We argue that the great efforts required to achieve forward movement suggest that we pick only the most important issue areas, topics in which the normative case for global governance is particularly strong. Section 7 assumes that we avoid worst-case scenarios and attempts to project the general state of international economic affairs five to seven years from now. We attempt to identify the issues that we think will be central to this new phase in the international economic order. Section 8 summarizes and concludes.

We emphasize that cooperation among national governments over global economic problems is more important in certain areas than in others.³ But where

³ The scholarly literature in International Relations typically distinguishes between cooperation and coordination. The former implies a Prisoner's Dilemma or similar game, with a Nash equilibrium that allows for a Pareto superior Nash bargaining solution, toward which governments can work. The latter implies more of something like an

macroeconomic spillovers are concerned, it is both vital, and difficult to achieve. National political systems do not easily set aside important domestic problems to focus on more remote international ones; and the preferences of both broad publics and powerful special interests in different nations are often at odds. This is especially the case in the context of a difficult recovery from a wrenching crisis. It is also especially the case when there are several actors on the international economic scene who have gradually moved from the periphery of global economic developments toward the center, and whose concerns are often radically different from those of the traditional economic powers.

Given the undoubted difficulty of achieving substantial international cooperation, we emphasize the need to focus efforts on where they are most required, and most likely to succeed. This leads us to undertake a normative analysis of the argument for greater global governance, and to argue for minimal rather than radical objectives. We also try to identify the issues of greatest prominence, and on which cooperation is most important;

Assurance game, in which governments agree on converging on a focal point, although different focal points may have different welfare and distributional effects. For our purposes, we elide the two definitions; different issue areas may fall into one or the other category, and in any case the classification is sometimes controversial. Indeed, many scholars believe that inter-state bargaining *always* involves both cooperation and coordination. An influential statement is James D. Fearon, "Bargaining, Enforcement, and International Cooperation," *International Organization*, Vol. 52, No. 2 (Spring, 1998), pp. 269-305.

we focus on macroeconomic policy coordination and attention to global imbalances. These are likely to be of central importance; there are strong arguments for international cooperation to deal with them; and there is some political support for movement in this direction.

Our conclusions are rarely rosy, and may appear pessimistic. We prefer to think that we are realistic, and guardedly optimistic. It is, after all, better to confront the obstacles we face than to ignore them. Plans for the future that take the difficulties we are likely to face into account are clearly better than those that do not.

Chapter 2

The ghost of globalization past: lessons for globalization present

2.1. Globalization past

We can look to history for some guidance as to the problems the world economy is likely to face.⁴ Indeed, the world has been here before. For decades before 1914, the international economy was roughly as integrated as it is today. Scholars disagree about just how integrated it was, and is, but all indications are that goods and capital moved around the world very easily between 1870 and 1914 – not as quickly or cheaply as they do today, but with as few explicit government controls. In fact, on a couple of dimensions the world economy was more “globalized” then than now. There was an international monetary order that tied almost all major countries together in something approaching a monetary union. By the early twentieth century every economy of any economic significance, except China and Persia, was on the gold standard, which facilitated trade, investment, and travel in important ways. By the same token, international immigration

⁴ The classic statement, with regard to international monetary relations, is Barry Eichengreen, *Golden Fetters* (New York: Oxford University Press, 1996). See also Jeffrey Frieden, *Global Capitalism* (New York: W W Norton, 2006).

was much freer then than it is today: Europeans, at least, could migrate to much of the New World with no documents at all.

That first era of globalization was remarkably successful, by the standards of economic development achieved to date. The world economy grew more in the 75 years before 1914 than it had in the previous 750, and there was substantial convergence among countries of the core and lands of recent settlement. Some poor and middle-income countries moved toward the living standards of the early industrializers, although the world was divided between an industrial core and a resource-exporting periphery. Macroeconomic conditions were relatively stable, despite periodic crises and “panics,” as were prices. None of this is to ignore the uglier sides of the period – colonialism, authoritarian governments, agrarian crises, and grinding urban poverty were all parts of the nineteenth and early twentieth century world order. Nonetheless, compared to what had come before – and what came immediately after – this was a flourishing global economy.

2.2. Globalization collapsed

And yet that globalized economy came to a grinding halt in 1914. After World War One was over, the world’s political and economic leaders attempted to restore the classical order that had prevailed for so long – and they failed. It was not for lack of trying, as conferences, meetings, treaties, and international organizations proliferated as never before. But nothing worked; the global economy fragmented and eventually, after

the 1929 downturn hit, broke down into trade and currency wars, and eventually shooting wars.

The interwar economy started off on a promising note. After a surprisingly fast few years of reconstruction, by 1922 international trade and finance had resumed at something resembling their pre-war pace. The central financial nexus of the era was the flow of capital from the world's leading surplus country, the United States, to borrowers in Central and Eastern Europe, Germany in particular. This particular "macroeconomic imbalance" helped speed the return to something approaching normalcy on both sides of the Atlantic, as American industry and finance boomed and the German economy recovered rapidly.

The weaknesses of the interwar settlement were revealed after recession began in 1929. Cooperation among the principal economic players broke down quickly. The French and Germans continued to spar over every aspect of their relationship, infusing even purely financial issues with the venom of their diplomatic conflicts. Some hoped that the new economic powerhouse, the United States, would contribute to a resolution of the problems, especially since the United States had become the world's principal creditor nation. Yet Americans preferred to stand aside from European affairs, both because they were preoccupied with the country's own problems and because their political system was dominated by economic nationalists and isolationists who objected on principle to subordinating national concerns to global cooperation. One source of American reticence is of contemporary relevance: many Americans felt that existing international organizations did not accurately reflect the role of the United States in the world, and

were indeed to some extent intended to constrain American influence in favor of the European powers.

As the world economy stagnated and spiraled downward, domestic affairs loomed ever larger in the concerns of other national governments as well. By 1934 every semblance of international economic cooperation had disappeared. Trade wars, currency wars, and eventually shooting wars ensued.

2.3. Lessons from the past

There are two principal lessons of that previous age of international economic integration and its collapse after 1918. First, an open international economy can sometimes require the purposive collaboration of the major economic powers, especially during periods of economic stress. The nineteenth-century fiction of self-equilibrating international markets may have applied to particular markets; but it did not apply to the world economy as a whole. For a globalized economy to persist, especially in the face of periodic crises, the principal financial centers need to cooperate to stabilize markets and safeguard openness.⁵

⁵ To be sure, the view expressed here – drawn largely from Eichengreen – has been challenged to some extent. See, for example, Marc Flandreau, “Central Bank Cooperation in Historical Perspective: A Sceptical View,” *The Economic History Review* New Series, Vol. 50, No. 4 (Nov. 1997), pp. 735-763.

The second lesson of the collapse of the classical version of globalization is that national governments will not be able to undertake the measures needed to sustain an open economy if they do not have the support of their constituents. Policymakers must answer to their constituents – who might be narrow elites or broad masses – and if constituents are hostile to the world economy, policymakers who ignore this hostility will be pushed out of office. Many of the major powers of the nineteenth century had been either undemocratic or only partially so; they had not needed to answer to the demands of the middle and working classes. By the 1920s, this had changed, and almost every industrial country was democratic. A failure to reflect accurately the interests of constituents led, quickly, to a powerful backlash – both against the government, and often against the rest of the world.

Past successes, and failures, of globalization demonstrate that a functioning, open, international economy requires some degree of cooperation among nations, especially among the major economic centers. They also demonstrate that cooperation in turn requires domestic political support for the measures necessary to help keep the world economy functioning smoothly. How does the current situation look, in the context of these lessons?

Chapter 3

The current situation

3.1. Introduction

The past thirty years have been an extraordinary period in international economic history. After a very troubled decade in the 1970s, the 1980s saw the developed countries gradually resolve to redouble their engagement with one another, and with the world economy. Over the course of the 1980s, most developing countries followed suit, turning away from semi-autarkic policies of import substitution and pushing their producers into world markets. China and Vietnam also joined the world economy, turning their Communist-ruled nations away from central planning and toward a hybrid form of open-economy capitalism. After 1989, in the most striking shift, the Soviet Union collapsed, and its successor states and former allies also joined the international economic order.

Globalization had arrived, the Cold War was over, and capitalism had won. Rapid economic growth in China and India raised the possibility of real convergence between poor and rich countries. Macroeconomic conditions stabilized, as inflation came down almost everywhere and recessions were infrequent and mild – so much so that there was talk of a “Great Moderation.”

All this was interrupted by the global crisis that began in 2007. Since then, the world has struggled with a continuing series of related financial and economic emergencies.

3.2. An imbalanced world

What ties together the various crises that have peppered the ongoing Great Recession – the sub-prime crisis, the broader American financial meltdown, the Eurozone debt disaster, financial stress in other parts of Europe – is their connection to “global imbalances,” the existence of large-scale surpluses and deficits among countries. For the better part of a decade, trillions of dollars flowed from surplus countries – largely in Northern Europe, East Asia, and the Middle East -- toward deficit countries, especially the United States, the United Kingdom, and peripheral Europe (Ireland as well as Southern, Central, and Eastern Europe). In the new post-crisis atmosphere, most of these deficits cannot be sustained. Over the next several years, both deficit and surplus countries alike will be absorbed with the difficult task of “rebalancing,” adjusting to an environment in which deficits in most cases will of necessity have to be smaller – and, as a result, so too will surpluses.

There is nothing inherently wrong with trade and current account deficits and surpluses, nor do they necessarily lead to crisis. In any well-functioning global economy there will be imbalances in trade and financial flows. In fact, capital should move from places where its marginal productivity is lower to places where its marginal productivity is higher. There have been many instances, such as in the United States for much of the nineteenth century, in which trade imbalances persist for years with few difficulties.

Trade deficits, and their counterpart, capital inflows, are desirable to the extent that the process is associated with productive investment in the deficit (borrowing) country. Rapidly growing nations – such as the United States and the other Areas of

Recent Settlement in the nineteenth century – typically run trade deficits and import capital as they grow. The deficits can be reversed, and the loans repaid, to the extent that the borrowed funds (and imported equipment) go directly or indirectly to investments that increase the productive capacity of the country, and its ability to export to earn the resources necessary to service the debts.

Problems arise when foreign borrowing goes to current consumption, or to other purposes that do not increase productivity. These problems are aggravated by the absence of global institutions that can moderate the effects of capital-flow reversals in a domestic setting. These were the core difficulty with the “global imbalances” of the past decade. Americans borrowed to finance a Federal budget deficit that was not justified on economic grounds, and to fund a housing boom and bubble. The pattern was similar in the United Kingdom. In most of peripheral Europe, deficits were also associated with a surge of spending on consumption; most of the investment financed went to the nontradables sectors – especially housing. Overall, the vast majority of the borrowing connected to these imbalances went toward government or household consumption.⁶ The fact that so few of the trillions of dollars in foreign investment and lending went to augment national productive investment is at the root of the continuing problems.

In this, the recent crisis was one in a long series of adjustments after years of policy distortions that led to large trade and capital imbalances. Many of the global and regional crises that had preceded it during the past two hundred years were driven by the same

⁶ See Chinn and Frieden (2011), for a survey.

kinds of imbalances, most famously the global crisis of the 1930s and the developing-country debt crisis of the 1980s. In these instances, as in the more recent cases, policy distortions in both deficit and surplus countries were at the root of the trouble. Most recently, the United States and peripheral Europe ran large current account deficits, engaging in borrowing that was hard to justify on economic grounds; and the major surplus countries engaged in lending that was similarly hard to justify. Now both deficit and surplus nations have to adjust to a new reality, in a process of “deleveraging” that is at the heart of the economic dilemmas raised by the aftermath of the global financial crisis.

3.3. The politics of adjustment

The political problems are perhaps even more daunting. Every debt crisis is followed by conflict over the distribution of the adjustment burden.⁷ When, as in the current case, cross-border debts are at issue, there are two dimensions of conflict. First, creditor countries and debtor countries square off to see which will undertake the bulk of the costly adjustment: creditors demand debtor austerity to maintain debt service, while debtors demand a debt restructuring to make the debt more manageable. Typically, some compromise is worked out – after all, both sides have an incentive to reach agreement – but the battle over the compromise can be hard-fought and drawn out.

⁷ Eichengreen, *Golden Fetters*, makes this argument convincingly about the analogous problems of the 1920s and 1930s.

A second dimension of conflict usually erupts *within* countries, over who domestically will be asked to contribute to deal with the debt overhang. In creditor countries, for example, the question might be whether it will be financial institutions or taxpayers. In debtor countries, the issue is the distributional incidence of the austerity measures necessary to maintain debt service: taxpayers or beneficiaries of government services, workers or managers, the private or the public sector. Debt crises are never resolved easily; they always lead to substantial international and domestic political tension. The current crisis and its aftermath have been no exception, and in some instances the tension has only just begun to manifest itself.

Two sets of imbalances, and their ongoing effects, are symptomatic both of the sources of the crisis and of the great economic and political difficulties we face in dealing with their enduring impact. The first is the series of intra-eurozone imbalances that continue to bedevil the European economy. The second involves the United States, although some of its most daunting dilemmas can best be seen from the standpoint of such surplus nations as China and Japan.

3.4. Europe on edge

The crisis affecting Europe has its origins in large-scale macroeconomic imbalances between Northern Europe and countries on the European periphery, and resultant capital flows from the North to the periphery (we speak of peripheral Europe to include Ireland and states in Eastern and Central Europe, many of which were major borrowers, none of which are Southern). The process as it unfolded illustrated some of the well-known

weaknesses in the design of the euro: the economic heterogeneity of EMU member states, the absence of common financial regulation in a common financial market, the lack of serious fiscal coordination, the absence of explicit lender of last resort provisions, and the lack of a credible commitment not to bail out member states in trouble.

The principal macroeconomic heterogeneity can be illustrated with the divergence between slow growth in Germany and rapid growth on the periphery. In the 1990s, in the aftermath of German reunification, the country's labor unions, businesses, and government agreed to restrain wage growth in order to help the country absorb low-productivity eastern Germany. Coupled with a rapidly aging population, German policies to restrain wages and consumption drove the already high German savings rate higher. Soon the deficits that had developed after reunification were trade surpluses, which grew dramatically after the introduction of the euro.⁸

Meanwhile, peripheral Europe was growing more rapidly, and both wages and prices were rising more than in Germany (and the rest of Northern Europe). The ECB, of course, could not set a monetary policy appropriate both for the slow-growing North and the fast-growing periphery; the monetary policy that developed was probably too tight for the North and too loose for the periphery. The result was what can be regarded as an increasingly depreciated real exchange rate for Germany relative to the rest of Europe, all of which allowed the country to dramatically increase its exports to the rest of Europe, and to the rest of the world. During the decade following the establishment of the euro,

⁸ For a recent reminder, see Artus (2012)

Germany's trade surplus was one of the three largest in the world. Exports in fact were responsible for most of German growth during that period. Germany was to the rest of Europe as China was to the rest of the world.

The counterparts to the large German surpluses were trade deficits in peripheral Europe. Before the creation of the euro, Italy, Spain, France, Greece and Portugal had a mixed record on this account – they occasionally ran fairly large trade deficits, and occasionally substantial trade surpluses. Only after monetary union did their trade deficits explode. Rapid growth and rising wages and prices in the periphery – whether due to national policy or to Balassa-Samuelson effects – meant that within the eurozone Germany's "currency" was depreciated in real terms while the peripheral "currency" was appreciated in real terms.

The Spanish situation is illustrative – both because it is perhaps the most important of the eurozone deficit countries, and because it did not have the features typically associated with the crisis. In the decade before the crisis, Spain had sound fiscal policies, and a relatively prudent and strictly regulated banking system.

Spain matched the German savings-investment surplus with an opposite deficit. The rise of Spanish prices and wages relative to those in Germany made investment in tradables unattractive, so private investment largely went into the nontradables sector. This primarily took the form of private investment in real estate, aided by the ability of households to take advantage of low interest rates to finance new mortgages. The result was a massive housing boom. There was also a rise in debt-financed current consumption

by households. As a result, Spain experienced both a boom in real estate construction and a consumption boom that drove down the domestic savings rate.

Spanish debt levels are now so high that the government's credit has been impaired and Spanish interest rates have soared, while both the real estate market and household consumption are in a state of collapse. Spain has been trying to reduce its absorption of German savings, cutting government spending and raising taxes in an effort to reduce consumption and raise savings further. Unemployment has soared and the prospects are for very high unemployment unless and until either the German stance changes, or domestic wages have adjusted sufficiently. But neither is particularly attractive to Germany, because they effectively force Germany to run a deficit, a position abhorrent to the country's export-oriented manufacturing sector.

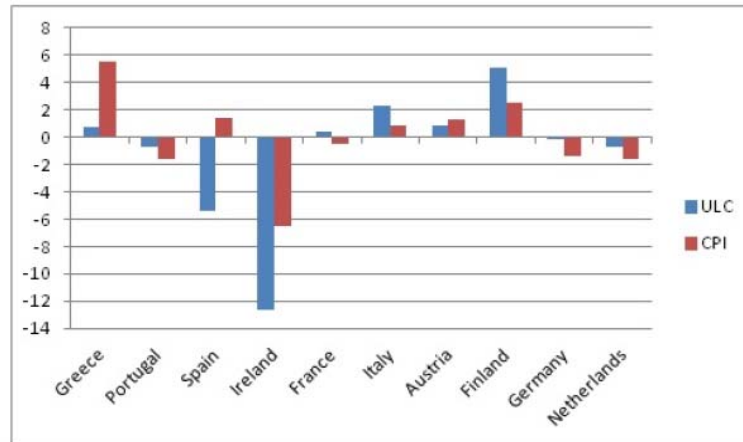
The key point is that the euro zone (and broader European) crisis is the result of deficits in the periphery and surpluses in the North. We see no particular ethical imbalance here, even in the financial boom and bubble leading to 2008 – after all, it is hard to argue that irresponsible lending is any better than irresponsible borrowing. Solutions to the European imbalances – dominated now by moralizing exhortations that Spaniards and Greeks become as virtuous, thrifty and hardworking as Germans – are to be found in the macroeconomic policies to avoid a recurrence of these unsustainable deficits and surpluses.

Resolving the European crisis in an orderly manner will be politically very demanding. Debtor-country governments face major difficulties in imposing austerity measures sufficient to allow them to service their debts – even if these debts are

substantially restructured. Adjustment in the surplus countries will also be difficult, and not only because restructured debts impose some costs on creditors. A more lasting resolution of the crisis requires substantial changes in the positions of both debtor and creditor countries; it requires Germany, for example, to raise domestic consumption significantly. The German government could reduce income and consumption taxes so as to increase real disposable household income, but this would inevitably put price pressures on German manufacturers, and might excite fears of inflation in Germany.

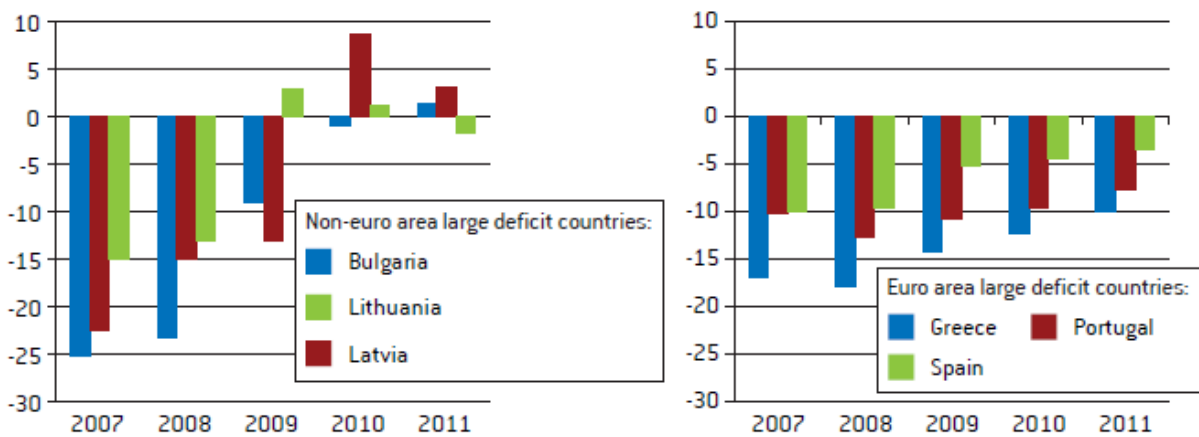
So far, most of the real adjustment that has taken place in the euro area has been on the part of the debtors, and then in some more than others. Figure A shows that only Spain and Ireland have realized a substantial reduction in unit labor costs since 2007, and unit labor costs have not risen in the major surplus countries – in fact, they have declined slightly in Germany. While it may seem perverse to fault Germany and other surplus countries for wage restraint, an increase in wages and consumption is the necessary counterpart of a reduction in their surpluses. Figure B is particularly striking. It shows the massive adjustment undertaken in such non-euro area deficit countries as Bulgaria, Lithuania, and Latvia, which have effectively eliminated current account deficits that a few years ago exceeded 15 percent of GDP. They did this at enormous economic, social, and political cost, and it is not a process that we recommend to those countries with a choice – which the non-euro area countries may not have had. Nonetheless, the speed of adjustment in the euro area countries has been quite slow – Spain and Greece still have current account deficits well above 5 percent of GDP. All of this is to illustrate how long and hard the road ahead is likely to be for the member states of the euro zone.

