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Formulating International Economic Policy in the 21st Century

The entire world has had its most successful growth experience in all of history over the past 60 years. The most spectacular growth performance has been that of some of the emerging markets, but living standards and related indicators (health, education, and so on) have also risen markedly in most low-income countries. Moreover, industrial countries have experienced more rapid growth than they did at any earlier time in their history.

The success of the world economy is due to many things, but the growth of international trade in goods AND in services has certainly been a key factor (e.g. Bordo and Rousseau, 2011, NBER Working Paper 17024).

Growth in international trade spurred economic growth and economic growth spurred international trade. In addition, an important stimulus to the expansion of trade was the lowering of trade barriers (tariff and nontariff). Quantitative restrictions on trade in goods have virtually disappeared and tariff barriers have fallen sharply, not only in the industrial countries, but also in emerging markets.

As a result of trade liberalization (both multilateral and unilateral) and technical change which greatly lowered transport and communications costs and time, the international economy has become increasingly integrated. Interdependence has grown markedly, as parts and components are produced in many different places and shipped to the place of final assembly.

But greater interdependence has increased the importance of a smoothly operating international economy. Trade and finance go together, of course, as the recent Great Recession amply demonstrated. A well-functioning and stable financial system is essential for trade to flourish. Indeed, the Articles of Agreement of the International Monetary Fund state that a major purpose of the Fund is to "facilitate the expansion and balanced growth of international trade".

The three global multilateral economic institutions – the International Monetary Fund (IMF), the World Bank, and the World Trade Organization (WTO) – have all been important over the past 60 years in enabling the international economy to function as well as it did. The IMF certainly contributed to international monetary cooperation, to the removal of exchange controls (especially on current account under Article VIII) and to international financial stability. The World Bank's role in increasing understanding of the challenges and policies for economic development, and in financing has been important as well. And the World Trade Organization (earlier the GATT) provided a forum for negotiations for multilateral tariff reductions, a locus for setting rules and procedures for

trade (such as uniform customs declaration) and a mechanism for dispute settlement, each of which was crucial for the lowering of trade barriers that contributed so much to growth.

In addition to these crucial functions, each of the three multilaterals provided a pivotal forum in which views could be exchanged, lessons could be learned from comparative experience, and cooperative solutions could be sought. All of these were vital to the successful growth of the past sixty years.

Going forward, the very fact that interdependence in the world economy has increased so much makes these institutions even more important for the 21st century. Each institution has a role to play, and a key determinant of the progress of the global economy is how well these roles can be carried out. Multilateral solutions are essential for addressing many of the ills that beset the international financial system during the Great Recession. Future growth can be enhanced both by further trade liberalization especially in agriculture and services through the WTO and by accelerated growth of the low-income countries supported by the World Bank. The three international economic organizations are the most promising fora for those issues to be addressed.

Moreover, the effectiveness of each institution will be enhanced by the successful efforts of the other two. A stable and effective financial system permits more rapid growth of trade, while more rapid growth of trade enables acceleration of economic growth and higher growth rates for low-income countries. More rapid growth of low-income countries in itself increases global growth, but it also enables faster growth of industrial countries and emerging markets.

Some of the challenges are specific to individual institutions, while others cut across institutions. I will address the specific challenges first, and then conclude by addressing the two most important common issues, support for multilateralism and governance.

Turning first to the international financial system, no one reading a daily newspaper could fail to be aware of the cracks in the system that were revealed by the Great Recession. Moreover, the cracks cast the spotlight on the importance of multilateralism. Two challenges are the most urgent: determining standards for financial regulation and finding means to contain global imbalances to a manageable level.

With respect to regulation, it is evident to all that if some countries adopt relatively strict financial regulation while others do not, the financial institutions in the countries with weak regulation will have an unfair competitive advantage. Their institutions will have lower capital requirements and be able to extend credit at lower interest rates or make higher profits than their competitors in countries with tighter regulation, but, of course, they will be taking on more risk.

There is widespread agreement that care must be taken so that an appropriate balance is struck between maintaining financial stability and providing competition and incentives for financial innovation. It is not necessary that all countries have identical financial regulation, but a common framework is re-

quired. Such a framework would require agreement across all countries, in part because some will not agree unless others do and in part because when there are significant holdouts the objective of financial stability is less likely to be achieved. To date, despite agreement on the desirability of a global regulatory framework, and steps taken under Basel III, further multilateral agreement has proven elusive.