Figure A
 Changes in Unit Labor Costs and the Consumer Price Index,
 various eurozone countries, 2007-2011



Source: Guntram B. Wolff, "Why is Rebalancing in Europe so Painfully Slow?" Bruegel March 14, 2012 at <http://www.bruegel.org/blog/detail/article/705-why-is-rebalancing-in-europe-so-painfully-slow> (accessed April 4, 2012)

Figure B
 Adjustment in euro area and non-euro area deficit countries, 2007-2011
 (current account deficits as a percentage of GDP)



3.5. The China syndrome

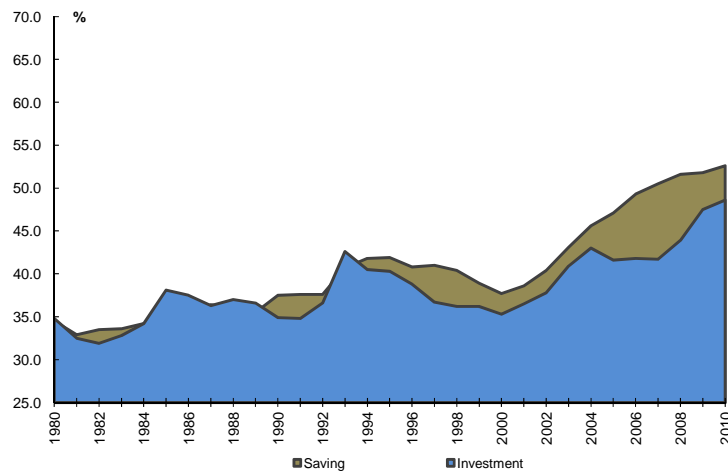
Confronting the imbalances outside of Europe will be no less difficult. The global crisis has accelerated pressure on China to move away from the economic model it has pursued for some thirty years. We address longer-term issues below; for now, we observe that rapid Chinese growth has been driven by a panoply of measures that constrained growth in household income and consumption, pushed the Chinese savings rate up to levels that eventually exceeded even the country's very high investment rate, and stimulated production for export. There is widespread agreement that Chinese trade surpluses of the size that have prevailed over the past decade cannot be sustained – even if the Chinese wanted to, the appetite to absorb these surpluses in North America and Europe has waned.

In order to adjust to the new reality, the Chinese government will have to reverse a series of long-established policies with powerful supporters within China. For political reasons, the adjustment has had to be postponed through at least 2012 because of the leadership transition and the need to develop a consensus; but the longer the postponement, the more difficult the transition will be.

While China's current account surplus has dropped since the crisis, this has been driven almost wholly by external conditions. The basic underpinnings of the surplus-generating model remain in place (of which more in section 5 below). As Figure C

indicates, the savings rate has substantially exceeded investment ever since 1994, when Beijing sharply devalued the renminbi. The resulting current account surpluses have been central to China's economic strategy, and they grew continually and dramatically over the course of the last decade.

Figure C: China's saving and investment as share of GDP



Source: China Statistical Yearbook 2011

China could reduce these surpluses by decreasing savings, or increasing investment, or both. In most senses, the preferred option would be to reduce savings by increasing domestic consumption, which has been severely constrained by a range of government policies. This would allow the Chinese people to realize more of the benefits

of the country's economic success, and would reduce the country's reliance upon exports as the engine of economic growth. The surplus can also be reduced by increasing investment without affecting savings, and this in fact is what has happened in the past several years.

The Chinese government responded to the Great Recession with a surge in investment after 2008. This may have been an appropriate policy response - otherwise growth would have collapsed - but in the absence of more fundamental changes, it will not be enough. For one thing, in order to stimulate increased investment the government has continued to hold borrowing rates extremely low, and to repress interest rates at the expense of household depositors; as a result, households have to increase their savings rates to make up the difference. So national savings continue to rise, and the surpluses are not reduced.

True adjustment would involve a substantial increase in domestic consumption, but consumption has not increased its share of GDP since the onset of the crisis. This is not surprising, as it would require a major reorientation of economic policy - with serious political and economic implications. Beijing has tried to increase the consumption share of GDP by subsidizing certain types of household consumption (white goods, cars), but since the subsidies are paid for indirectly by the household sector, the net effect is to take away with one hand what it offers with the other.

Beijing is finding it very hard to raise the consumption rate, and at the same time there is talk about reducing the current very high investment rate. This implies that the current account surplus will persist in the next few years, as the prospects for a dramatic

shift in Chinese policy seem slim. And yet it is not at all clear that the current international environment will permit China even to return to the level of current account surpluses it had run before the crisis began. In the absence of aggressive action to adjust to new conditions, China may face the possibility of much slower growth. What is more, a Chinese slowdown would be a serious adverse shock to developing countries heavily reliant on commodity exports.

3.6. Japan struggles back

Adjustment in both Europe and China is complicated by the difficulties Japan is facing in dealing with the aftermath of the very trying last twenty years. After the financial crisis of the early 1990s, over the course of one or two lost decades, government debt soared from roughly 20-30% of GDP in 1990 to 220% of GDP today. Tokyo is now planning to act to increase national savings. The plan is to reduce government spending and investment; to raise taxes, especially consumption taxes, beginning in 2014; and to put downward pressure on wages and salaries. On April 1, 2012, for example, all government employees, from university professors to postal workers, saw a 10% cut in salaries. This was part of a broader process of forcing down overall wages relative to GDP in an effort to increase Japan's international competitiveness.

These may seem like reasonable steps for a country struggling to address a substantial government debt load, but they cannot help but have significantly adverse effects on global attempts to restore more balanced trade and capital movements. In other words, after twenty years in which Japan gradually recovered from the excesses of the

1980s – bringing down its extraordinarily high savings rate and its current account surplus – Japan is set to reverse course, constrain domestic consumption, and push up its current account surplus. All of this is occurring just as the world urgently needs more consumption from low-consuming Asia.

3.7. Imbalanced again?

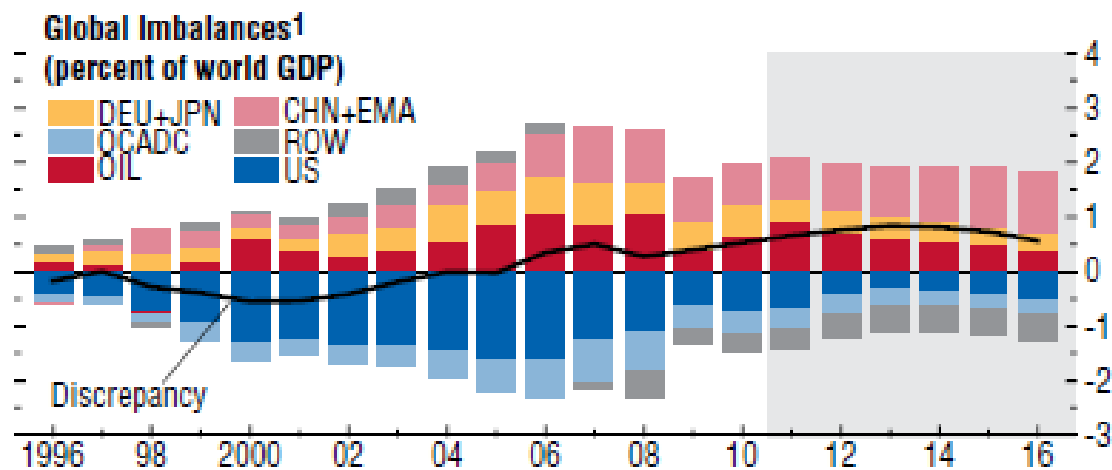
In the aftermath of the Great Recession, in short, the major surplus regions of the world have largely returned to, continued, or redoubled the policies that created the global imbalances that were central to the crisis itself. Figure D shows the pattern of current account balances among broadly defined regions of the world over the past fifteen years, with IMF projections for the next five. The projections are in fact for current account surpluses to remain near the levels of the past decade.⁹

This seems to us a serious problem. Most of the deficit countries have been, or will be, forced to adjust by the realities of international financial markets, and by the unwillingness or inability of national publics to accept continued deficits. It is hard to imagine a return to an era in which large-scale current account deficits are counterbalanced by debt-financed consumption in the United States and peripheral Europe. However, the surplus countries are not acting on their own to alter their relationship to the rest of the world economy (or, in the case of Northern Europe, to the rest of the eurozone). This suggests that, left to their own devices, national governments

⁹ Chinn, Eichengreen, and Ito present a careful analysis that arrives at similar conclusions.

are likely to head toward a new round of macroeconomic imbalances, with the attendant risks of another round of major financial crises. The prospect of a repeat of 2008-2010 is not a pleasant one; and yet national governments seem on track to recreate the conditions for such a repeat. This constitutes clear evidence of the need for some substantial internationally coordinated action to avoid a return to the brink of the abyss.

Figure D



Global current account imbalances, as a percent of world GDP

¹CHN+EMA: China, Hong Kong SAR, Indonesia, Korea, Malaysia, Philippines, Singapore, Taiwan Province of China, and Thailand; DEU+JPN: Germany and Japan; OCADC: Bulgaria, Croatia, Czech Republic, Estonia, Greece, Hungary, Ireland, Latvia, Lithuania, Poland, Portugal, Romania, Slovak Republic, Slovenia, Spain, Turkey, and United Kingdom; OIL: oil exporters; ROW: rest of the world; US: United States.

Source: International Monetary Fund, *World Economic Outlook*, September 2011.

Figures for 2011- are IMF estimates.

Chapter 4

Global economic coordination: on track or doomed to fail?

The Great Recession that began in 2007, and the global financial panic of late 2008, illustrated the importance of international cooperation in times of crisis. Today, we face the possibility that uncoordinated national policies, driven by national concerns for pressing domestic problems, will bring us back to the precarious conditions that made the Great Recession and the global financial panic possible. These are strong reasons to hope for a substantial increase in international economic cooperation among the major centers of economic activity. And yet the record of such cooperation is extremely spotty, even in the midst of the gravest economic crisis of the past 75 years.

4.1. Globalization and governance

Contemporary globalization, which has evolved progressively since the end of World War II, began to intensify markedly during the last decade of the past century. The fall of the Berlin Wall, the structural adjustment towards more openness in many developing countries, the conclusion of the Uruguay Round, the proliferation of regional trade agreements, the beginning of the emergence of China as a global economic power, and the information technology revolution are all associated with this intensification. By the second half of that decade, Michael Bordo, Barry Eichengreen and Doug Irwin were

arguing that our globalization had surpassed, at least on the trade and financial fronts, that phenomenon's previous great era 100 years earlier.¹⁰ At the same time, however, one of the authors of this report was asking whether globalization had not already gone too far.¹¹

For Bordo et al. noted that it was surprising, given the degree of market integration, that trade tensions and financial crises had not become even more severe than they had been a century before. They hypothesized that the multilateral institutions built over the second half of the 20th century had provided a substitute -- albeit an imperfect one -- for global governance. At the end of their essay, they cautioned, however, that, "Governments seeking to make the world safe for global capitalism still have a ways to go."¹²

The brute force of events, if nothing else, illustrated the accuracy of that statement. The sudden reversals in capital flows that occurred in Mexico (1994), East Asia (1997), Russia (1998), and later Brazil (1999) and Argentina (2001), shocked the international financial system and created awareness that the unprecedented degree of financial

¹⁰ Bordo, Michael D., Barry Eichengreen, and Douglas A. Irwin, "Is Globalization Today Really Different than Globalization a Hundred Years Ago?," NBER Working Paper No. 7195, June 1999, JEL No. F13, F21, F15, N20, E32

¹¹ Rodrik, Dani, *Has Globalization Gone Too Far?*, Institute for International Economics, Washington, DC, March 1997

¹² Bordo, Eichengreen, Irwin, page 58.

globalization brought with it substantial risks. Even before those traumatic episodes, it seemed that the gap was growing rapidly between the evolution of markets, on the one hand, and governance structures, on the other, that could level the playing field, correct negative externalities, compensate for asymmetric information, and provide public goods (domestic and international). The financial crises of the second half of the 90s seemed to provide the stimulus to start closing that gap decisively.

4.2. G20 Rising

By 1998 ministers of finance of the largest developed and developing economies spoke of reforming the international financial architecture and began to group themselves in a new forum, the Group of 20 (G20) financial and monetary authorities. The purported mission was to create an institutional framework that would prevent massive crises, or at least make it less difficult to manage them if they occurred, without depriving emerging countries of a sustained inflow of capital from their developed counterparts. Those years saw talk of bold initiatives, like making the IMF a true international lender of last resort,¹³ amending the IMF Articles of Agreement to provide sovereign governments with bankruptcy-style protections, and changing significantly the IMF's voting structure. The United Nations Millennium Summit of September 2000 appeared as a catalytic event where the international community, while embracing globalization as a positive force for

¹³ Fischer

prosperity, also made clear that success in realizing the full effects of that force would depend on good governance within each country as well as at the international level.¹⁴

In November 2001, in the midst of uncertain geopolitical circumstances in the aftermath of 9/11, countries strongly reaffirmed their commitment to the deepening of globalization, launching the 9th round of multilateral trade liberalizations in Doha, Qatar. Also at that meeting, after negotiations of almost 15 years, the accession of China to the WTO was at last approved.

4.3. Momentum unsustained

The multilateral momentum seemed to continue with the adoption of the Monterrey Consensus in March of 2002. The Consensus, in addition to providing an unprecedented commitment of international financial cooperation for development, endorsed concrete steps to enhance the coherence, governance and consistency of the international monetary, financial and trading systems.¹⁵ The document, which was endorsed by the large number of leaders of developed and developing countries attending the conference, speaks of the importance of continuing to improve global

¹⁴ United Nations Millennium Declaration, Resolution adopted by the United Nations General Assembly, 55/2, 8 September, 2000

(<http://www.un.org/millennium/declaration/ares552e.htm>)

¹⁵ *Monterrey Consensus on Financing for Development*, Monterrey Mexico, March 2002

(www.un.org/esa/ffd/monterrey/MonterreyConsensus.pdf)

economic governance, of strong coordination of macroeconomic policies, of the need for the IMF to strengthen its surveillance activities of all economies, of the need to ensure that the IMF has a suitable array of financial facilities and resources to respond to financial crises, and of strengthening international tax cooperation. It now looks remarkable that it was in large part the driving force of the United States that pushed forward the Monterrey Consensus and the launching of the Doha Round, inasmuch as that government would soon earn the reputation for being one of the most unilateralist US Administrations in recent history.

However, the ambitious aspirations for reform and international cooperation went unrealized. Apart from some enlargement and flexibilization of the IMF's financing capacity, no new international financial architecture was ever really built. The Doha Development Round, whose negotiations were supposed to conclude no later than January 1, 2005, has become one of the most disappointing undertakings in the history of the multilateral trading system. Failure to compromise and agree on the issues included in the Doha agenda led to repeated collapses of the negotiations between September 2003 and August 2008.

4.4. Problems proliferate

While governments were failing to fulfill their commitments for stronger international coordination, the need for it was increasing. After the modest slowdown of the world economy in 2001-2002, the pace of globalization accelerated and changes in the structure of the world economy that had started earlier on became quickly accentuated.

Computing and telecommunication capabilities became cheaper and more powerful, which made it increasingly attractive to decompose previously integrated and concentrated production processes and to form internationalized supply chains that became highly competitive. As Richard Baldwin has put it, what used to be about economies of scale, vertical integration and production clusters is now about fragmenting productive processes and finding the most profitable location for each fragment.¹⁶ Each good or service sold at the end of its supply chain is a conjunction of many countries' capital, labor, technology, infrastructure, finance and business environments. This new organization of production is having far-reaching implications for the international division of labor, and is changing the global pattern of production and trade probably faster than ever in history.

One consequence is that developing countries do not need to wait until they have sufficient large-scale industries to achieve fast industrialization. In fact, they do not even have to build supply chains; they just have to join them competitively in order to speed their industrialization. Another consequence is that countries' comparative advantage is no longer about finished goods or commodities; it is about the finer tasks that make up the manufacturing, commercial and financial processes necessary to ultimately produce

¹⁶ Baldwin, Richard, "Trade and Industrialization after Globalization's 2nd Unbundling: How Building and Joining a Supply Chain are Different and Why It Matters," Working Paper 17716 (<http://www.nber.org/papers/w17716>). This description relies heavily on Baldwin's paper.

and deliver the goods demanded by consumers.¹⁷ It also follows that less and less international trade is a flow between two locations – goods produced in one country sold to customers in another -- and more and more is becoming a web of multi-directional flows connecting numerous locations.

No developing country has taken better advantage of the new organization of production and trade than China. Thanks to its quick assimilation into global supply chains, and rapidly expanding participation in the flows of global trade, China's economic growth has accelerated dramatically over the last quarter of a century. In the process, China has become a country with an immense trade surplus. It is not only the second largest destination for FDI, but at the same time one of the largest global investors, and certainly the holder of the largest foreign exchange reserves, in the world. Although not as spectacularly as China, over the same period other developing countries - not least India, the other Asian giant- also emerged as important players in the world economy, thanks to faster economic growth. Consequently, for more than two decades the developing economies have grown faster than the developed ones; this is translating into a markedly different distribution of global GDP. The developed countries, which had

¹⁷ Grossman, G. and E. Rossi-Hansberg (2006), "The Rise of Offshoring: It's Not Wine for Cloth Anymore," July 2006. Paper presented at Federal Reserve Bank of Kansas City Jackson Hole conference for Central Bankers. <http://www.kc.frb.org/> (<http://www.kansascityfed.org/Publicat/Sympos/2006/PDF/8GrossmanandRossi-Hansberg.pdf>)

kept a share of global output of around 60% from 1950 to 1990, have now seen that share reduced to less than 50%.¹⁸

If the abrupt reversal of capital flows from rich to emerging countries was seen as a chief risk to the stability of the international financial system during the last two decades of the 20th century, the story had changed dramatically by the middle of the first decade of this century. By virtue of very high domestic savings that translated into huge current account surpluses, fast growing emerging economies, particularly China, became massive financiers of rich countries' large current account deficits, particularly of the United States.¹⁹

4.5. Warnings issued

By 2006 the global imbalances had become a serious cause of concern for many analysts of the global economy, although others, including some distinguished members of the economics profession, were providing rather benign tales about the causes and consequences of those imbalances.²⁰ To its credit, the IMF's management took the global imbalances seriously, not only by extending repeated warnings in the institution's basic

¹⁸ Give references of these calculations. Maddison, Buiters, etc.

¹⁹ Of course, rich countries like Germany and Japan contributed to the unprecedented savings surplus.

²⁰ Quote the IMF, Zedillo, on the one hand, on the other quote Bernanke, Cooper, Hausmann.

reports, but also by eventually making members agree on a process of multilateral consultation on global imbalances, which was announced in April of 2006.²¹ The IMF carried out its consultation on global imbalances focusing tactfully on the United States, China, the Eurozone, Japan, and Saudi Arabia, then presented its report in April 2007. The report was expeditiously ignored or dismissed by the very same ones who had given the institution the go-ahead for the consultation.

Ironically, the IMF was still licking its wounds both from the rebuttal by its key members of the multilateral consultation exercise and a mandate to reduce drastically its personnel and other operating expenses while adapting to a new Managing Director -- the third in less than five years -- when the international financial system started to crack with the eruption of the subprime crisis in the late summer of 2007. Although some of the root causes of the crisis could be traced to strictly domestic policy decisions in the countries where it erupted, ultimately the crisis happened because the key players in the global economy failed to address, in a coordinated way, significant issues stemming from the intensification of globalization, despite the fact that those issues had been identified early on as threats to international financial stability.

4.6. Warnings heeded?

²¹ International Monetary Fund, "The Managing Director's Report on Implementing the Fund's Medium-Term Strategy," April 5, 2006

(www.imf.org/external/np/pp/eng/2006/040506.pdf)

Considering that lack of adequate collective action was a chief cause of the crisis, the formation of the G20 was excellent news, despite the dramatic circumstances that triggered it in the fall of 2008. It seemed that at last the leaders of the largest economies in the world would take up the challenge of filling the governance gap. It was encouraging to learn that at their first summit meeting in November 2008, the G20 leaders themselves admitted that inconsistent and insufficiently coordinated policies had led to the crisis and that on this occasion and at two subsequent meetings, they made concrete commitments to bring about that purported cooperation.²²

During its first three summits, the attention of the G20 focused largely on reform of financial systems, preservation of open markets, reinforcement of the multilateral financial institutions and, of course, macroeconomic policy coordination. Not surprisingly, given how the crisis erupted, the G20 gave much attention to issues of their financial sectors. At their first summit, the G20 leaders bluntly identified “weak underwriting standards, unsound risk management practices, increasingly complex and opaque financial products, and consequent excessive leverage” as root causes of the crisis. They frankly charged that “policy makers, regulators and supervisors, in some advanced countries, did not adequately appreciate and address the risks building up in financial markets, keep pace with financial innovation, or take into account the systemic

²² Include reference to G20 Washington declaration

ramifications of domestic regulatory actions.”²³ Although stressing that regulation is first and foremost a national responsibility and agreeing on a set of common principles to exercise that responsibility, the G20 was equally emphatic on claiming that the increasing globalism of financial markets needs intensified international cooperation in order to mitigate adverse cross-border externalities stemming from those markets.

The G20’s apprehension about the multiple weak flanks of financial markets was expressed in a long list of commitments articulated both in their Washington and London declarations. In a noticeable display of granularity for a leader’s summit, the G20 at Washington committed to immediate and medium-term actions aimed at reinforcing regulation, transparency, accountability, integrity and prudential oversight of financial markets. The G20’s to-do list at that meeting hardly left any aspect of financial markets untouched. It was not an exaggeration to present it as a “comprehensive work plan” for reform. Accounting standards, credit rating agencies, unregulated instruments and markets, credit default swaps and over-the-counter derivatives, compensation schemes, investor and consumer protection, capital requirements, and resolution regimes and bankruptcy laws, plus a few others, were issues purported to be to be dealt with diligently by the G20 membership. It looked as if the G20 were providing a common platform for a coordinated move towards sweeping reform in all the members’ financial

²³ Paragraph 3, Declaration of the Summit on Financial Markets and the World Economy, Washington, D.C., November 15, 2008

(<http://www.g20.utoronto.ca/2008/2008declaration1115.html>).

systems. In every section of the G20's Washington work plan for financial reform, the importance of international cooperation is duly stressed. The boldness of the language used should have left no room for doubt: "We call upon our national and regional regulators to formulate their regulations and other measures in a consistent manner. Regulators should enhance their coordination and cooperation across all segments of financial markets, including with respect to cross-border capital flows. Regulators and other relevant authorities as a matter of priority should strengthen cooperation on crisis prevention, management, and resolution."²⁴

The emphasis on fixing the financial system and the role of cross-border coordination did not diminish at the second summit of April 2009. The Action Plan adopted at the first meeting was not only re-endorsed but also reinforced with some additional decisions, such as the elevation of the Financial Stability Forum to Board status -- by virtue of expanded membership and additional responsibilities -- and an agreement on the basic criteria for what eventually would become the third Basel Accord.

4.7. Warnings forgotten

The sense of urgency for undertaking financial reform under the terms stipulated at Washington and London was clearly diminished by the time of the third summit in the fall of 2009. At Pittsburgh, the G20 claimed to have developed "sweeping reforms" and to

²⁴ Paragraph 9, Declaration of the Summit on Financial Markets and the World Economy, Washington, D.C., November 15, 2008.

have achieved “substantial progress” in strengthening prudential oversight and transparency, improving risk management, promoting market integrity and reinforcing international cooperation, none of which was by then in fact the case.²⁵ Admittedly, that summit did produce an additional push for new capital and liquidity requirements, as well as some commitments on the intended timing for reforms on compensation, trading and clearing of OTC derivatives, global accounting standards, and prudential standards of systemically important financial institutions.

Some of those deadlines -- like completing implementation of the work in progress on new capital and liquidity standards -- were reiterated at the fourth Toronto summit, but the sense of urgency for financial sector reform continued to decrease, perhaps due to a combination of complacency stemming from the early signs of recovery and realism about the difficulty of undertaking the actions agreed early on. The tone of urgency continued to fade at the Seoul meeting of November 2010. Although the Basel III Accord that had been released in September of 2010 was endorsed and none of the other significant issues were ignored in the G20’s declaration, the level of precision about most commitments was clearly subdued. By contrast, one topic of financial reform that was meriting increasing attention was that of the systemically important financial institutions (SIFIs) where obviously dealing with cross-border recovery and resolution questions is unavoidable.

²⁵ Paragraph 11, G20 Leaders Statement: The Pittsburgh Summit, September 24-25, 2009 (<http://www.g20.utoronto.ca/2009/2009communique0925.html>).

That attention was kept at the following G20 Summit at Cannes in November 2011 where the work of the Financial Stability Board (FSB) for a comprehensive policy framework on the topic, including its determination of which banks should be considered globally systemically important, was endorsed. Another topic that received special attention at Cannes, because of its potential for creating regulatory arbitrage and systemic risk, was that of the shadow banking system whose regulation and oversight the G20 agreed to strengthen.

Interestingly, by the Seoul meeting the pledges for international coordination of financial reforms so prominent at the first two summits had diminished significantly, if not disappeared altogether. The benign explanation is that it was no longer necessary to insist on this emphasis, given the institutionalization of coordination already achieved through the FSB and other organizations. More likely, the lesser emphasis on coordination was recognition that, contrary to the early pledges, some of the major players had proceeded unilaterally with their respective reform undertakings. The U.S. Dodd-Frank Financial Reform is a case in point, but not the only one. Other jurisdictions have put in place laws or regulations without ensuring that they are – as originally offered - collectively consistent. When notice is taken of conflicts that are arising as a result of norms such as the “Volcker Rule,” OTC derivatives, shadow banks and even capital requirements, it is tempting to say that the G20 substantially gave up its early pledge of coordination around 2010.

4.8. Trading failure

The same can also be said about some of the G20's key commitments on trade. At Washington, the G20 committed to "refrain from raising new barriers to investment or to trade in goods and services, imposing new export restrictions, or implementing World Trade Organization (WTO) inconsistent measures to stimulate exports."²⁶ It also pledged to put the Doha Round back on track towards a successful conclusion. At London, these commitments were reiterated, as they were also at Pittsburgh, with an important addition. At the latter summit, the G20 leaders declared that they were "determined to seek an ambitious and balanced conclusion to the Doha Development Round in 2010."²⁷ It is interesting to notice that while in London they committed to reach a conclusion of the Round, acknowledging that it was urgently needed. At Pittsburgh, they committed not to "reach," but to "seek" that conclusion, sweetening the downgrade with the 2010 deadline.

That deadline was dropped altogether by the following summit in Toronto, although the commitment to promptly bring the round to conclusion was preserved all the way up to the Seoul summit. By the time of the Cannes meeting, the sense of failure was inescapable. Laconically the G20 declared, "We stand by the Doha Development Agenda (DDA) mandate. However, it is clear that we will not complete the DDA if we

²⁶ Paragraph 13, Declaration of the Summit on Financial Markets and the World Economy, Washington, D.C., November 15, 2008.

²⁷ Paragraph 49, G20 Leaders Statement: The Pittsburgh Summit, September 24-25, 2009.

continue to conduct negotiations as we have in the past. We recognize the progress achieved so far.”²⁸

4.9. Institutional reform on the agenda

Naturally, under the impulse of the crisis, the G20 immediately went back to the old, but repeatedly unfulfilled, objective of reforming the International Financial Institutions (IFIs). Right from the start, at the first summit of November 2008, they set as a short-term objective to look at the adequacy of those institutions’ resources. Maybe remorseful about the mistreatment applied to the IMF with its multilateral surveillance exercise of the previous year, the G20 stated that “The IMF should conduct vigorous and even-handed surveillance reviews of all countries, as well as giving greater attention to their financial sectors and better integrating the reviews with the joint IMF/World Bank financial assessment programs” -- although this was qualified as a medium term objective. Also sounding remorseful, the G20 “underscored that the Bretton Woods Institutions must be comprehensively reformed so that they can more adequately reflect

²⁸ Paragrah 66, The G20 Seoul Summit Leaders Declaration, November 11-12, 2010

(<http://www.g20.utoronto.ca/summits/2010seoul.html>)

changing economic weights in the world economy and be more responsive to future challenges.”²⁹

More boldly, at the G20 London summit, the leaders admitted that they had to strengthen the World Bank’s and – more importantly given the circumstances of the day – the IMF’s relevance, effectiveness and legitimacy. The G20 leaders literally affirmed that they would reform those institutions’ mandates, scope and governance to reflect changes in the world economy and the new challenges of globalization, and – as they had said at Washington -- would give emerging countries greater voice and representation. Pertinently, and complying with their earlier commitment, they also agreed upon the allocation of significantly larger resources to the IMF, a decision that allowed the institution to help put out fires before they spread in some emerging countries that came under financial stress.³⁰

The attention given by the G20 to the IMF at the Pittsburgh summit had two somewhat contradictory components. One was in the direction of strengthening the institution by stating that the modernization of the IMF’s governance was essential to improve its credibility, legitimacy, and effectiveness, and backing this statement with a commitment to address – as part of a quota review process to be concluded by early 2011 -- issues such as size and composition of the Executive Board, enhancement of the Board’s

²⁹ Action Plan to Implement Principles for Reform, Declaration of the Summit on Financial Markets and the World Economy, Washington, D.C., November 15, 2008 .

³⁰ Mexico, Turkey?

effectiveness, and involvement by the Fund Governors in its strategic oversight.³¹ At the same time, the IMF's authority to exercise its surveillance responsibility was clearly diminished when the G20, in order to deal with the correction of the global macroeconomic imbalances, opted for a sort of peer review mechanism (titled Mutual Assessment Process, or MAP) in which the IMF was assigned an essentially subsidiary role of just giving technical assistance to the G20's finance ministers and central bank governors.³²

Some, but not all, of the committed reforms in the IMF's representation and governance had been agreed by the time of the G20 Seoul meeting in November of 2010. A shift in quota share, mostly in favor of the largest emerging economies, and an offer to reflect that shift in the institution's executive board – reforms that fell quite short of changing the balance of power among the members in any significant way -- was the step taken and it was underlined as an important one at that summit.³³ Possibly more consequential was the G20's call for the IMF to play a bigger role in the MAP³⁴ and to re-launch its earlier commitment to enhance the IMF's surveillance mandate and action.³⁵

³¹ Paragraph 21, G20 Leaders Statement: The Pittsburgh Summit, September 24-25, 2009.

³² Paragraph 7, G20 Leaders Statement: The Pittsburgh Summit, September 24-25, 2009.

³³ For a brief description of the reforms agreed in November 2010, see:

<http://www.imf.org/external/pubs/ft/survey/so/2010/NEW110510B.htm>

³⁴ Paragraph 11, The G20 Seoul Summit Leaders Declaration, November 11-12, 2010

³⁵ Paragraph 20, The G20 Seoul Summit Leaders Declaration, November 11-12, 2010

The IMF's repositioning on the G20's radar was undoubtedly caused by the lackluster evolution of the MAP since its launch in September 2009 and up to the meeting in Seoul. It should have been clear by then not only that the MAP was moving very slowly, but that despite early pledges, the structural correction of the global macroeconomic imbalances was still pending and the problem had by then exploded in the European Monetary Union (EMU). At that point and at subsequent events throughout 2011, the diagnosis provided by the G20 at their first summit about what caused the crisis in the first place should have resonated loudly: "Major underlying factors to the current situation were, among others, inconsistent and insufficiently coordinated macroeconomic policies, inadequate structural reforms, which led to unsustainable global macroeconomic outcomes. These developments, together, contributed to excesses and ultimately resulted in severe market disruption."³⁶

Although at the G20 Pittsburgh meeting of September 2009, the language to stress the importance of the global imbalances was subdued relative to that used in the Washington Communiqué, it is clear that the imbalances continued to be a central concern of leaders. So much so that they launched the above-mentioned MAP with, among other goals, to "ensure that fiscal, monetary, trade and structural policies are collectively consistent with more sustainable and balanced trajectories of growth," and also to collectively "undertake macro prudential and regulatory policies to help prevent

³⁶ Paragraph 4, Declaration of the Summit on Financial Markets and the World Economy, Washington, D.C., November 15, 2008.

credit and asset price cycles from becoming forces of destabilization.”³⁷ This statement of purpose was impeccable; however, the G20, rather than empowering the IMF to perform its multilateral surveillance duty, adopted “a cooperative process of mutual assessment” where members themselves would agree on shared policy objectives, set medium-term policy frameworks, assess the collective implications of national policies and identify risks to financial stability. How this sort of peer review mechanism would in fact work was left to be agreed later by the G20 ministers.

Ministers did provide, not long after the Pittsburgh meeting, a timetable for developing the mutual assessment process.³⁸ According to that timetable, each country would provide its own policy framework and projections by end of January 2010. With this input, the G20 -- supported by the IMF and the World Bank -- would conduct the initial phase of the MAP, checking the consistency of national policies with the collective objectives, and develop accordingly a basket of policy options for leaders to consider at the June 2010 Toronto Summit. Ultimately the objective, supposedly after refining the MAP, was to present leaders with more specific policy recommendations for their decision at their Seoul, Korea Summit of November 2010.

4.10. Multilateral surveillance frustrated

³⁷ Reference to Pittsburgh Declaration

³⁸ Reference to the St. Andrews, Scotland meeting of November 2009

That the MAP as depicted at Pittsburgh would prove to be ineffectual was confirmed by the fact that the deadlines agreed by the G20 ministers at St. Andrews were not effectively met. There was no basket of policy options ready for Toronto, nor more specific recommendations ready for Seoul where, instead, leaders settled for a call to their subordinates to develop “indicative guidelines composed of a range of indicators” that “would serve as a mechanism to facilitate timely identification of large imbalances that require preventive and corrective actions to be taken.”^{39 40}

Only at their February 2011 meeting in Paris were finance ministers able to agree on three types of indicators to assess national economic policies. These indicators are public debts and fiscal deficits, private savings rates and private debts, and external imbalances composed of the trade balance and net investment income flows and transfers, with exchange rate, fiscal, monetary and other policies being left to be taken only in “due consideration.”⁴¹

³⁹ Paragraph 11, The G20 Seoul Summit Leaders Declaration, November 11-12, 2010

⁴⁰ It is interesting to notice that the failure to deliver at Seoul what was committed at Pittsburgh and at St. Andrews has been, after the fact, presented as if the first stage of the MAP, consisting of two steps, had actually been achieved. See IMF Factsheet, The G20 Mutual Assessment Process (MAP), where that assessment is provided (<http://www.imf.org/external/np/exr/facts/g20map.htm>).

⁴¹ Paragraph 3 of the “Communiqué of the Meeting of Finance Ministers and Central Bank Governors, February 18-19, 2011,” Paris, France

It took the G20 ministers one more meeting to agree on four approaches (one “structural” and three “statistical”) to determine the guidelines against which the previously determined indicators would be assessed. Ministers also agreed that countries identified as having persistently large imbalances by at least two of the approaches would be further assessed “to determine in a second step the nature and root causes of their imbalances and impediments to adjustment.”⁴² Although asking the IMF to carry out the task of applying the indicators and approaches agreed by the ministers to identify the problematic cases did devolve some technical authority to the institution, it is also clear that a peculiar mix of over-prescription and ambiguity limited such devolution.

The IMF has tried to do its best to exercise its rather limited technical mandate by producing and making public a set of staff reports for the G20 MAP. The set consists of umbrella, accountability, MAP as well as individual sustainability reports for countries, which given the relative size of their economies and their imbalances, are considered to

(http://www.oecd.org/document/9/0,3746,en_21571361_43854757_47180361_1_1_1_1,00.html)

⁴² “Final Communiqué of Meeting of G20 Finance Ministers and Central Bank Governors, April 15, 2011,” Washington DC (<http://www.g8-g20.com/g8-g20/g20/english/for-the-press/news-releases/meeting-of-finance-ministers-and-central-bank.1104.html>)

have the greater potential for spillover effects (United States, People's Republic of China, Japan, India, Germany, United Kingdom and France).⁴³

Although it is hard to know exactly how much influence the IMF MAP reports might have had in the preparation of the G20 documents released at the Cannes Summit, it seems that the G20 Action Plan for Growth and Jobs agreed there is sufficiently consistent with the IMF's own analyses and assessments. It is yet to be seen whether and how this modest step could signal a trend where the center of gravity of the G20 MAP moves away from the ineffectual peer review mechanism originally intended and towards the IMF's independent analysis.

4.11. Promises, promises....

Admittedly, it is too soon to pass definitive judgment on the G20's performance as an effective catalyzer of international collective action. It is true that some key decisions taken during the initial phases of the crisis that erupted in the fall of 2008 -- such as the adoption of fiscal stimulus and monetary easing to prevent a total collapse of aggregate demand, the commitment to avoid an explosion of protectionism, and the announcement of additional resources for the IMF -- have come to be associated with the G20. But it is also true that it could be argued that the various fiscal stimulus packages implemented in 2009 could have happened anyway, as it is similarly true that the extremely useful

⁴³ 2011 *Staff Reports for the G-20 Mutual Assessment Process (MAP)*, November 2011

(<http://www.imf.org/external/np/g20/map2011.htm>)

coordination among monetary authorities since the summer of 2007 is rooted in a long-standing practice of communication and collaboration among central bankers.⁴⁴ It is less clear that the commitments to avoid protectionism and give the IMF more ammunition would have been taken so early in the absence of the G20.

It is clear, however, that the G20 is still far from earning its self designated stature of “premier forum for international cooperation,”⁴⁵ as proven by its rather limited efficacy to deal with the key issues on the agenda of its own making. Passing that test of efficacy is essential to provide the G20 with much needed legitimacy. Being a group of self-appointed members, albeit producing altogether more than 80% of global GDP, the G20’s origin has weak political legitimacy. This shortcoming will only be circumvented if it shows to the international community -- and certainly to each member’s national constituencies -- that it can take and execute important decisions that make a positive difference for each G20 country and the world at large.

The chances of achieving such efficacy and legitimacy have been eroded by the G20’s failure to deliver fully on a number of important commitments contained in the four key avenues for action established by the group itself in its first two meetings – financial reform, open markets, IFIs and macroeconomic policy coordination. The G20 has compounded its credibility problem by introducing other issues into its agenda, but not

⁴⁴ Describe how the central bank governors get together periodically at the BIS in addition to their meetings at the IMF/World Bank Spring and Fall annual meetings.

⁴⁵ Paragraph 19, G20 Leaders Statement: The Pittsburgh Summit, September 24-25, 2009.

solving them. Pledges on reduction of poverty, infrastructure, food security, energy security, climate change, marine environment, and anti-corruption are examples of challenges that have crept into the G20's declarations and action plans.

4.12. Failure explained, but not excused

If it is accepted that the world needs something like the G20, then it is important to inquire why this initiative so far has failed to live up to its initial promise. There is, of course, the circumstance that much of what the G20 has offered to deliver constitutes a global public good.⁴⁶ The need for collective action stems precisely from the nature of the G20's deliverables. Global financial stability and a rules-based multilateral non-discriminatory trading system – two of the basic endeavors of the G20 -- are for the most part global public goods because once provided, they can be enjoyed in principle by each country without impinging on the enjoyment of others. The objectives of financial stability and preventing trade protectionism are conceivably widely shared, but this does not mean that every state would be willing to put in its own share of effort to achieve them.

⁴⁶ For a discussion of global public goods please see *Meeting Global Challenges: International Cooperation in the National Interest*, Report of the International Task Force on Global Public Goods, 2006. Ernesto Zedillo served as co-chair of the Commission.

It is in the nature of global public goods that if left freely to the actions of the political and economic markets, their supply will tend to be short of their demand. On the one hand, governments do not want, or are politically constrained, to limit their sovereignty by accepting binding rules and mechanisms to enforce their compliance. There is also the free rider problem, which means that given the non-excludability of a public good, there is the incentive for each country to wait for others to provide it without sharing in the effort to supply it. The fact that many countries value public goods differently is also an obstacle to assembling the necessary collective action for the provision of global public goods. This circumstance is exacerbated now that countries that are still developing and are even relatively poor have become global economic powers due to the sheer size of their GDP and degree of engagement in the world economy.

It is mainly for these reasons that historically it has taken a special catalytic force to harness the international cooperation necessary to provide global public goods, a force that this time was supposed to be generated by the G20 and, more specifically, by some of its key members exercising enlightened leadership. Admittedly, even if a true wish to provide that leadership were present, as seemed to be the case at inception, in its initial steps the G20 member governments were bound to confront significant domestic political economy limitations in their ability to pursue the necessary international cooperation. As one of these authors warned early on in the crisis: "There will be a natural tendency for economies and people to turn inward, and for governments to reduce the priority they

give to their external ties. As they do so, there is a risk that they will slip toward a breakdown in international cooperation, and even toward conflict.”⁴⁷

The concern underlying this prediction was that, once the emergency phase of the crisis was overcome, and as governments tried to pursue the adjustments and reforms needed to address the policy failures that caused the crisis as well as the political factors that led to those failures, forces pulling away from internationally cooperative solutions would be unleashed to the point that governments would minimize or ignore the importance of fulfilling their commitment to cooperate. Since adjustment is never painless, even for surplus economies, in each country domestic politics would push toward shifting the burden of rebalancing to those foreign counterparts involved in the disequilibrium to be corrected, and away from the needed domestic effort. This circumstance reinforces the inherent political difficulty faced by governments in the construction of global public goods such as those entertained in the G20 agenda.

There is a profound disconnect between the G20’s statement of purpose as laid out in their initial meetings and what has happened with economic policy in the United States and in the European Union. This points toward what may be a deeper obstacle to the construction of the global public goods that are indispensable for globalization’s sustainability: the limitations of each domestic political system, democratic or not, to

⁴⁷ Frieden, Jeffrey A. “[The crisis and beyond: Prospects for international economic cooperation](#),” Policy Paper No. 5, Politics, Economics and Global Governance: The European Dimensions (London, December 2009).

internalize the consequences of others' policies on one's own economic performance as well as the ramifications of one's policies on others' performance.

Chapter 5

The domestic political economy of international economic cooperation

It is easy for observers to point out the desirability of all manner of international cooperative ventures, and to bemoan the paucity of successful efforts in this direction. But policymakers – the ones who actually need to undertake the cooperation – face limits on their action. They have to answer to domestic constituents, for a policymaker who ignores what his constituents wants will not be a policymaker for very long. This is true in all political systems, inasmuch as they all have some social choice mechanism that determines who influences policy and politics – from a tiny elite to the broad electorate.

Governments will only make the sacrifices necessary to carry through on their international obligations if they have domestic support for these sacrifices. And constituents will only put up with costly and difficult measures if they are convinced that the benefits – in particular, the benefits of sustaining the country's international economic commitments – outweigh the not inconsequential costs. If we are to have a clear sense of the prospects for international economic cooperation, then, we need a clear sense of the domestic political constraints under which policymakers are likely to operate. It is to this that we now turn, concentrating on some of the main centers of economic influence: the United States, the European Union, China, and Brazil. These are not meant to reflect an exhaustive survey of the world's major powers, but rather to give a flavor of the kinds of

domestic political obstacles that can stand in the way of well-laid plans for international cooperation. The broad conclusion to which we are driven is that in virtually all cases, the political incentives are heavily weighted on the side of focusing on domestic problems, even at the expense of international ones.

5.1. The United States

While the United States has weathered the crisis that began there in 2007, it faces some serious economic and social challenges. The underlying social and economic realities that were, in one way or another, at the root of the crisis, persist, and have not been addressed by the country's political system.

Most immediately, Americans have not fully undertaken the adjustments necessary to address the overhang of debt that continues to hamper recovery. While households have reduced consumption and increased saving, they have not done so in anything like the measure necessary to restore some balance to their finances. Creditors, in particular major financial institutions, are still struggling to adjust their balance sheets to allow a resumption of normal lending. It will undoubtedly be several years before we see the American financial system playing its appropriate role as intermediary between savers and investors. On other dimensions as well – such as the trade balance and post-crisis fiscal policy – basic adjustments have yet to be undertaken. We are confident that they will eventually, and that by 2020 we will be firmly in a post-crisis environment.

Turning to the longer term, nonetheless, it seems clear that the United States will face important choices. We assume that the country will not return to running current

account deficits in the 5-7 percent of GDP range. The reserve currency role of the dollar, and the safe haven role of the United States, probably allows current account deficits of 2 percent of GDP, but more than that is unlikely – and probably also both unnecessary and unwise. But a “rebalancing” in the United States will require constraining consumption and raising savings. Inasmuch as it also requires increasing productivity, this requires turning around the relatively sluggish productivity growth of the past decade. After very rapid increases in labor productivity starting in the middle 1990s, largely associated with high-technology industries and the application of their technologies in other areas, productivity growth has slowed.

The United States has almost certainly been under-investing in human capital formation, especially in math, science, and other areas related to modern information technologies. It has also cut back its spending on research and development, so that Americans are now surpassed by foreign innovators in applications for *American* patents. Indeed, foreign patent applications have risen continually from about one-quarter of the total in the 1960s, to 44 percent in 2000, to over 50 percent today.⁴⁸ While this is not in itself worrisome – foreigners apply for American patents in part due to the nation’s technological edge – the relative slowdown of American applications are an indication of the country’s more general slowdown in education and innovation in areas associated with math, science, and information technologies.

⁴⁸ http://www.uspto.gov/web/offices/ac/ido/oeip/taf/us_stat.pdf (accessed April 7, 2012).

It is easy to identify important areas in which substantial investment, largely public, is desirable and may even be necessary. This includes the country's educational system, and its economic infrastructure. However, it is equally easy to identify powerful pressures on the fiscal stance of the Federal government. In particular, the financing of Medicare and Social Security programs require attention. The latter could be addressed with modest reforms – fully taxing benefits, raising the retirement age, reducing benefits and raising taxes by fairly small amounts. The former, however, is tightly tied up with the galloping increase in the cost of medical care, a problem for which the diagnosis, let alone the prescription, is very uncertain.

Americans face serious questions about the appropriate role of the Federal government, and of its financing. Whatever the country decides about the services it wants from the government – the level of national defense, the size and generosity of the social safety net, the extent of support for the elderly -- it will need to pay for them and cannot continue indefinitely to borrow to finance them. However, there are major disagreements among Americans as to how these constraints should be met – by cutting back on spending, or increasing taxes, or some combination. These disagreements are fueled by material differences within American society. The United States has become substantially more unequal since the early 1970s, and the experience of the recent crisis has reinforced the socio-economic diversity – some income groups, and some regions, were extremely hard hit, while others were much less severely affected. The disagreements over the future course of American economic policy are also fueled by serious partisan disagreements, motivated by both ideology and electoral politics.

American politics is likely to remain at least as divided, even as polarized, as it has become in the past decade. This means that the United States is likely to be absorbed in its own battles, too much so to pay sufficient attention to conditions in the rest of the world or to how American policy might ameliorate global problems. The United States will continue to want to exercise international economic leadership, but its ability to find the political consensus, and the resources, necessary to do so will be seriously tested.

The ability of the United States to provide purposive international economic leadership will be hampered by the distractions of its difficult domestic political disputes; it will also be impeded by growing skepticism about the world economy on the part of many Americans. Public opinion toward globalization has become increasingly negative, so that Americans are now the most hostile to international trade of the 47 countries regularly surveyed by the Pew Charitable Trust.⁴⁹ Table A, which shows American views toward agreements to liberalize trade, indicates that by enormous majorities, Americans believe that freer trade costs the country jobs, reduces wages, and slows the economy.

⁴⁹ Pew Global Attitudes Project, *World Publics Welcome Global Trade – But Not Immigration: 47 Nations Pew Global Attitudes Survey* (New York: Pew Research Center, 2007).

Table A
Most Say Trade Agreements Lead to Job Losses
(Percent responding in each category)

Impact of free trade agreements on...

	Total %	Rep %	Dem%	Ind%
Jobs in US				
Create jobs	9	6	14	7
Lead to job losses	64	67	55	69
No difference	27	27	31	24
Wages in US				
Make wages higher	9	6	13	9
Make wages lower	52	52	49	53
No difference	39	42	38	38
Nation's Economy				
Lead to growth	22	20	27	19
Slow economy	50	55	42	53
No difference	28	25	31	28

Source: "Americans Are of Two Minds on Trade," Pew Research Center (Pew Research Center for the People & the Press), Nov. 9, 2010. Available at <http://pewresearch.org/pubs/1795/poll-free-trade-agreements-jobs-wages-economic-growth-china-japan-canada> (accessed on March 26, 2012).

Socio-economic trends in the United States threaten to deepen skepticism about the international economy. Attitudes toward globalization tend to track income relatively closely. Table B illustrates the relationship: only those Americans with household incomes above \$100,000 a year hold positive views about trade liberalization. Table C demonstrates the impact in one specific instance: only those Americans with some college

education are favorably inclined toward trade with China. In this context, the deterioration of the country's income distribution has almost certainly fed sentiment hostile to or skeptical about globalization.

Table B
Few Say They Have Been Helped Financially by Trade Agreements
(Percent responding in each category)

Impact of free trade agreements on personal finances:

	Helped %	Hurt %
Total	36	64
Education		
College grad+	46	54
Some college	36	64
HS or less	31	69
Family income		
\$100,000 or more	52	48
\$75-99,999	32	68
\$30-74,999	30	70
Less than \$30,000	33	67

Source: Source: "Americans Are of Two Minds on Trade," Pew Research Center (Pew Research Center for the People & the Press), Nov. 9, 2010. Available at <http://pewresearch.org/pubs/1795/poll-free-trade-agreements-jobs-wages-economic-growth-china-japan-canada> (accessed on March 26, 2012).

Partisan effects are also worrisome for those who favor international economic integration. Tables A and C both point to the fact that Republicans are substantially more hostile to international trade than are Democrats. The very existence of a partisan difference of this sort – and to some extent it does not matter what the direction is – means that it is too politically dangerous for American politicians to express open support for globalization or its component parts.

Table C
Views of Increased Trade with China
(Percent responding in each category)

	Good for U.S. %	Bad for U.S. %
Total	50	50
By party		
Republican	45	55
Democrat	53	47
Independent	51	49
By education		
College grad+	56	44
Some college	54	46
HS or less	43	57

Source: "Americans Are of Two Minds on Trade," Pew Research Center (Pew Research Center for the People & the Press), Nov. 9, 2010. Available at <http://pewresearch.org/pubs/1795/poll-free-trade-agreements-jobs-wages-economic-growth-china-japan-canada> (accessed on March 26, 2012).

American policymakers and Americans more generally, are likely to be even more wary of foreign economic entanglements than they have been in the past. If the world is lucky, the average American will be generally indifferent to what goes on in the rest of the world economy; if unlucky, he may be openly hostile.

5.2. The European Union

The ongoing crisis in the eurozone is only one indication of how serious are the internal challenges facing the member states of the European Union (EU). In a broad historical sense, the EU is an extraordinary success, as it has created the largest single market in world history, and the largest multinational economic union. Even the euro could reasonably be regarded as a general success, inasmuch as the currency has continually gained new adherents and remains stable and trusted.

Nonetheless, the EU confronts some major concerns. The first is to resolve the weaknesses in the eurozone that have become so evident since 2007. Since the earliest discussions of monetary union, there have been three difficult issues, none of which has yet been settled. The first is the application of a common monetary policy to countries with divergent economic structures. The second is the creation of a common financial system with disparate (national) financial regulators and regulations. The third is the existence of an implicit expectation that member states will bail out eurozone countries in crisis, which leads to serious problems of moral hazard. All three of these issues have been central to the eurozone crisis, and none has really been resolved. It is likely to take the better part of this decade to come to a satisfactory settlement that is both politically acceptable and economic sustainable.

Members of the eurozone will have to work out its inherent weaknesses even as it gradually expands to include more EU member states. For it will be very difficult to exclude central and eastern European countries that have already starting asking for inclusion in the eurozone. However, the incorporation of still more relatively poor

nations, with economic structures even more different from those of the core eurozone countries, raises the specter of a return to the intra-eurozone macroeconomic imbalances that were at the root of the eurozone crisis. The EU will have, then, to repair the structure of the eurozone as currently constituted, but it will have to do so as the eurozone becomes a moving target, with more countries joining.

The European Union more broadly will have to deal with its internal structure. It is still very much open for debate whether the EU will be able to sustain the two-track organization that has emerged. While the principle of subsidiarity is well-established, it was never really meant to generate a union with two groups of countries moving in very different directions. The United Kingdom and other non-euro member states – including, most likely, some important central and eastern European ones such as Poland and the Czech Republic – seem headed in the direction of something close to associate membership in the much more closely integrated core eurozone. This may be tenable; but it may also give rise to internal tensions that will erupt into major intra-European conflicts over the future of the European Union.

All this is on top of the inherent economic problems that the member states of the EU face, even without having to worry about the structure of the union itself. Demographic trends in Europe are even more troubling than in the United States. The old-age dependency ratio for the EU-25, already at 25 in 2005, is expected to reach 32 by 2020 and to exceed 40 by 2030 (the old-age dependency ratio is the ratio of people 65 and over to those between 15 and 64, multiplied by 100). This means that while there are currently four working-age Europeans for every European 65 and over, in less than

twenty years there will be only 2.5 working-age Europeans per elderly person. This is likely to put an unsustainable burden on pensions, and more generally on government finances.

As in the United States, public opinion in Europe has become quite a bit more unfavorable toward international economic integration. Table D compares opinions on trade in France to those in the United States and China. While most people in all three countries think trade is good for the economy, national companies, and consumers, the French are firmly convinced that trade is bad for job creation, job security, and the environment. More broadly within the European Union, Table E explores public opinion on international economic integration and cooperation. While attitudes toward globalization in general remain positive – albeit less so in France than elsewhere – Europeans overwhelmingly believe that globalization makes society more unequal, and that it is only good for large companies, not for people like them. When asked explicitly about international cooperation, Europeans as a whole are roughly divided as to whether their global interests are in line with those of the United States – while those in Germany, France, and the UK are much more skeptical. European opinion is overwhelming that China’s interests are not consistent with their own when it comes to dealing with the effects of globalization.

Table D
Attitudes toward trade in the United States, France, and China

Question: Overall, do you think international trade is good or bad for... (percent responding in each category, “don’t know” omitted)

	US	FRANCE	CHINA
The Economy			
good (%)	57	65	92
bad (%)	43	35	8
Companies			
good (%)	54	56	86
bad (%)	46	44	14
Consumers like you			
good (%)	73	62	80
bad (%)	27	38	20
Creating jobs			
good (%)	38	26	81
bad (%)	62	74	19
The environment			
good (%)	48	31	66
bad (%)	52	69	34
Job security for workers			
good (%)	31	19	75
bad (%)	69	81	25

Source: *The Chicago Council on Global Affairs/ WorldPublicOpinion.org*, April 2007. Available at

http://www.thechicagocouncil.org/UserFiles/File/POS_Topline%20Reports/POS%202007_Globalization%20and%20Trade/2007%20GlobTrade_quaire.pdf (accessed March 26, 2012)

Table E
Public Opinion in the European Union
(Percent responding in each category)

Question	EU		Germany		France		UK	
	Agree	Disagree	Agree	Disagree	Agree	Disagree	Agree	Disagree
Globalization is an opportunity for economic growth	67	33	70	30	52	48	78	22
Globalization increases social inequalities	72	28	76	24	84	16	66	34
The EU and the USA have the same interests when dealing with globalization	52	48	44	56	40	60	43	57
Globalization is profitable large companies, not for citizens	73	27	68	32	85	15	74	26
The EU and China have the same interests when dealing with globalization	31	69	24	76	17	83	26	74

Source: Standard Eurobarometer Report 73, "Public Opinion in the European Union," November 2010. Available at http://ec.europa.eu/public_opinion/archives/eb/eb73/eb73_anx_full.pdf (accessed March 26, 2012).

As in the United States, globalization and international economic cooperation are not particularly popular in Europe. While views vary from country to country, and issue area to issue area, public opinion in Europe is wary enough about involvement in the world economy – let alone substantial increases in openness or in international cooperation – to make it difficult for European policymakers to undertake substantial initiatives without being able to demonstrate a measurable, direct payoff to their constituents.

5.3. China

The “Chinese development model” is a variant of the “Asian development model,” probably first articulated by Japan in the 1960s, and shares features with such other periods of rapid growth as Germany during the 1930s, Brazil during the 1960s and 1970s, and the USSR in the 1950s and 1960s. These policies can generate tremendous early growth, but they also can lead to deep imbalances.

At the heart of the models are large subsidies for manufacturing, meant to increase investment in manufacturing capacity, generate employment growth, and provide high profits to private or public investors. In nearly every case these subsidies are paid for by the household sector. China used three mechanisms to this end, following the model pioneered by Japan in its post-War boom.

The first mechanism is to constrain wage growth to well below the growth in labor productivity. During the past decade, wages have slightly more than doubled, while productivity nearly tripled. The gap is maintained with the help of the huge pool of surplus labor in the countryside; prohibitions on meaningful labor organization; and the creation of an underclass of migrant workers who lack legal residence permits (*hukou*), and therefore have virtually no legal protections. Lagging wage growth represented a transfer from workers to employers, effectively subsidizing businesses, increasing production, constraining household income and consumption, and thus forcing up the domestic savings rate.

The second mechanism is an undervalued exchange rate, which has prevailed since the massive devaluation of the renminbi in 1994, especially given soaring productivity. Most economists estimate the undervaluation to be anywhere from 15 percent to 30 percent, a substantial consumption tax imposed on all imported goods, and on consumers more generally. The principal beneficiaries are manufacturers in the tradable goods sector, heavily concentrated in Guangdong and the coastal provinces.

The third mechanism to boost manufacturing is severe financial repression. Almost all household savings in China are in the form of bank deposits, and the monetary authorities control banks, determining the direction of credit, risks, and interest rates. The People's Bank of China, following instructions of the State Council, sets the maximum deposit rate and the minimum lending rate. These rates effectively

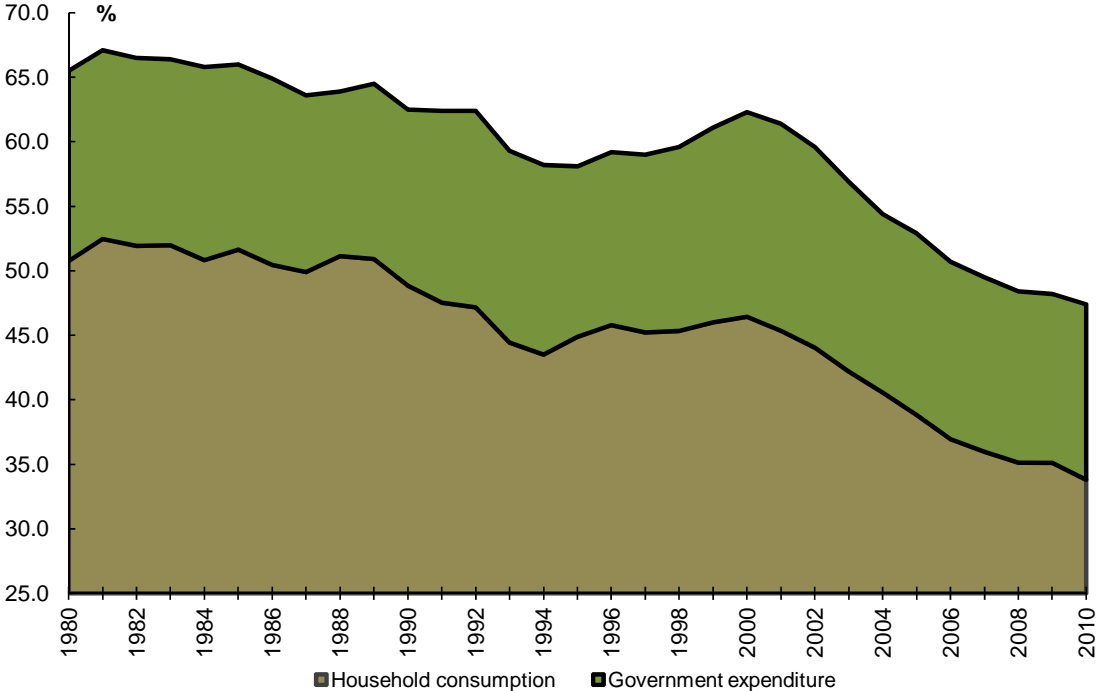
transfer resources from depositors to borrowers. For example, in the past decade nominal lending rates have averaged little more than 6 percent even as the economy grew nominally by 14 to 16 percent annually. Household deposits (including farm deposits) have been anywhere from 80 percent to 100 percent of GDP. The minimum spread between the deposit rate and the lending rate is also set very high in order to guarantee the banks a large and safe profit; excessive spreads are estimated to be roughly equal to 1 percent of GDP. Overall, the combined interest-rate-related transfers of 4 to 9 percent of GDP represent a very high hidden tax on households.

All three of these mechanisms do the same thing, albeit by distributing the costs and benefits in different ways to different groups among households and producers. They effectively tax household income and use the proceeds to subsidize producers, infrastructure investors, real estate developers, local and provincial borrowers, central government borrowers – in fact anyone who has access to bank lending, who employs workers, or who manufactures tradable goods, whether or not they actually export them.

The policies were of course successful at generating large trade surpluses. Domestically, they were reflected in the extraordinarily low and declining share of GDP represented by household consumption. In the 1980s household consumption represented about 50 to 52 percent of GDP, which was far below that of developed countries and Latin America, but in line with that of other Asian export-driven

economies. As indicated in Figure E, over the course of the 1990s, Chinese consumption declined further, to reach a meager 46 percent of GDP by 2000. And by 2005 household consumption in China had dropped to an astonishing 40 percent of GDP.

Figure E: China’s household consumption and government expenditure as share of GDP



Source: China Statistical Yearbook 2011

This eventually prompted policymakers to pledge during 2005 that they would take every step necessary to raise household consumption to help rebalance the economy. They expressed concern such low levels of domestic consumption implied excessive

reliance on the trade surplus to generate growth. But there was no political consensus in favor of taking the steps necessary to change course, and Beijing found it next to impossible to increase consumption without abandoning the investment and export-driven growth model altogether. Despite the expressed desire to reverse the trend, by 2010, the last year for which we have complete statistics, household consumption had fallen further to just 34 percent of GDP.

The counterpart to the very low level of consumption has been the high and rising level of savings. Household savings are high in part due to the underdeveloped financial system and lack of an effective social-insurance safety net. After bouncing around between 10 percent and 20 percent of disposable income in the 1980s, around 1992 household savings began rising steadily until 1998, stabilizing at around 24-26 percent. But the real increase in national savings in recent years has been due to a sharp rise in corporate and government savings. Of course, investment rose steadily during this period from around 23 percent of GDP in 1990 until it reached 50 percent in 2011.

All this led to the well-known dramatic evolution of China's trade position, from small surpluses or deficits until 1996, followed by a steady upward march of its trade surplus. This reached around 5 percent of China's GDP in 2003, after which it surged to over 10 percent of GDP in 2007-2008. The Great Recession led to a collapse in global demand, which brought the surplus down, but the underlying conditions that create enormous Chinese surpluses have not changed.

The result of this model is so much investment-driven and employment-generating growth that even with massive transfers from households, household income has grown dramatically. For the past decade, as the country was clocking growth rates of 10-12% annually, household income grew 7-9% annually. So why not continue this growth model forever?

The model cannot be sustained, for at least three reasons, two internal and one external. The obvious internal constraint is that rapid economic development has put major upward pressure on labor costs, which undermines export growth. The other internal constraint is on investment, which begins to bind as development progresses. When the capital stock is small and of very low quality, as was the case in China in 1979, almost any increase in capital stock is likely to increase labor productivity. But over time, it becomes more and more likely that cheap capital and socialized credit fund economically wasteful projects. The investments are profitable for those who make them, while the costs are spread through the entire country. China cannot simply continue to subsidize investment at the levels of the past, and expect it to be of a type and quality justified by the country's needs.

The second constraint is in the foreign sector. Sustaining the current policy mix will continue to require large trade surpluses. As long as the rest of the world – primarily the United States and the deficit countries of Europe and Latin America – were able to absorb China's exports, the fact that domestic households bought a

declining share of Chinese production did not much matter. But by 2007 China's trade surplus as a share of global GDP had become the highest recorded in 100 years, perhaps ever, and the rest of the world found it increasingly difficult to absorb it. To make matters worse, the global financial crisis sharply reduced the ability and willingness of other countries to maintain current trade deficits, and this downward pressure on China's current account surplus is likely to continue.

So China has hit both constraints – capital is wasted, and the world is finding it increasingly difficult to absorb excess Chinese capacity. For all its past success, China now needs to revise its development model, and the sooner it does so the less painful the adjustment will be. China needs to raise wages, interest rates, and the value of the currency in order to reverse the flow of wealth from the household sector to the state and corporate sector. This will run into opposition from the beneficiaries of this flow; and it could also cause financial distress to those businesses which have become heavily dependent on state subsidies. In the context of an already-weak banking system, this raises the specter of serious problems in the country's financial system.

The historical precedents for this kind of adjustment are not encouraging, and the adjustment China needs to make dwarfs those of its predecessors. There is reason for concern that China will adjust too slowly, and that the troubled and contentious adjustment will lead to lower growth rates. A small but rising number of Chinese

economists are now beginning to predict sharply lower annual growth rates of 6 to 7 percent over the next few years; this may in fact be optimistic.

All this suggests skepticism about the pace of China's rebalancing. For the country to change course requires a rate of growth of consumption that seems unlikely without a major transformation of China's economic and political circumstances. This is of course possible, but given political constraints it may be unrealistic to expect it. The Chinese growth model has been a great success in many ways. It has created an economic structure with major stakes in a continuation, and a whole range of actors with strong interests in keeping it going. While pressures for change abroad and at home promise to grow, it is not clear that the Chinese political and economic order are in a position to respond effectively to these pressures.

5.4. Brazil

We take Brazil as roughly symbolic of many democratic developing countries which have generally embraced integration into the international economy. Latin America's biggest economy has been doing reasonably well lately, despite some trying times in the 1990s. Economic reform has continued, both under the center-left government of Fernando Henrique Cardoso, and the somewhat more leftist governments of the succeeding Workers' Party presidents, Luiz Inácio ("Lula") da Silva and Dilma Rousseff. The economy has benefited from a substantial commodity boom,

with dramatic improvements in the terms of trade and large export surpluses. Economic growth has been coupled with a continuation of social reforms that have aimed at reducing the country's very unequal income distribution.

Brazil is something of a paragon of an economically open, progressive political economy that has been able both to participate in world markets and to engage in some important social reforms. In this, it can be contrasted with governments, including some in neighboring countries, that have turned away from "globalization" and taken a militantly populist, often anti-globalization, stance. Notable among these in the past decade have been Venezuela, Ecuador, Bolivia, and Argentina; and there are many non-Latin American examples. In comparison to these turns toward traditional populist nationalism, Brazil represents a combination of sympathy for globalization, commitment to greater social equity, and stable democratic politics.

Nonetheless, at least some of Brazil's achievements have been due to favorable external conditions. Rapid growth in East Asia has fueled demand for Brazilian raw materials and agricultural products, and is largely responsible for the country's growth even during the troubled years after 2007. Between a major increase the country's export volumes, and a substantial improvement in its terms of trade, Brazil's exports in 2010 were nearly triple what they had been 2002. Perhaps more important, the country's trade has been strongly reoriented toward East Asia: in 2000, Brazilian exports to the

United States were more than ten times what they were to China, while by 2010 the nation's exports to China are more than twice what they are to the United States.

This means that a major portion of economic growth in Brazil – and in other major commodity-exporting nations – relies on a continuation of rapid manufacturing growth in Asia, which in turn may depend upon rapid export growth. Inasmuch as one doubts the long-term prospects for sustaining the rate of export and manufacturing expansion in Asia, this calls into question the continuation of patterns and rates of economic growth in Brazil.

Another dimension is that of the country's enduring social problems. The social programs of the last twenty years have had only a minor impact on the country's income distribution. Substantially more than half of the country's population lives on less than the legal minimum wage, and illiteracy remains high, especially in the more backward Northeastern regions of the country.⁵⁰ Poverty and criminality remain serious problems in the country's major cities, and are the focus of much political attention.

Brazil has never been particularly passionate about its involvement in the global economy. The country is large and rich in resources, and has a very large and developed business community and middle class – neither of which has traditionally

⁵⁰ Joe Leahy, "2010 census shows Brazil's inequalities remain," *Financial Times*

November 17, 2011.

seen itself as heavily engaged with the rest of the world economy. While Brazil has not in recent decades gone down the populist path of, say, Argentina or Venezuela, there are social and political forces that could conceivably push it more in that direction. Even if it stays on its current course, the country is hardly a globalization enthusiast; it is more of a reticent fellow traveler.

Over the coming decades, the Brazilian government will need to deal with the likelihood that commodity exports will not sustain the country's economic growth, and with the nation's continuing social divisions. Brazil continues to aspire for leadership in Latin America, and in the world more generally. Nonetheless, the country's concerns differ substantially from those of the developed world. Despite its advances, Brazil is very much a developing country, whose interests are first and foremost in securing opportunities for its further growth. It is very unlikely to be willing, or able, to play a leadership role in managing international economic affairs.

5.5. Inconvenient truths

These brief surveys of the domestic political economy of the major centers of economic activity illustrate two simple, if inconvenient, truths. First, for the foreseeable future, most of the world's nations will be primarily engaged in dealing with difficult domestic economic, social, and political problems. Second, for a variety of reasons, enthusiasm for international economic integration has waned substantially in almost

every major region. On both accounts, then, it will be a struggle to sustain and increase the level of international economic collaboration. National policy will focus on national (or, in the case of the EU, on European) problems. And national publics appear poorly disposed to make serious compromises and sacrifices to shore up an international economic order about which they have grave doubts.

National policymakers in the advanced industrial countries face domestic audiences that are ambivalent about international economic integration, and that are wary of even their traditional economic partners. They also face large emerging economies whose views of the world, and whose domestic political constituencies, often are at odds with those of the industrialized world. Both realities are illustrated in Tables F, G, and H. Table F shows that while overwhelming majorities of the Brazilian and Chinese public view international trade as favorable to their countries, bare majorities are pro-trade in Europe while American opinion is even less favorable. Brazilians and Chinese, similarly (Table G), believe that their countries are well-positioned in international economic competition, while such confidence is only shared unambiguously by the Germans; the British are divided, and the French and Americans decidedly pessimistic. Perhaps even more striking, and more directly relevant, Table H demonstrates that large majorities in the US, the UK, and France, regard the rise of such emerging economies as China and India as a threat rather than an opportunity (the Germans are split on the matter). All this highlights the fact that many national

governments have a hard time convincing their people that it is worthwhile to forego some national prerogatives in favor of global governance.

Most governments have had difficulties convincing their constituents to make significant sacrifices on behalf of international cooperation, and are likely to continue to face such difficulties. This makes it particularly important to identify the areas in which, and ways in which, initiatives for greater global governance are especially important. In light of the great political costs of obtaining national agreement on a further delegation of government functions to the global level, we need a clear sense of where we should focus our efforts.

Table F
Attitudes toward trade across countries

Is the development of international trade...

	US	UK	Germany	France	China	Brazil
Mainly a good thing for your country	39	62	50	53	90	76
Mainly a bad thing for your country	26	9	27	16	6	10
Neither one nor the other	35	29	23	31	4	14

Source: *IFOP pour LA CROIX*. "Perspectives towards Globalisation Across Ten Countries." January 2011, available at http://www.ifop.com/media/poll/1390-2-study_file.pdf (accessed April 12, 2012).

Table G
Views on national competitive position

How well positioned is your country in international economic competition?

	US	UK	Germany	France	China	Brazil
Well positioned	44	52	81	35	71	77
Poorly positioned	56	48	19	65	29	23

Note: Those who answered “don’t know” or “no opinion” are excluded

Source: *IFOP pour LA CROIX*. “Perspectives towards Globalisation Across Ten Countries.” January 2011, available at http://www.ifop.com/media/poll/1390-2-study_file.pdf (accessed April 12, 2012).

Table H
Views toward emerging economies

Do you believe that the growth of countries like China and India is...

	US	UK	Germany	France
A serious threat to your country's companies and jobs [Une grave...]	64	57	49	67
A great source of opportunities for your country to conquer new markets [Une formidable...]	36	43	51	33

Note: Those who answered “don't know” or “no opinion” are excluded

Source: *IFOP pour LA CROIX* . “Perspectives towards Globalisation Across Ten Countries.” January 2011, available at http://www.ifop.com/media/poll/1390-2-study_file.pdf (accessed April 12, 2012).

Chapter 6

The normative case for governance of the international economy⁵¹

Global problems push us to think in terms of global solutions. Discussions in the G20, World Trade Organization, and other multilateral fora often proceed as if the correct remedy for our economic problems is always more global cooperation – more rules, more harmonization, more discipline on national policies. But, as we have seen, there are major obstacles to the construction of robust global institutions. National sovereignty is zealously guarded, not least by domestic politicians who do not want to see their prerogatives eroded. And the challenge is not going to get easier in the years ahead. The rising powers of the world economy -- China, India, Brazil and other emerging market economies -- place if anything greater importance on national sovereignty than the traditional great powers. The practical and substantive challenges that global governance faces call for a more calibrated approach that focuses on areas where the need for building global institutions is greatest, while not wasting political or organizational capital in areas where the returns are small.

⁵¹ This section draws on Rodrik (2011a, chap. 10) and Rodrik (2012).

In this section, we present a taxonomy of economic policies to clarify what *is* and *is not* important to look for in international economic cooperation. The objective is to differentiate domains in which policy coordination is desirable (and more likely to be achievable) from issues where it is neither necessary nor achievable. We make a distinction in particular between two types of policies with global spillovers: “beggar-neighbor” policies, which aim to extract economic advantage at the expense of other nations, and “beggar-thyself” policies where the economic costs, if any, are borne primarily at home. The latter calls for global oversight that is weaker and qualitatively different.

6.1. New modes of global governance?

We begin with a quick review of the state of thinking on global governance. There was extensive discussion of effective models of global governance even before the international financial crisis struck, with policy makers as well as academics proffering visions of new forms of governance that leave the nation state behind. Few of these models envisage a truly global version of the nation state; a global legislature or council of ministers is too much of a fantasy. The solutions on offer rely instead on new conceptions of political community, representation, and accountability. The hope is that these innovations can replicate many of constitutional democracy’s essential functions at the global level.

The crudest forms of such global governance envisage straightforward transfers of national powers to international technocrats. Economists appear to be particularly enamored of such arrangements. For example, when the European economics network VoxEU.org solicited advice from leading economists on how address the frailties of the global financial system in the wake of the 2008 crisis, the proposed solutions often took the form of tighter international rules administered by some kind of technocracy: an international bankruptcy court, a world financial organization, an international bank charter, an international lender of last resort, and so on.⁵²

Others, such as international lawyer and political scientist Anne-Marie Slaughter, have focused on transnational networks created by regulators, judges, and even legislators. These networks can perform governance functions even when they are not constituted as inter-governmental organizations or formally institutionalized. Such networks, Slaughter argues, extend the reach of formal governance mechanisms, allow persuasion and information sharing across national borders, contribute to the formation of global norms, and can generate the capacity to implement international norms and agreements in nations where the domestic capacity to do so is weak (Slaughter 2004). The club of central bankers centered at the Bank for International Settlements is a premier example of such a network.

⁵² See <http://voxeu.org/index.php?q=node/2544>.

John Ruggie has emphasized the parallel role that global civil society can play, enunciating norms of corporate social responsibility in human rights, labor practices, health, anti-corruption, and the environment. The United Nation's Global Compact, which Ruggie had a big hand in shaping, embodies this agenda. The Compact aims to transform international corporations into vehicles for social and economic progress. The goal is to allow the private sector to shoulder some of the functions that states are finding increasingly difficult to finance and carry out, as in public health and environmental protection, narrowing the governance gap between international markets and national governments (Ruggie, 2004, pp. 499-531).

Joshua Cohen and Charles Sabel have gone even further in outlining a future in which accountability takes a truly global form. They envisage global deliberative processes among regulators which feed into the development of a global political community, with people coming to share a common identity as members of an "organized global populace" (Cohen and Sabel, 2005, p. 796). At the end of the day, true global governance requires individuals who feel that they are global citizens.

The nation state does not have many defenders. As Sen puts it, "there is something of a tyranny of ideas in seeing the political divisions of states (primarily, national states) as being, in some way, fundamental, and in seeing them not only as practical constraints to be addressed, but as divisions of basic significance in ethics and political philosophy" (Sen, 2009, p. 143). At the same time, political authority still

remains vested for the most part in national governments. The global governance arrangements described above require the transfer of substantial authority from national institutions to transnational, multi-national, or multilateral entities. Arguments on behalf of new forms of global governance—whether of the direct subordination, network, or corporate social responsibility type—raise difficult questions. To whom are these mechanisms accountable? From where do these global clubs of regulators, international non-governmental organizations, or large firms get their mandates? Who empowers and polices them? What ensures that the voice and interests of those who are less globally networked are also heard? In a nation state, the electorate is the ultimate source of political mandates and elections the ultimate vehicle for accountability. If you do not respond to your constituencies' expectations and aspirations, you are voted out. The democratic state is tried and tested. Its global counterpart sounds too experimental and utopian.⁵³

⁵³ For example, it is interesting that Slaughter's (2004) most telling illustrations of networked global governance come from the area of financial markets. She points to the International Organization of Securities Commissions (IOSCO) and the Basel Committee on Banking Supervision as networks of regulators that set global rules for financial markets. Most economists would say, however, that these institutions have failed to deliver an adequate set of rules. Many would also argue that they have been

6.2. Thinking about global governance: first principles

Going back to basics, the principle of “subsidiarity” provides the right way of thinking about issues of global governance. It tells us which kinds of policies should be coordinated or harmonized globally and which should be left largely to domestic decision-making. The principle demarcates areas where we need extensive global governance and areas where only a thin layer of global rules is adequate. We can think of this as a choice between a WTO-type (thick) global regime versus GATT-type (thin) regime.

The premise in what follows is that any practical mechanism of global governance must rely on the willingness of national governments to submit to international discipline. Nation states, the primary decision-making units in the world economy, must be provided with a reason as to why it is in their interest to cooperate and coordinate, rather than go at it alone. Transnational altruism is not a reliable pillar on which to construct global governance.

too dominated by financial industry interests and that the Basle Committee’s capital adequacy rules have in fact played a contributing role in both the Asian financial crisis of 1997-98 and the global financial crisis of 2008-2009.

6.3. A quartet of policy problems

To see how the principle of subsidiarity applies, we make a distinction between four different variants in which economic policies come. We start from the two extremes, “purely domestic policies” and “global commons policies,” which are the easiest to describe and have the most direct implications for global governance. Then we turn to the trickier intermediate cases, which we call “beggar-thy-neighbor” and “beggar-thyself” policies.

6.4. Purely domestic policies

At one extreme are domestic policies that create no (or very few) direct spillovers across national borders. Examples are educational policies, highway safety standards, and urban zoning. Since the object of regulation in both instances is a non-traded service (human capital, local transportation, and real estate, respectively), such policies do not affect economic interests of other countries, at least directly. They therefore require no international agreement and can be safely left to domestic policymakers. This seems to be widely accepted, as there is little clamor for internationalization of regulation in such areas.

Of course, in practice regulations in non-traded markets influence the rest of the economy and therefore have implications for other nations as well. Highway safety

standards, for example, can affect the demand for oil and its price on world markets.⁵⁴ Nothing is purely domestic when general equilibrium implications are taken into account. But it is understood or presumed that such effects are indirect, uncertain, and that the intent of policies is not to discriminate against foreign economic interests.

6.5. Global commons policies

At the other end are policies that relate to “global commons,” such as global climate. The characteristic of a global commons is that the outcome for each nation is determined not by domestic policies, but by (the sum total of) other countries’ policies. The classic case is greenhouse gas emissions. Global climate is a pure global public good, in that no country can be excluded from benefiting from the control of greenhouse gases in other countries, nor can a country keep the benefits of such policies to itself.

There is a very strong case for establishing global rules in these policy domains, since it is in the interest of each country, left to its own devices, to neglect its share of the upkeep of the global commons. Absent a binding agreement, the rational strategy for any small country is to free ride on other countries’ emissions policies. Since each

⁵⁴ And one of the most significant disputes between NAFTA partners was the US-Mexico conflict over Mexican truckers’ access to American highways.

country reasons the same way, the decentralized outcome is one where no country invests in costly climate control policies. Hence failure to reach global agreement would condemn all to a collective disaster.⁵⁵ That is why there is no alternative to global governance in the area of climate change, as difficult as it may be to achieve.

True global public goods are rare. Even though the global economy is often portrayed in a similar light, in fact few economic policies qualify as “global commons policies” in the sense sketched out above. We commonly hear statements to the effect that “a growing, open world economy is a global public good.” The idea seems to be that as each nation pursues its own narrow interests, the world economy would slide into rampant protectionism and everyone would lose as a result.

But this logic relies on a false analogy of the global economy as a global commons. What makes global warming a global rather than national problem, requiring global cooperation, is that the globe has a single climate system. It makes no difference where the carbon is emitted. One might say that all our economies are similarly intertwined, and no doubt that would be true to an important extent. But in the case of global warming, domestic restrictions on carbon emissions provide no or little benefit at home. By contrast, good economic policies –including openness -- benefit

⁵⁵ Large countries have some incentive to control emissions, to the extent that their contribution to the global stock of greenhouse is non-trivial.

the home economy first and foremost. The economic fortunes of individual nations are determined largely by what happens at home rather than abroad. If open economy policies are desirable it's because openness is in a nation's own self-interest—not because it helps others. Openness and other good policies that contribute to global economic stability rely on self-interest, not on global spirit.

Free trade and appropriate financial regulations at the national level are desirable, regardless of the policies of other countries. If other countries also follow “good” policies, all the better for us. But unlike with climate change, there is no logic that suggests countries will systematically follow policies that are harmful to the world economy. In fact, quite to the contrary.

However, there are two caveats. First, sometimes domestic economic advantage comes at the expense of other nations. Second, there is no guarantee that countries will do what is economically right for themselves, for reasons of domestic politics gone awry or sheer ignorance. These exceptions give us two intermediate cases between purely domestic policies and global commons, which we analyze under the headings of “beggar-thy-neighbor policies” and “beggar-thyself policies.”

6.6. Beggar-thy-neighbor policies

These are policies with which a nation derives an economic benefit at the expense of other nations. The purest illustration occurs when a dominant supplier of a

natural resource, such as oil, restricts supply on world markets so as to drive up world prices. In this instance the exporter's gain is the rest of the world's loss, and there is an additional global deadweight loss due to the supply restriction. A similar mechanism operates with the so-called "optimum tariff," with which a large country manipulates its terms of trade by placing tariffs on its imports. There is a clear case in these instances for global coordination taking the form of limiting or prohibiting the use of such policies.

In some instances, beggar-thy-neighbor effects may be intermingled with other, domestic motives. Consider for example currency undervaluation, which is often treated as a mercantilist policy aimed at extracting economic advantage from other countries. China's motive in pursuing such a policy seems to have been primarily to accelerate its economic growth by promoting structural change from low- to high-productivity areas. To the extent that this policy generates an external surplus, it requires that other nations be willing to bear the counterpart deficits. But in what sense does this impart a harm on other countries? In the case of China's currency policies, for example, it was often asserted prior to the global financial crisis that there was a willing partner in the United States. America's trade deficit allowed it to borrow and finance its consumption and credit boom on the cheap, while China subsidized its exports through a cheap renminbi. There were some complaints in the U.S. from those adversely affected

by China's exports. But these complaints were drowned by those who argued the relationship was mutually beneficial, even if of doubtful sustainability.

Global imbalances have become a much more serious issue in the aftermath of the financial crisis, as we discuss elsewhere in the report. It now seems clear that large current account surpluses such as those of China have contributed to financial fragility. There is also concern due to the spike in unemployment in the U.S. and Europe. When the economy looks as if it is caught in a Keynesian situation of excess supply, external deficits contribute to the deficiency of aggregate demand and aggravate unemployment. Paul Krugman famously wrote in 2009 that "we're looking at 1.4 million U.S. jobs lost due to Chinese mercantilism" (Krugman 2009). Whether there is such a direct link or not, currency policies that export unemployment and financial instability increasingly look like beggar-thy-neighbor policies. They are an area where global cooperation and coordination becomes necessary, at least among systemically large countries.

Rules with regard to bank secrecy or the taxation of capital present other instances where there is a mix of considerations. A jurisdiction that is set up as a pure tax haven, with the sole objective of attracting deposits and capital from abroad can be said to gain economic advantage at the expense of other nations and to follow beggar-thy-neighbor policies. But what if a nation views low taxes or strict secrecy as "correct" policies to follow *for domestic reasons*, regardless of consequences for cross-border flows

of money? Then, even if such policies have adverse effects on others, the case for global coordination is significantly weakened (as we discuss below under “beggar-thyself policies”). Disciplining low-tax jurisdictions under such considerations would require, at a minimum, an account of how a *global* economic loss is created in the absence of coordination.

Analytically, it helps to distinguish between the level of a policy that is domestically optimal absent cross-border interactions and the increment in that policy that becomes desirable once those interactions are taken into account. There should be a much higher threshold for disciplining the first component. Take tariffs for example. Suppose t is the domestically second-best level of taxation in an economy (due to, say, revenue reasons), holding the external terms of trade constant. Assume that the optimal level of the tariff becomes $t' = t + dt$ once external terms-of-trade effects are taken into account. The dt component of the tariff is the pure beggar-thy-neighbor component, which ought to be regulated internationally. There is much less ground for international discipline on t , unless other countries can demonstrate significant negative spillovers which more than offset the benefits to the home country.

6.7. Beggar-thyself policies

Beggar-thy-neighbor policies have to be distinguished from what we may call “beggar thyself” policies. The latter are policies whose economic costs are borne

primarily at home, even though they may produce effects also on others. Examples are agricultural subsidies, bans on genetically modified organisms, or lax financial regulation. In each instance, there may be costs to other countries. But these policies are deployed not to extract advantages from other nations, but because other competing policy objectives at home – such as distributional, administrative, public-health or other political concerns -- dominate the economic motives.

Consider for example agricultural subsidies in Europe. Economists generally agree that these are inefficient and that the benefits to European farmers come at large costs to everyone else. Economists also agree that the bulk of those costs are paid by European residents, in the form of high prices, high taxes, or both. The subsidies do produce spillovers to other nations. Agricultural producers around the world get hurt, while consumers of agriculture benefit.

Even though the presence of such spillovers is often taken to establish a case for global governance over these policies – as in the Doha Round of trade negotiations – it is not clear why that should be so. There can be two reasons for the pursuit of beggar-thyself policies: there can be compensating non-economic benefits, or the government in question can be simply making a mistake. Consider each of these two possibilities in turn.

Say that European governments have decided the economic costs of agricultural subsidies are worth paying for as the price for sustaining healthy rural farming

communities. Even though the policy is economically inefficient, in this case it serves a broader social purpose and therefore is “optimal,” from Europe’s own perspective. A direct implication is that any global effort to reduce or eliminate these subsidies would leave Europe worse off. Even if such an attempt were to produce net economic benefits to the rest of the world, it would come at the expense of socio-economic losses for Europe. Thus there would seem to be a very weak case for global discipline.

The same logic applies to bans on genetically modified organisms or hormone-fed beef, where the perceived compensating benefit at home is precaution against health risks. It also applies broadly to the conduct of industrial policies by developing nations, where the intent is to reap the dynamic benefits of more rapid structural change and economic diversification. In none of these cases does it seem appropriate to empower the “global community” to tell individual nations how they ought to weight competing goals.

This doesn’t preclude a global conversation over the nature of diverse benefits and harms to the parties. Such conversations can be helpful in reducing international misunderstanding about the objective of policies, and sometime in establishing new behavioral norms. But global restraints on domestic policy space would seem inappropriate since there is no prima facie reason why the economic interests of other nations ought to take precedence over the social-economic benefits to the home nation.

Once again, it is unclear whether the net benefit to the world from global discipline is positive.

The case against global regulation becomes even stronger when the spillovers to the rest of the world are, on balance, positive. This may seem unlikely, but note that it is indeed the case with export subsidies in agriculture. Economic analysis suggests that such subsidies improve the terms of trade of the rest of the world and is therefore a “gift” from a country to its trade partners. Some countries or groups are harmed, of course. But it is difficult to see why this should be a reason for restraining home country policies. Consider an analogous situation where a country decides, unilaterally, to reduce its import tariffs. Similar to the export subsidy case, some other nations – those who import similar things -- may well get hurt. Yet economists, reasonably, would never contemplate enacting global rules that restrict a country’s ability to liberalize its trade!

Let’s now go to the second case where the country in question has actually made a “mistake.” Suppose agricultural subsidies are an unambiguously bad idea, even when all the other potential non-economic benefits are taken into account. Yet somehow the country’s political system fails, and delivers a bad policy. Indeed, there is no guarantee that domestic policies accurately reflect societal demands. Policy makers may be short-sighted, ignorant, or captured. Even democracies are frequently taken hostage by special interests.

One class of policy failures is easy to deal with, at least conceptually. These are failures due to time inconsistency, in which policy makers' incentive to give in to short-term temptation results in long-term losses. Trying to generate "surprise" inflation or protectionist horse-trading among legislators are well-known examples. Many nations deal with time- inconsistency failures through "delegation," the transfer of authority to an autonomous body – an independent central bank or tariff-setting authority – that is less susceptible to the push and pull of daily politics. International disciplines can play the same insulating role too.

At the same time, in democracies delegation takes place only under a narrow range of circumstances. We tend to see delegation domestically when there is little distributive conflict over the objectives of policy, the issues are technical rather than political, and the "chain of delegation" can be kept short. Delegating rule making to an autonomous body so everyone can be better off is one thing; delegating so one political party gains at the expense of another is something else altogether. Moreover, it is not clear why international delegation should hold an advantage over the domestic kind, even when those conditions are satisfied. Policy discipline exerted by an extra-national body may or may not be more effective than a domestic one. The case for global governance on account of time inconsistency is at best a qualified one.

Things get even more complicated when policy failures do not derive from a simple time inconsistency. To be sure, both domestic and foreign welfare would be

enhanced if one could design global rules that prevent mistaken policies from being adopted. One problem is that similar or worse policy failures can take place at the international level as well. For example, most economists would agree that banking interests and pharmaceutical companies have exerted too much influence in setting Basle capital adequacy rules and WTO intellectual property rules, respectively.

Another problem is that it is not easy to distinguish in practice domestic policy failures from non-economic considerations. Technocratic governance at the global level may fail to reflect adequately the kind of non-efficiency objectives that play a role in democracies, as in the agricultural subsidy context for example. In other words, technocrats (trade lawyers, economists, financial specialists) may substitute their own normative judgments for those of democratic polities.

These issues come into full play in the area of financial regulation. It is widely accepted that regulatory practices in a number of jurisdictions – the United States, in particular – failed to rein in excessive leverage and risk-taking in the shadow banking system. The failure was of a beggar-thyself type, even though the consequences were amply felt throughout the rest of the world as well. The attempt to address the problem through internationally coordinated and harmonized financial regulations has borne some fruit, mainly in the form of Basel III. But as we have discussed, expectations about international cooperation were not fully realized and much of the real action in terms of

new regulations took place nationally (or within a subset of EU members) in an uncoordinated manner.

The slow progress of global governance in this area reflects genuine differences in preferences over how finance should be regulated. The U.S., Britain, Switzerland, and France-Germany have taken their own different paths because their financial systems differ and are the product of varying circumstances. Switzerland feels it can afford much higher capital requirements than others. France and Germany believe it is politically important to institute an international financial transaction tax. The U.S. thinks restrictions on proprietary trading by banks would diminish financial fragility. Emerging markets have their own special concerns with hot money inflows. None of these positions is obviously right or wrong. In fact, the appropriate form of financial regulation depends on national circumstances and preferences, and cannot be determined in a uniform, technocratic manner.

The preference for domestic action also reflects in part the disappointing experience with previous international agreements. Basel I and Basel II both had flaws, that in some ways contributed to subsequent crises -- by encouraging short-term debt (prior to the Asian financial crisis) and by endorsing reliance on banks' own risk models (prior to the global financial crisis). Many economists feel international banks have exerted too much influence in softening capital adequacy and other requirements in Basel III. It is by no means clear that the technocratic perspective that dominates the

Basle process has served the global financial system well. Stronger democratic accountability to national parliaments may reduce banks' influence and base regulations on the preferences of a wider group of domestic constituencies. As Erasmus School of Law Professor Nicholas Dorn has argued, "democratically-fuelled regulatory diversity is a safeguard against the recently experienced frenzy in global financial regulation and markets" (Dorn, 2009).

So fixing *domestic* policy failures by setting global rules on acceptable policy is problematic, both in theory and in practice. But we can envisage another type of global discipline which acts directly on the relevant margin. We have in mind procedural requirements designed to enhance the quality of domestic policy making. Global disciplines pertaining to transparency, broad representation, accountability, and use of scientific/economic evidence in domestic proceedings – without constraining the end result – are examples of such requirements.

Disciplines of this type are already in use in the WTO to some extent. The Agreements on Safeguards and Anti-Dumping specify domestic procedures that need to be followed when a government contemplates restricting imports from trade partners. Similarly the SPS Agreement explicitly requires the use of scientific evidence when health concerns are at issue. Procedural rules of this kind can be used much more extensively and to greater effect to enhance the quality of domestic decision-making. For example, anti-dumping rules can be improved by requiring that consumer and

producer interests that would be adversely affected by the imposition of import duties take part in domestic proceedings. Subsidy rules can be improved by requiring economic cost-benefit analyses. Domestic financial regulation can be enhanced by global norms that emphasize transparent procedural rules limiting the influence of financial interests.

6.8. Summarizing the typology

To summarize, different types of policies call for different responses at the global level. The conceptual framework laid out here suggests the following typology of optimal global regimes:

- A. Purely domestic policies require no global action.
- B. Global commons require globally harmonized policy regimes. (Example: a global set of rules that allocate emission permits.)
- C. Beggar-thy-neighbor policies require the regulation of cross-border spillovers. (Examples: tariff bindings and restrictions on maximum size of current account deficits/surpluses.)
- D. Beggar-thyself policies require global regimes aimed at enhancing quality of domestic decision-making. (Examples: rules pertaining to transparency, representativeness, accountability, and use of scientific/economic evidence in domestic proceedings.)

The previous section summarized some of the political-economy barriers that can make international economic cooperation – global governance – difficult. Domestic political constraints can stand in the way of even the most desirable global actions; and it is neither prudent nor practical simply to ignore these constraints. Rather, we should recognize how limited is the room to maneuver of major governments. In this section, we supplement our attempt at a realistic assessment of what is *possible* in the realm of global governance with a survey of what is *desirable* in this realm. Especially because meaningful collaboration is difficult, it is important to choose battles wisely. On the basis of our normative and positive analyses of prospects for international cooperation, we now turn to a survey of some of the issue areas we anticipate are likely to be at the center of controversy over the coming period.

Chapter 7

Macro is the new trade: Future problems of the international economy

7.1. Introduction

There is no guarantee that the world will avoid major catastrophes over the next decade, but we prefer to believe (or at least assume) that we will muddle through. This allows us to move on to consider the challenges that will face the international economy once the aftermath of the current crisis is behind us. At this point, the world will face a new range of issues. What features are likely to characterize this new phase in international economic affairs; what problems are likely to confront us?

Recognition of the constraints confronted by the G20 to do as it said inevitably should lead to a frank assessment of its true short- and medium-term capability to execute its original reform agenda. The question is where to apply whatever political capital is available to pursue collective action. Should it be applied to global financial governance? To the multilateral trading system? Or to macroeconomic policy coordination? In other words, where should the world's principal governments apply their muscle to achieve strong, sustainable and balanced growth?

We identify five areas of particular importance. The first two are commonly discussed as central to the management of international economic problems:

international trade, and financial reform. While we regard these as important, we do not think that they need (or are likely to receive) a concerted collaborative effort from the world's major players, so we see them as less likely candidates for enhanced governance. We are not convinced that major new initiatives are either necessary, or politically realistic.

The next two topics have to do directly with macroeconomic matters: first, with potential conflicts over national macroeconomic, and especially currency, policies; second, and more broadly, with the persistence and recurrence of the global imbalances that characterized the decade leading up to the Great Recession. We anticipate that these will be central to international economic discussions, and we believe that there is both a strong normative case for enhanced cooperation and a reasonable chance that it might be feasible – hence the title of this section. The final issue has to do with the role of developing countries in the world economy. We anticipate that they will face difficulties in the more constrained environment to come. To the extent that this raises issues of international conflict and cooperation, these issues largely fall under the rubric of the macroeconomic policies discussed in the first two topics. In each setting, we illustrate the tensions we expect, and the scope of desirable and feasible international cooperative action.

7.2. Trade

The crisis has, to the surprise of many, not led to a dramatic upsurge in protectionist policies. This does not necessarily mean that governments have not been confronted with political pressures to alleviate the impact of the crisis on their citizens, but rather that their efforts along these lines have generally not taken the form of substantial increases in visible trade protection.

There are a number of explanations for the generally continued commitment to an open trading system. First, most major economies are now full members of the World Trade Organization (WTO) and subject to its rules. As the WTO has some fairly serious enforcement capabilities, this may have moderated governments' incentives to use trade protection as an early line of defense from the global financial crisis and ensuing recession. Second, trade protection is particularly (politically) well suited to sector-specific difficulties, such as the decline of a steel industry. The crisis had a broad impact on economic activity and employment, and while there were certainly industries that could have benefited from protection, most policymakers were more concerned about the broader macroeconomic blow that had been dealt to their countries.

Nonetheless, the G20's failure to strengthen the multilateral trading system by concluding the Doha Round, as was solemnly promised, should be seen as a major cause of lack of credibility and embarrassment. If the prolongation of slow growth in the developed economies or any other circumstance were to unleash substantive

protectionist actions, the G20 would come to regret deeply not having honored its Doha commitments, even if those protectionist measures were kept within what is permitted by the WTO. The problem is that the excess of bound over applied tariffs, plus the latitude of other WTO disciplines in their present form, leave a huge space to sustain “legal” protectionist interchanges that could have devastating economic effects. Providing insurance against this scenario all along has been the most significant - and least appreciated - value of a successful conclusion of the Doha Round. However, utilizing what is left of the G20’s capacity to organize effective collective action should not be spent, at least not in the very short-term, in trying to finish this trade Round.

For one thing, the current political business cycle is not propitious for such an undertaking. Too many important electoral processes are underway, and unemployment rates in the developed countries are too high to allow for serious trade talks. Also -- if not meticulously since as reported both by the Global Trade Alert⁵⁶ and the OECD-WTO-UNCTAD *Reports on G20 Trade and Investment Measures*,⁵⁷ practically every G20 country has undertaken protectionist actions despite repeated pledges -- the

⁵⁶ Global Trade Alert (<http://www.globaltradealert.org/>)

⁵⁷ OECD, WTO, UNCTAD, *Reports on G20 Trade and Investment Measures* (Mid-October 2010 to April 2011), 24 May, 2011

(<http://www.oecd.org/dataoecd/20/46/47955250.pdf>)

moratorium on additional trade and investment barriers agreed by the G20 (or more cynically, the fear of retaliation within the WTO boundaries) has allowed some reasonable preservation of open markets. Unless there is a catastrophic shock to globalization, the time to conclude the Doha Round surely will come. What is already on the table plus a modicum of political leadership and enlightenment to solve the still contentious issues should allow for concluding the Doha Round, and this would finally leave the WTO in a position to deal with the other topics already posing a challenge to the multilateral trading system in this early part of the XXI Century.

7.3. Financial regulatory harmonization

The panic that hit the international financial system in 2008 was the first truly global financial crisis since the 1930s. The world was stunned by the speed with which what had appeared to be relatively minor, reasonably isolated problems in American housing finance led to the contemporary equivalent of a massive global bank run that threatened to shut down the entire enormous edifice of today's international financial markets. This extraordinary turn of events has, not surprisingly, provoked widespread

interest in the reform of financial regulation, and in some form of international cooperation in designing and implementing such reforms.⁵⁸

Views differ as to the desirability of significantly greater coordination in reforming financial regulation systems. The system of regulation that is best for one country may not be well suited to another. Still, the unilateralist course taken by some of the reforms in the most significant jurisdictions may not be the best way to go if the global financial system is going to be sufficiently resilient. The complexity of the topics yet to be satisfactorily addressed is daunting. Dealing with liquidity standards, resolution regimes, OTC derivative markets and shadow banking, not to mention compliance with what has already been agreed, leaves a very open field for conflictual competition and even confrontation among different jurisdictions. The challenge is not about having exactly the same rules in every country. It is about providing enough coherence among the various national regulatory environments in a way that prevents regulatory arbitrage that could rapidly transform into a dangerous race to the bottom or – equally damaging -- a “spaghetti bowl” of contradictory, unsupervisable and unenforceable regulations.

⁵⁸ For one important study on the subject, see Charles A. E. Goodhart, Anil K Kashyap, Dimitrios P. Tsomocos, and Alexandros P. Vardoulakis, “Financial Regulation in General Equilibrium,” Chicago Booth Paper No. 12-11(March 2012).

And yet, without ceasing to monitor its evolution, financial reform is not where the major powers should spend their marginal units of political capital. This observation is based on three considerations. One is that the institutions already in place, like the FSB and the BCBS along with the traditional collaborations among national regulators and central banks as well as the IMF, could conceivably be, if not optimal, at least enough to keep the reform effort broadly on track. The other is that if those mechanisms proved insufficient to provide for the necessary cooperation and the situation descended into a competition of incoherent reforms, the consequences for some financial jurisdictions would be so pernicious that some urgency for coordination would soon be restored. The third is that, at the present time, there appears to be very little political support for the harmonization of financial regulations. Most major financial systems seem content to go their own ways, willing to confront issues of regulatory arbitrage by a combination of fine-tuning and managing flow so as to limit potentially pernicious race-to-the-bottom effects.

7.4. Conflicts over macroeconomic policy and related trade issues

This brings us to macroeconomic policies, and in particular to specific macroeconomic policies pursued by major economic powers that conflict with the goals of their partners. We expect to find ourselves in a world in which virtually all countries will be attempting to promote their exports and limit their imports, and in which job

creation will be a crucial goal of every major government. In this context, we are likely to see increased tension over the macroeconomic policies of the major economies – in particular, over their exchange rate policies. And conflicts over exchange rates will feed into conflicts over trade more generally. A sense of how this might develop can be gained by looking at how the crisis that began in 2007 was reflected in macroeconomic policies, and in policies that could (or did) create tensions among nations.

In the aftermath of the crisis, many governments pursued economic policies that had broad macroeconomic effects; but these policies also had important external effects on commercial and other ties among nations. Both fiscal and monetary policies responded quickly to the downturn, and both raised issues directly and indirectly related to other aspects of international economic relations. Monetary policy, to take the clearest example, directly implicates the exchange rate, which in turn affects national trade relations in much the same way as import barriers or export subsidies. Stimulative monetary policies in the aftermath of the crisis pushed currencies down. If the problems had been restricted to one country or region, this might have been an appropriate response – depreciation could stimulate necessary adjustments to consumption, real wages, and to the current account. But in the context of a global crisis, attempts to weaken national currencies risk turning into a downward spiral of “competitive devaluations,” as they were called in the 1930s, and which are generally believed to have had broad negative effects on all concerned. In the years since 2008, most attention

has been focused on the attempts by China, and other export-oriented developing countries, to keep their currencies weak.

The problems associated with exchange-rate policies that may impose externalities on other nations are broader than those associated with export-promoting developing countries with weak currencies. To take one example, relevant to the past crisis, when one country's stimulative monetary policy weakens its currency, the relative strengthening of another country's currency can impede its adjustment process. For example, the relative strength of the US dollar since 2008 probably slowed some desirable adjustments – although this was due more to the country's safe-haven status than to active monetary policy. Nonetheless, impediments to the adjustment process could feed into broader political tensions within and among nations.

There are other ways in which exchange rate-related issues can create political strains among nations. One such complex of problems can arise as governments attempt to sustain a fixed exchange rate. The inability to adjust the exchange rate can confront the country's tradable producers with serious competition from imports – especially if the country's inflation rate is above that of its partners, so that the currency is appreciating in real terms. It is common for governments struggling to maintain a fixed exchange rate to face strong protectionist pressures from those most affected by the added import competition. In fact, such pressures became a major political issue in Mercosur in the late 1990s. In the context of an overvalued peso associated with

Argentina's currency board, Argentina faced a flood of imports: in the first eight months of 1999, Argentine imports of Brazilian textiles and footwear rose by 38 and 66 percent respectively. This in turn provoked protests from Argentine manufacturers, who forced the Argentine government to impose barriers on Brazilian iron, textiles, and paper. The Brazilians retaliated, complained to the WTO, and even threatened to dissolve Mercosur (Carranza 2003).

The Mercosur crisis was reminiscent of an earlier episode in the European Monetary System (EMS). The 1992-1993 currency crisis in the EMS led to large devaluations of some EMS currencies. As a result, producers in countries whose currencies had been stable – in particular France and Germany – came under competitive pressures. This in turn led to domestic complaints about imports from the countries whose currencies had depreciated, which threatened the core commitments of the European Union, especially in the wake of the completion of the single European market. As Barry Eichengreen has noted about the aftermath of the 1992-1993 crisis (Eichengreen 2004):

The choice became whether to turn back to more freely fluctuating exchange rates, which might jeopardize the single market, or to move forward to monetary union, which would eliminate the problem of exchange rate instability by eliminating the exchange rate. Retreating to more flexible exchange rates threatened to fuel a backlash against the single market, since currency

depreciation could then confer an arbitrary competitive advantage on some national producers.

As countries find themselves torn between two important concerns – to stabilize exchange rates, and to maintain the competitiveness of their tradables producers – there will be continuing possibilities that this will create conflicts among nations.

Fixed rates can also raise other difficult problems with international implications, as the adjustments they require can be severe. Some of the pain associated with the crisis in Europe was exchange rate-related – not even considering how the very structure of the Eurozone may have contributed to the crisis. Attempts to maintain formal or informal ties to an anchor currency, especially in difficult times, can lead to major economic dislocations. For example, Estonia and Latvia endured huge drops in GDP in order to sustain their links to the euro. These sorts of painful adjustments often create a social and political backlash – they are associated with a turn toward populism in Latin America.

Fiscal policy in the crisis, too, sometimes implicated other economic relations, albeit not so directly as monetary policy. When a government undertakes stimulative fiscal policies, it is looking for effects on domestic economic activity. Yet some spending will inevitably “leak” into demand for imports. The government of a neighboring country might purposely avoid otherwise appropriate fiscal expansion in the hope that it will be able to take advantage of the “leaked” demand from its more fiscally active

neighbor. The result could be a backlash that threatened commercial or other retaliation against the country seen to be free riding on the fiscal expansion. This concern about “fiscal free riding” was common in the aftermath of the 2008 crisis.

As we move out of the post-crisis period and into a new economic era, we expect macroeconomic policies to continue to be the source of potential conflict, and to implicate commercial and financial relations among nations. The reasons are straightforward. In an integrated international economy, national macroeconomic policies can have immediate and powerful effects on other nations. The cross-border “spillovers” from monetary and fiscal policies can create political tensions in other countries, and feed back into clashes among governments. This is why we have titled this section “Macro is the new trade.” In the past, many of the tensions that erupted among governments in times of economic stress took the form of trade conflicts; we think that in the future they are much more likely to take the form of conflict over macroeconomic policies.

Macroeconomic policy divergences will be intensified as the relevant actors expand to include rapidly developing countries with very different priorities, and very different domestic economic structures. Monetary policy coordination among members of the OECD has been difficult, and the societies in question are very similar. However, the monetary and fiscal policy concerns of a Brazil, China, or India differ dramatically from those of the United States or the Eurozone. All of the former – and a whole host of

other emerging and transitional economies – are primarily concerned with speeding their developmental paths. This often involves exchange-rate and other macroeconomic policies meant to promote exports, and not to stimulate domestic consumption. These are precisely the policies most likely to provoke controversy in the developed nations. The long-term prospect, then, is for a continuation and proliferation of conflicts analogous to the simmering US-China dispute over the renminbi.

In this context, there are likely to be substantial conflicts over macroeconomic policy over the coming couple of decades, and significant demands for a higher level of inter-governmental collaboration. But is there really a need for purposive cooperation on international monetary policy? There is long-standing skepticism about this, for good reasons.⁵⁹ After all, if a government purposely manipulates its currency so that it deviates from what would be its market-driven level, the principal effects will be felt at home. To the extent that the movements of one country's currency imposes costs on another country, the latter can simply reverse the charges by counteracting the currency movement.

⁵⁹ One classic statement is Jeffrey Frankel, "Obstacles to International Macroeconomic Policy Coordination," *Studies in International Finance* No. 64 (Princeton University Press: Princeton, 1988); see also Barry Eichengreen, "International Policy Coordination: The Long View," NBER Working Paper No. 17665, December 2011.

Nonetheless, in currency affairs, as elsewhere, there are varieties of external effects that go beyond the impact on the national economy and national economic actors, and for which a unilateral response is either not possible or not desirable. Exchange rate misalignments, for example, can be the source of substantial problems for other nations and for international economic relations more generally. A government may purposely keep its currency relative weak, in the expectation that a depreciated currency will stimulate exports.⁶⁰ Of course, a depreciated exchange rate has a negative effect on national purchasing power, but this is solely a domestic matter in which the government has decided to trade off the welfare of exporters and import-competers, on the one hand, for that of consumers. However, a depreciated currency puts competitive pressure on the country's trading partners, and can stimulate protectionist sentiments abroad.⁶¹ The result may be to trigger commercial discord between countries, and even to endanger broader trade agreements.

⁶⁰ It is of course understood that such policies cannot prevail forever; but there is strong evidence that the rate at which exchange rates converge toward PPP can be quite slow – certainly slow enough to allow such misalignments to have substantial effects on the real economy.

⁶¹ Again, this is not a purely economic negative externality: the cheaper products benefit foreign consumers. The point is one of political economy: the increased

Exchange rate-provoked conflicts have placed a significant strain on the international trading system, both in bilateral relations between the countries in question, and more generally inasmuch as they have called into question the commitment of major countries to the multilateral resolution of trade disputes. Strongly misaligned currencies create problems not just for their home countries but for their economic partners, and in some instances for regional or global economic relations more generally. Inter-governmental cooperation could be of great help in avoiding some of the problems that arise as a result. And we think that such cooperation is rising higher and higher on domestic political agendas as the issues become more salient. This is especially true in the context of ongoing discussions of global macroeconomic imbalances.

7.5. A new round of global imbalances

It seems likely that global macroeconomic imbalances will persist for the foreseeable future, despite the fact that this seems a manifestly bad thing for the world economy. The United States is something of a special case, as its unique role allows it to continue to borrow at very low rates and in its own currency. This may of course

demand for protection may stimulate retaliatory national policies that harm both countries.

change over time, but it is much more likely that Americans will not feel the pinch of austerity typical of a heavily indebted country in the midst of a financial crisis. Instead, the public and private sectors will continue to be net borrowers from the rest of the world.

Nonetheless, it is highly unlikely that the United States will run current account deficits of the levels of the past decade. This would require persistence or increase of the very large trade deficit, which would only amplify the already substantial pressures for relief from tradables industries. In addition, it would involve a continuation of sizable Federal fiscal deficits, and these are increasingly controversial. There will be domestic limits on continued deficits. There may conceivably be international limits as well, if investors abroad begin to revise their estimates of the value of American assets. This would not be due to fears of default, but rather fears of inflation. These fears are probably justified, as even reliably conservative observers have come to regard several years of modest inflation as desirable to help reduce the country's debt overhang.⁶² In

⁶² Kenneth Rogoff, "The Second Great Contraction," *Project Syndicate*, August 2, 2011, at <http://www.project-syndicate.org/commentary/the-second-great-contraction> (accessed April 6, 2012); see also Menzie Chinn and Jeffrey Frieden, "How to Save the Global Economy: Whip Up Inflation. Now." *Foreign Policy* (January 2012).

this context, foreign appetite for dollar-denominated assets may decline, raising the costs to Americans of continuing to run substantial current account and budget deficits.

If the United States is to reduce its deficits – a process we regard as desirable, even necessary – then surplus countries must reduce their surpluses. Yet, as our discussion has illustrated, there are substantial barriers to a meaningful reversal of the surpluses of countries that have come to rely on exports as the engine of their economic growth. The current account surpluses of both China and Japan declined due to the global crisis, and although the two countries' governments have indicated their desire to restrain their surpluses, there is little indication of a significant enough reorientation of economic policy in either country to point confidently in this direction. Indeed, the Japanese appear to be counting on export growth to help pull their economy forward, while the Chinese government seems bent on continuing its own emphasis on boosting manufactured exports. This raises the prospect of a return to large and growing American trade deficits, which would simply return the world to its precarious position before 2007. Yet in the United States the conversation is largely about the opposite tack, relying on exports at least in part to fuel a more robust recovery.

In Europe, the dynamic is similar, if more troubling. There continue to be substantial current account imbalances within the eurozone. There appears to be little indication that Germany and other Northern European countries are on a path to reduce or reverse their current account surpluses with other members of the eurozone,

and of the European Union more generally. This is, of course, inconsistent with the need of peripheral European debtors to run substantial surpluses of their own in order to generate the resources necessary to service their debts. But simple accounting means that European debtor nations cannot service their obligations without running trade surpluses. It is hard to see how the European Union will work toward a lasting resolution of its debt crisis without a major change in the pattern of trade flows between the core and the periphery. As in the relationship between the United States and China, it is hard to imagine that an intra-European rebalancing could be achieved solely by austerity in the debtors: it will almost certainly require *both* significant austerity measure in the periphery, *and* stimulative measures in the core. So far, the evidence that this is likely to occur is weak.

This state of affairs implies that left to their own devices, the world's principal centers of economic activity are on something of a macroeconomic collision course. The major debtor/deficit nations either have to, or want to, reduce their deficits and aim at surpluses; the major creditor/surplus nations seem bent on maintaining their surpluses. This implies, as we have indicated, that there is scope for meaningful international cooperation. Understandable attempts on the part of, say, the Spanish government to expand exports and reduce consumption are inconsistent with equally understandable attempts on the part of the German government to encourage its firms to export

successfully to the Spanish market. But both goals cannot be achieved; and the world is full of countries whose policies are at odds with those of their partners.

This suggests that there is a real need for some coordinated effort to avoid these macroeconomic collisions, and in fact to collaborate on common policies to ease economic growth in the new post-crisis environment. But is such coordination political feasible? We think that there is greater hope for it now than there has been in recent memory. The basic principles have been discussed for the better part of a decade, as indicated in section 4 above, even if the realization of these principles has been elusive. While some may dismiss the G20's discussion of macroeconomic imbalances as lip service, it at least opens the door to more substantial measures. Within the major countries, there would seem to be real opportunities to garner support for collaborative measure. Governments in the surplus countries could make the case to their publics that the goal is increase consumption and to improve national living standards. There may be opposition from entrenched export interests, but there is some scope for counteracting this with purposive measures to develop domestic markets. Most governments in the deficit countries are already constrained to undertake austerity and other adjustment measures; if cooperation is obtained, it will make these measures easier to implement. Even in the United States, where the financing constraint does not bind, there appears to be real interest in everything from tax reform to entitlement restructuring.

This leads us to conclude that the G20 can make the most difference in restoring global growth and stability in the area of global macroeconomic imbalances. The Governor of the Bank of England puts the central argument best in a nutshell. “Improved financial regulation will help intermediate the flows associated with global imbalances. But we cannot expect too much of regulation: it may well be circumvented or diluted over time, and there will be leakages, both across borders and through the shadow banking system. So the global economy will remain vulnerable to the risks associated with imbalances if they are not tackled at source. That will require some way on ensuring that countries’ policies result in a sustainable outcome.”..... “What is needed now is a grand bargain among the major players in the world economy”..... “A natural forum in which to strike a bargain is the G20...” “So far, the process has failed to achieve a move to a better outcome. If we cannot achieve cooperation voluntarily then a more rules-based automatic system may need to be considered to restore global demand and to maintain future global economic and financial stability.”⁶³

Obviously, the Governor’s analysis is not universally shared. For example, Raghuram Rajan believes that governments know what they need to do but don’t do it

⁶³ King, Mervyn, “Global imbalances: the perspective of the Bank of England,” Banque de France, Financial Stability Review, No. 15, February 2011
(www.bankofengland.co.uk/publications/speeches/.../speech473.pdf)

because domestically it is politically difficult. Moreover, he argues, the value of an international grand bargain – even if this were possible -- is at best uncertain. He submits that the contribution to be expected from the multilateral institutions should be a modest one, basically “communicating the international consequences of a country’s policies to that country’s elite.”⁶⁴

Of course, in the economics profession there is a long tradition of skepticism about the feasibility and viability of international policy coordination. Two of the most distinguished contemporary international economists, Maurice Obstfeld and Kenneth Rogoff, provided scholarly support for the skeptical view as recently as a decade ago.⁶⁵ But that was before the great crisis, which has forced a reconsideration of what had been well-established results in the fields of macroeconomics and financial theory. Interestingly, Obstfeld and Rogoff, in a more recent collaboration, support the case for cooperation. “The recent crisis has dramatically illustrated the important and pervasive external effects of domestic macro and financial policies. In the interest of global stability, the policy choices of sovereign nations, including their exchange rate

⁶⁴ Rajan, Raghuram G., “Currencies Aren’t the Problem. Fix Domestic Policy, Not Exchange Rates,” *Foreign Affairs*, March/April 2011.

⁶⁵ Obstfeld, Maurice and Kenneth Rogoff, “Global Implications of Self-Oriented National Monetary Rules,” *Quarterly Journal of Economics*, vol. 117, 503-536, May 2002.

arrangements, must be viewed as legitimate subjects for international discussion and negotiation.”⁶⁶

Indeed, one of the more cogent arguments for direct attention to sustained current account imbalances comes from Obstfeld himself, in his recent Ely Lecture to the American Economics Association:

The arguments that current account deficits are self-correcting, that huge cross-border financial flows promote efficient risk sharing, and that private-sector self interest leads to socially efficient allocations absent government-imposed distortions all look increasingly implausible in light of recent experience...To my mind, a lesson of recent crises is that globalized financial markets present potential stability risks that we ignore at our peril. Contrary to a complete markets or “consenting adults” view of the world, current account imbalances, while very possibly warranted by fundamentals and welcome, can also signal elevated macroeconomic and financial stresses, as was arguably the

⁶⁶ Obstfeld, Maurice and Kenneth Rogoff, “Global Imbalances and the Financial Crisis: Products of Common Causes,” CEPR Discussion Paper No. 7606, Centre for Economic Policy Research, December 2009.

case in the mid-2000s. Historically large and persistent global imbalances deserve careful attention from policymakers, with no presumption of innocence.⁶⁷

It must be admitted that as of 2012 there is no sound theory or robust empirical evidence to unwaveringly support, or reject for that matter, the case for international coordination in a world so financially and otherwise globalized like the present one. No model, however sophisticated, has yet captured the connectivity and interdependence existing nowadays in the world economy and, given the recency of the phenomenon, the data to test robustly any reasonable hypothesis may not even be available in a fully satisfactory way. Ultimately opting for or against the value of international cooperation needs to be based on good judgment informed by a mixture of theory, empirical evidence and history.

Our own judgment is that the enormous policy predicaments confronting the governments of the countries with the most significant economies -- if ultimately solving them is their own and primary responsibility—can be addressed within a framework of coordination with considerably less pain than in a scenario of mainly unilateral and inward-looking policies.

⁶⁷ Maurice Obstfeld, “Does the Current Account Still Matter?” Richard T. Ely Lecture, American Economic Association Annual Meeting, Chicago, January 6, 2012, pages 24 and 39.

Not even the country with the biggest economy and the chief world reserve currency, the United States, can be confident that unilateral policies are in its best medium- and long-term interest. It should be clear by now that minimizing its own responsibility for adjustment and trying to shift as much as possible the burden of adjustment onto others, particularly onto the large surplus countries, cannot be sustained successfully for too long. The right principle is that of symmetric responsibilities between surplus and deficit countries, not one in which just one side of the imbalance is left to fix it. If the latter were attempted stubbornly, this would invite resistance and reactions that eventually would make it more onerous for the U.S. to achieve its own domestic policy objectives.

The idea that negotiation and agreement between only the two largest contributors to the imbalances, the United States and China, would be enough to solve most of the problem should also be rejected. Not only is it the case that this approach would unnecessarily place the problem on a trajectory more prone to conflict, but there is a lot at stake for others --irrespective of whether they make a large or small contribution to the imbalances—for their corresponding interests and responsibility to be ignored.

However difficult it is to achieve, there is hardly an alternative to broad consensus. It seems that the G20 accepted this principle to begin with and yet the challenge of how to obtain that consensus is proving to be an extremely recalcitrant one.

On overcoming that challenge, two things are clear to us. One is that striking a grand bargain that would deliver once and for all the new architecture needed to rebalance the global economy unfortunately is not within reach any time soon -- on just that part, we side more with Rajan than with King. The other is that the MAP as sketched and tried so far by the G20 is not the way to go either. The procedures to engage, define basic monitoring criteria, characterize each party's current policies, agree on each party's desirable policies, and procure compliance of each party's responsibilities, as contemplated until now in the MAP, do not constitute a governance framework with any significant chance of success. The present arrangement seems to be built to provide the ones bearing the greatest responsibility for adjustment multiple escape hatches from either acknowledging or complying with that responsibility. As designed, the MAP, rather than a system of peer review, looks more as a system of peer complicity.

Safeguards, or even veto power, are usually indispensable in international agreements for reasons of political economy. But too much of any of those components is a sure formula for falling into a trap of inefficacy and irrelevance. The G20 must find a way to get out of this trap or else fail completely in its commitment to provide the cooperation needed to achieve sustainable and balanced growth.

Since a reform that fully overhauls the global financial architecture is not feasible in the near future, the G20 would do best by aiming at incremental but substantive steps towards building more effective mechanisms to diagnose and address

macroeconomic disequilibria of global implications. The ultimate objective should be none other than the one determined at Pittsburgh, that of ensuring that national economic policies are mutually coherent and consistent with global stability. This implies endowing the system with effective disciplines for global adjustment. Unquestionably, this is a fundamentally multilateral endeavor that requires a truly multilateral implementation through a multilateral institution sufficiently empowered to influence national policies of both deficit and surplus countries.

In principle that institution already exists - the IMF. Although some of its articles of agreement could be interpreted so as to provide the institution with the legal capacity to play effectively that role,⁶⁸ the institution's governance, also inscribed in its articles of agreement as well as in long standing practices, significantly limits the IMF's ability to perform that function satisfactorily. The G20 seemed to be aware of these limitations when it issued its statement of purpose for reforming the IFIs at the London summit. However, as argued before, the reforms already undertaken have fallen quite short of

⁶⁸ Article 1.6 reads: "the purpose of the IMF (is)... to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members". Article 4.3a reads "The Fund shall oversee the international monetary system in order to ensure its effective operation, and shall oversee the compliance of each member with its obligations".

the original expectation and do not yet enable the IMF to perform adequately its duty of multilateral surveillance.

In order to pursue effectively its own objective of macroeconomic policy coordination, the G20 must drive a more ambitious reform to strengthen the IMF's legitimacy, governance and financial capacity. Inaction to reform seriously the IMF is not due to lack of ideas about what are the necessary steps. There is already an appreciable stock of sound and responsible proposals that we endorse for the most part.⁶⁹

⁶⁹ Examples of those ideas can be found in Eichengreen, Barry, *Out of the Box Thoughts about the International Financial Architecture*, International Monetary Fund, IMF Working Paper WP/09/116, May 2009; Independent Evaluation Office of the International Monetary Fund, *Governance of the IMF: An Evaluation*, International Monetary Fund, Washington, D.C., 2008; Committee on IMF Governing Reform (Trevor Manuel, Chair), *Final Report*, Washington, D.C., March 24, 2009; Palais Royale Initiative (convened by Michael Camdessus, Alexandre Lamfalussy and Tommaso Padoa-Schioppa), *Reform of the International Monetary System: A Cooperative Approach for the Twenty-First Century*, February 8, 2011; Truman, Edwin M., *A Strategy for IMF Reform*, Policy Analyses in International Economics, Institute for International Economics, February 2006.

Of course, the difficulty of empowering the IMF is due to some of the key players' resistance to relinquishing a portion of their long-enjoyed powers and influence. But if that resistance can be overcome, the result will be an institution that is much more effective in supporting those players' own long-term interests.

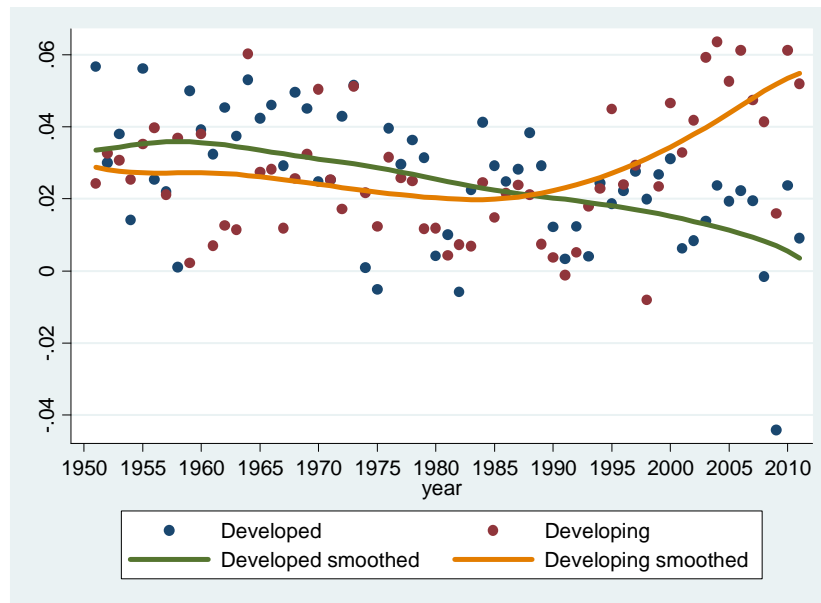
The measures necessary confront many obstacles. Domestic publics will need a great deal of convincing that their sacrifices will be worthwhile. National governments will need to be shown that their interlocutors abroad are serious. And rebalancing faces the current version of the long-standing problem of the asymmetry of the adjustment burden: there are powerful pressures on deficit countries to adjust, but surplus countries are under much less compulsion. This creates a bargaining asymmetry that can sabotage any attempt at international cooperation – as it did in the 1930s, and again as the Bretton Woods system collapsed. Nonetheless, we believe that a new push to engineer serious macroeconomic policy coordination, specifically aimed at monitoring and controlling global macroeconomic imbalances, is both desirable and possible.

7.6. Problems of development in the new global environment.⁷⁰

The very rapid growth of the world economy in the decade before the global financial crisis, was due almost exclusively to developing countries. Growth in developing countries nearly tripled from around 2 percent per capita in the 1980s to almost 6 percent before the crisis of 2008 (Figures F and G). It is China (and the rest of developing Asia) that were the engine behind this performance accounts for the bulk of this performance. But growth also picked up in Latin America and Africa starting around 1990, and surpassed levels not experienced since the 1960s. Growth in the developing world was both rapid and, for once, very broadly-based. The performance gap between developed and developing countries has continued to widen in the years since the onset of the crisis.

⁷⁰ This section is based on Dani Rodrik, "The Future of Economic Convergence," August 2011.

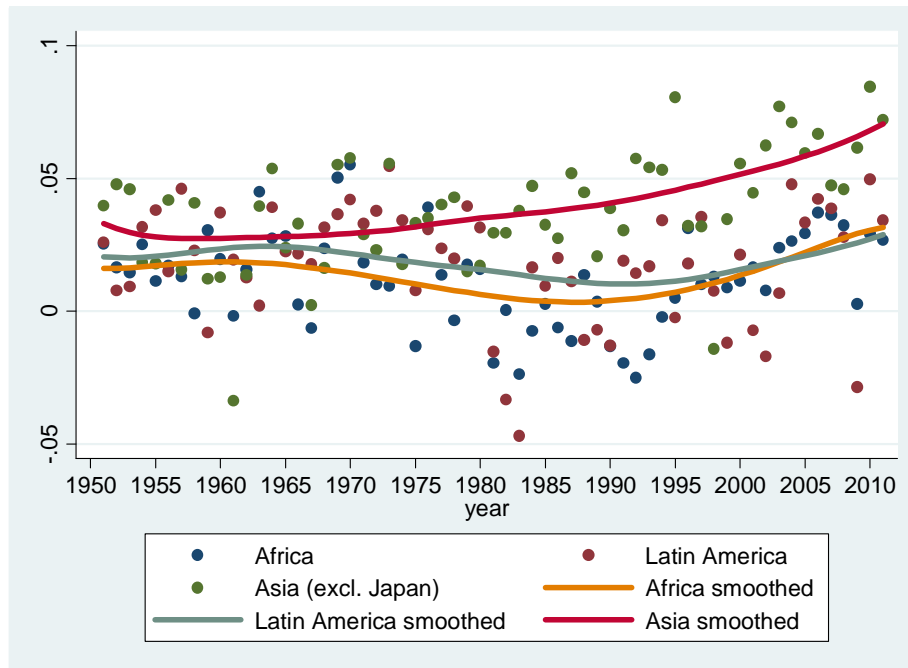
Figure F
Growth trends in developed and developing countries, 1950-2011



Source: Angus Maddison, "Historical Statistics of the World Economy: 1-2008 AD," available at http://www.ggd.net/maddison/Historical_Statistics/horizontal-file_02-2010.xls, updated with data from World Bank, World Development Indicators, and IMF, World Economic Outlook.

Figure G

Developing country growth trends by region, 1950-2011



Source: Same as Figure F.

Many analysts have extrapolated that this performance will continue in decades ahead. Citigroup economists, for example, predict that per-capita incomes in the world economy will grow by 3.6 percent in 2010-2030 (very similar to the pre-crisis levels), even though each of the advanced regions of the world are projected to grow at below 2 percent (again, just as in the pre-2008 period) (Citigroup 2011, Fig. 24). Subramanian estimates global growth at 3.4 percent over the same period, with emerging and developing countries growing at 4.6 percent (2011, Table 4.2). The accounting and

consulting firm PwC (2011) projects China, India, and Nigeria to grow at rates exceeding 4.5 percent until 2050. (All these estimates are in PPP and per-capita terms.)

Are such growth rates in the poorer parts of the world feasible in an environment where advanced countries will be suffering from their debt hangover? Low growth in the North will imply reduced import demand, low commodity prices, and uncertain capital flows. Won't such adversities bring down growth elsewhere too?

In principle, there is nothing that prevents developing countries from growing rapidly regardless of economic conditions in the advanced countries. In the medium- to long-term growth depends not on demand, but on productivity increases driven by the adoption and dissemination of modern technologies. Low growth in the North does not diminish the stock of technologies that are available and which developing countries can adapt and adopt. Convergence can happen as long as developing countries follow the right policies that spur technological progress and accumulation.

Growth optimists point to several reasons why recent trends are likely to continue. First, there has been significant improvement in the conduct of *monetary and fiscal policies* in the developing world. With rare exceptions, macroeconomic populism has gone out of fashion. Price stability and debt sustainability have become the norm rather than the exception. Second, again with few exceptions, developing countries have opened themselves up to international trade (and to capital flows). Indeed, developing nations are now more integrated to the global economy than at any time

since the 19th century. Third, developing nations are now generally much better governed. Most of Latin America is now ruled by democratically-elected governments. In Africa, peace settlements have restored some semblance of stability to conflict-ridden countries such as Congo, Sudan, Sierra Leone, Liberia, and Cote d'Ivoire. Finally, the globalization of markets and the spread of global production networks have created a more hospitable environment for economic catch-up, at least for countries with the necessary background conditions (so-called "fundamentals"). These allow for the faster spread of ideas and blueprints, and facilitate the plugging of firms from poor countries into advanced technologies.

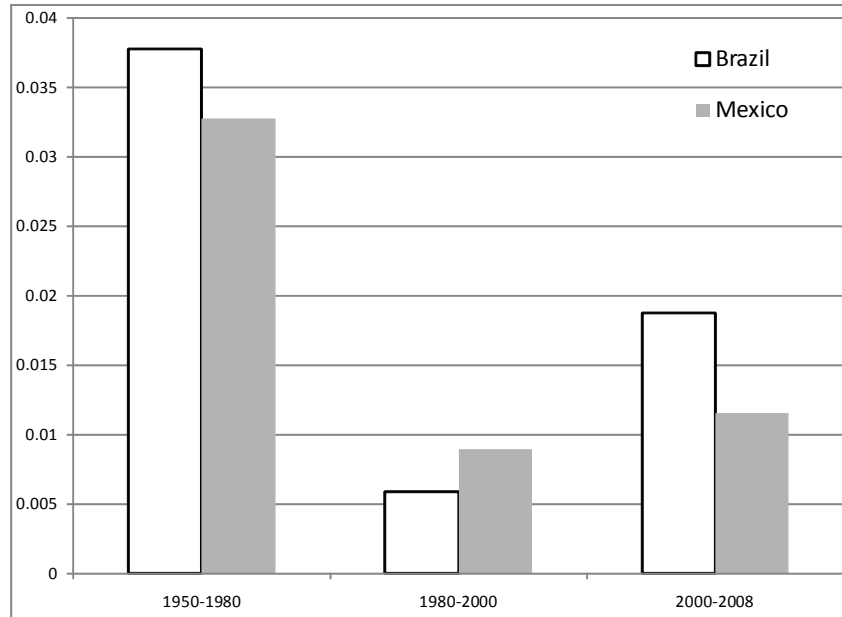
Prudent macroeconomic management, openness, and improved governance surely help avoid large policy mistakes and economic disasters. By eliminating the lower tail of growth outcomes, they raise the average performance. What is less clear is whether these policy improvements in the conventional sense are sufficient -- or indeed even necessary -- for promoting sustained economic growth.

Countries with improved policies and institutions have been doing better of late, but it is equally true that many have yet to replicate their performance from previous eras. Brazil and Mexico, for example, are two countries that have become poster children for the new policy mindset in emerging markets. Yet these two have recently registered growth rates that are only a small fraction of what they had experienced during the three decades before 1980 (Figure H). And note that this cannot be

explained by growth having become harder over time: these two countries had larger convergence gaps in 2000 than they did in 1950.⁷¹ Moreover, none of the Asian growth superstars, with the possible exception of Hong Kong, fit the standard paradigm neatly. China, India and the East Asian cases are all instances of mixing the conventional and the unconventional – of combining policy orthodoxy with unorthodoxy (Rodrik 2007, chap. 1).

Figure H
Growth rates of GDP per capita of Brazil and Mexico by period

⁷¹ Neither does demography help explain the under-performance. Recent growth rates look even more disappointing, compared to the earlier period, when expressed in per-worker terms.



Source: World Bank, World Development Indicators

China's policies on property rights, subsidies, finance, the exchange rate and many other areas have so flagrantly departed from the conventional rulebook that if the country were an economic basket case instead of the powerhouse that it has become, it would be almost as easy to account for it. One can make similar statements for Japan, South Korea and Taiwan during their heyday, in view of the rampant government intervention that characterized their experience. As for India, its half-hearted, messy liberalization is hardly the example that multilateral agencies ask other developing countries to emulate.

What is common in countries that have managed to achieve sustained convergence is that they have been able to stimulate ongoing structural change from

traditional, low-productivity activities to modern industries and high-value services. Evidence shows that some activities, like organized manufacturing, are “escalator” industries that exhibit automatic convergence to the global productivity frontier (Rodrik 2011c). Countries that are able to latch on those industries grow rapidly while others lag behind.

The requisite structural transformation is not a process that takes place smoothly on its own, or once governments simply stabilize and liberalize. Virtually all successful countries have required pro-active policies to spawn new industries and shift resources in their direction. The mark of such policies is that they subsidize tradable sectors to compensate for government or market failures and speed up structural transformation. Trade protection, industrial policies, and undervalued currencies are leading examples.

Not all countries that have experimented with these policies have succeeded, but none (again with the possible exception of Hong Kong) has experienced high growth without. Countries that have explicitly renounced the use of these kinds of policy supports have in fact tended to experience reduced growth. The fact that Latin America’s growth rate after 1990 fell considerably short of that before 1980 is intimately linked to the fact that the region began to experience *growth-reducing* structural change in the later period. Unlike in Asia or in Latin America itself before 1980, labor has been moving from higher-productivity activities such as manufacturing to lower-productivity ones such as informal services (Pages 2010; McMillan and Rodrik 2011).

The policies behind sustained convergence in Asia have been a mixture of the orthodox (macro stability, investment in human capital, emphasis on exports) with the unorthodox (undervalued currencies, industrial policies, and significant state intervention). Moreover, even conventional policy objectives, such as outward orientation, have often been accomplished in unconventional ways.

Skilled reformers know that a given economic target can be achieved in diverse ways, some more unorthodox than others. Integration into the world economy can be accomplished via export subsidies (as in South Korea and Taiwan), export processing zones (as in Mauritius or Malaysia), Special Economic Zones (as in China)—or free trade (as in Hong Kong). Domestic industries can be promoted through subsidized credit (South Korea), tax incentives (Taiwan), trade protection (Brazil, Mexico, and Turkey), or by reducing barriers to entry and lowering their costs of doing business. Property rights can be enhanced by importing and adapting foreign legal codes (as in Japan during the Meiji restoration) or by developing domestic variants (as in China and Vietnam). A “messy” reform that buys off the beneficiaries of status quo may be preferable to the “best practice” which proves impossible to implement.

Asian-style structural transformation policies have never been easy to administer, especially outside Asia. They will face the added obstacle over the next decade of an external environment that is likely to become increasingly less permissive of their use. The WTO already has fairly strict rules against the use of export subsidies

(defined somewhat broadly) and domestic content requirements – except for the poorest countries, which are exempt. But many practices have remained under the radar screen. A determined government can get an entire industry up and running by the time a WTO panel and appellate body rule on a case. We can expect this to change if industrial policies are used more widely and the rich nations continue to struggle with high unemployment and low growth. Policies that favor domestic industries will then be perceived – with some justification – as “beggar-thy-neighbor” policies that violate the basic rules of the game and aggravate economic problems in importing countries. There will be much greater domestic political pressure to retaliate against such policies.

There are currently no international agreements against currency undervaluation, but as we discuss elsewhere in the report the question of “currency manipulation” has already become a flash point in the global economy. Unlike industrial policies which need not create macroeconomic imbalances,⁷² currency undervaluation is associated with trade surpluses. That means in turn that advanced countries, as a whole, must be willing to run the counterpart trade deficits. The United

⁷² A production subsidy on tradables can spur the output and employment in tradables without generating a trade surplus, if the exchange rate is allowed to adjust appropriately. See Rodrik (2010b).

States, as the largest deficit country, tended to treat its external imbalance with benign neglect. The financial and economic crisis has rendered that approach more difficult to sustain. Whether driven by undervalued currencies and mercantilism or not, developing country trade surpluses will be seen as inconsistent with the desire of industrial countries to prop up aggregate demand for their flailing economies.

No emerging country faces a bigger challenge here than China. Prior to the late 1990s, China's manufacturing industries were promoted by a wide variety of industrial policies, including high tariffs, investment incentives, export subsidies, and domestic content requirements on foreign firms. As a pre-condition of WTO membership, China had to phase out many of these policies. From levels that were among the highest in the world as late as the early 1990s China's import tariffs fell to single-digit levels by the end of the decade. Local content requirements and export subsidies were eliminated. Currency undervaluation, or protection through the exchange rate, became the de facto substitute.

It has now become conventional wisdom in the West that China has to make transition to a different growth model, one that replaces foreign with domestic demand. However, if what matters for China's growth is ultimately the structure of production, a shift in the composition of demand may do real harm to the economy's growth. A reorientation towards services and domestic consumption would reduce the demand for its industrial products and blunt the forces of convergence described earlier.

Estimates in Rodrik (2008, 2010) suggest that a 20 percent appreciation could reduce China's growth rate by nearly two percentage points. This is a sizable effect, and a slowdown of this magnitude would push China dangerously close to the minimum threshold its leadership apparently believes is necessary to maintain social peace and avert social strife.

China is a special case for sure. Its leadership has been very successful since the late 1970s in tinkering with the policy regime in order to maintain the growth momentum. Perhaps it will continue to show similar ingenuity in the future. But China's case illustrates in extremis the difficulties that growth policies that promote structural transformation in the developing world will pose for under-performing industrial economies. Both because they are difficult to administer and because they will raise tensions with trade partners when successful, it is difficult to envisage that growth promoting diversification policies will be employed en masse and effectively.

The implication is that rapid convergence will remain the exception rather than the rule in the developing world. There will be increasing tension and conflict over the nature of policies followed in those countries that are particularly successful. China will be at the forefront of this, but other large emerging market economies with unorthodox policies such as India, Brazil, and Turkey will also likely face criticism.

One of the paradoxes of the last two decades of globalization is that its biggest beneficiaries have been those countries that have flouted its rules – countries like China

and India that have effectively played the game by Bretton Woods rather than post-1990 rules (controlled finance, controlled currencies, industrial policies, significant domestic maneuvering room). But as such countries become large players and turn into targets for emulation, the tensions become too serious to ignore. How we handle those tensions will determine not only the future of convergence, but the future of the world economy as well.

Going forward, one thing that these large developing nations will have to learn is that policy space is a two-way street. If they wish to retain their autonomy to restructure and diversify their economies, they will also have to allow ailing industrial countries a certain amount of space to safeguard blue-collar workers and assist the worst affected sectors. Insisting on free trade purism at a time of great social and political stress is unlikely to make the global economic regime healthier.

More generally, the larger developing countries will have to take responsibility for the broad international impact of their own policies. This brings us back to macroeconomic policy, and macroeconomic imbalances. Export-oriented growth strategies have been enormously successful for many countries. But they cannot be extended to the entire world, or sustained indefinitely. Especially in the case of large, systemically important, developing countries – China, India, Brazil, perhaps a half-dozen others – governments that have typically aggressively pursued export-led growth will now have to take into account the global impact of their national policies.

This will require concessions on both sides, and will run up against powerful interests in both sets of countries. However, the most likely alternative is a strong backlash in the developed countries against the macroeconomic and trade policies of the developing nations, a backlash whose impact would be harmful to both sides.

Chapter 8

Looking ahead

Contemporary international economic integration has been a powerful force for economic growth and development. In broad historical terms, the most striking development of the past 30 years has been very rapid growth in Asia, which has helped lift hundreds of millions of people above the absolute poverty line. This feat would almost certainly have been impossible if these nations had not had access to the world's markets, capital, and technologies. Even if only on these grounds, current levels of economic integration are of value, and worth sustaining.

The global reach of today's markets has led many to call for expanded "global governance," to provide some of the typical functions of government at the international level. The argument implies that global markets require global regulation and management. Certainly there are many circumstances in which national governments, acting separately, cannot adequately deal with the problems that arise with flows of goods, capital, and people across borders. The maintenance of an open

international economy requires substantive and purposive cooperation among the major economic powers.

However, international cooperation is difficult enough in normal times, untroubled by crises or new entrants. National publics focus on national concerns, and are often loathe to see their representatives deal away national prerogatives on behalf of vague promises of eventual global gains. National policymakers cannot ignore the reservations of their constituents, and may be tightly constrained in how much they can do and how far they can go in making international commitments.

These are not normal times. The global crisis that began in 2007 continues to trouble the world economy, some of its constituent parts more than others. Europe has fallen into a second recessionary dip, driven by the continued difficulties associated with its debt overhang. The recovery in the United States is halting, and job growth in particular continues to be disappointing. Virtually all developed countries face medium- and long-term fiscal challenges, some more dramatic than others. To complicate matters, there are a number of important new emerging-economy players on the world scene, and their priorities and preferences are quite different from those of the traditional incumbents. All this raises major questions about the future of international economic cooperation.

Economic hard times, an increase in the number of major actors, and growing divergences in preferences will complicate the negotiation and implementation of major

new global measures. For this reason, we think it the better part of valor for the principal governments to focus their attention on areas in which cooperation is particularly desirable, and in which it is particularly likely to be successful. We draw on both normative theory, and an evaluation of the domestic economic and political circumstances of the major actors, to suggest what the principal goals should be, and where the principal obstacles may lie.

We anticipate that the most important issues of the next decade or so are likely to revolve around global macroeconomic problems. It appears likely that there will be a continuation or resurgence of the global current account imbalances that were so central to the origins of the crisis. There are important domestic pressures in the surplus, creditor, countries that will make it hard for them to shift gears to consume more and save less, import more and export less. There are analogous domestic pressures in the deficit, debtor, countries to resist the austerity measures necessary to turn their own finances around. However, we have experienced the serious consequences of uncoordinated macroeconomic policies leading to major capital flow cycles and attendant booms and busts. It is hard to believe that a recurrence of large-scale imbalances will somehow be more benign in the future than they have been in the past, or in the present. For this reason, we anticipate (and endorse) substantial efforts to coordinate macroeconomic policies to avoid a recurrence of the past crisis. Although enhanced cooperation on international trade and international financial regulation

might be useful, we do not see it as so necessary, nor so likely to be achieved, as cooperation on macroeconomic policies.

Macroeconomic policy differences are likely to be at the core of international economic problems for the foreseeable future. Little has been accomplished to avoid serious disagreements among the principal developed and emerging-market governments. Domestic political obstacles in every major country, and the difficulties of negotiating agreement among governments with very different views, stand in the way of progress on this front. Nonetheless, we believe that movement to better coordinate national macroeconomic policies, and in particular to avoid a resurgence of global current account imbalances, is both desirable and feasible.

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