There are a number of other issues regarding financial regulation, which, while not as significant as the regulatory one, still deserve global attention. These concern understandings regarding the regulation of behavior of cross-border subsidiaries and branches, on the one hand, and of jointly owned banks, on the other. Again, the desirability of such agreement is evident, but achieving such a framework has to date proved elusive.

But if the issue of financial regulation is difficult, it pales in comparison with the difficulty of achieving a meaningful way of preventing global imbalances from recurring. There is widespread recognition that global imbalances at a minimum greatly intensified, and perhaps even were the chief culprit in bringing on the Great Recession.

It has long been recognized that there are far greater pressures on countries with unsustainable current account deficits to adjust than there are on surplus countries. In the case of deficit countries, financing runs out or threatens to run out and the deficit country must take action or else be confronted with a crisis. In the latter case, it may seek support from the IMF or other foreign agencies, but must in return take policy actions designed to prevent a recurrence of the crisis and permit sustainability over time. But when a country runs a surplus, the pressures take longer to be felt and usually arise mainly through inflation.

When the deficit country was the U.S.A. and the surplus country China (and the oil exporters after about 2004), however, the two sides were mutual enablers. China's willingness to invest the surplus enabled current account deficits to continue without the pressures that would have resulted had the surplus been invested internally or had the rest of the world been more or less in macroeconomic balance. The U.S.A.'s current account deficits would have been far more difficult to finance without currency depreciation or higher nominal and real interest rates had it not been for the Chinese surpluses. It is estimated that Chinese consumption is currently not much more than 35% of GDP, surely a record low except during wartime, if then.

The result of these mutually enabling global imbalances was very low (and even negative) real interest rates. Low interest rates always encourage consumers to consume more, and especially to borrow to finance residential housing. They also encourage financial institutions and other investors to accept more risk in a search for yield, thus carrying portfolios subject to more danger when circumstances change. And the search for yield also encourages other risky behavior, through such mechanisms as the "carry trade" as for example when investors borrowed Japanese yen at virtually zero interest rates to invest in New Zealand dollar assets which carried much higher interest rates. At a minimum, a result of global imbalances and the low real interest rates they engendered was a bigger and longer-lasting construction boom and a larger portfolio of nonperforming loans when the downturn came.

Even in 2005-06, the then-Managing Director of the IMF, Rodrigo de

Rato, sought to bring together the large deficit and surplus countries in a process of multilateral consultations with a view to achieving agreement across countries as to how to reduce the imbalances to more sustainable levels. The participating six all agreed that imbalances were dangerous and that action should be taken. Each side, however, believed that the necessary corrective measures should be taken by the other. As a result, nothing happened. The IMF had, and has, no legal authority to bring about any needed adjustments.

For a period during the Great Recession, global imbalances receded. The U.S. current account deficit, which had risen to over 6% of GDP, fell to 2.9% in 2009. But as the upturn has proceeded, it appears that global imbalances are once again starting to increase.

After the initial shock of the Great Recession, the G-20 also sought to find a corrective mechanism for global imbalances. They asked the IMF to undertake a mutual assessment process (MAP), under which the large countries would have their current and prospective macroeconomic policies scrutinized by the others, in the hope that this would bring about the necessary changes.

It is too soon to assess the effectiveness of the MAP. To date, however, there is little evidence that any of the large countries have adjusted any of their macroeconomic policies because of peer pressure under the MAP. The problem is all the more urgent because of the looming demographic pressures on fiscal balances in the countries with aging populations. The least painful policies for addressing these imbalances will be those for achieving more rapid growth; yet the reemergence of global imbalances could bring about the opposite result, and perhaps even another crisis.

There is yet another set of financial issues looming on the horizon in the 21st century, which time limitations prevent me from discussing. That is, at the present time, there is no international regime governing capital flows. Countries are free to discriminate between countries, to tax capital flows, or to impose any regime they wish to upon them. As capital flows increase in importance, and as the world economy becomes increasingly integrated, these issues will become increasingly serious. As yet, they are not at all addressed except in bilateral and plurilateral agreements, many of which are potentially discriminatory.

The increasing breadth and depth of the international financial system served the real economy well, at least for the last half of the 20th century. That, in turn, enabled the rapid growth of trade. International trade in goods and services was spurred by growth, by falling transport and communications costs, and by trade liberalization, both unilateral and multilateral under the GATT, and then the WTO.

Because transport and communications costs had already fallen so much prior to 1950, the biggest spur to increased trade (in addition to growth itself) was the virtual elimination of quantitative restrictions and reduction of tariffs, at least on manufactured goods, to levels less than one tenth of those (even among the industrial countries) prevailing at the end of the Second World War.

That trade liberalization required an international organization, both as a forum for reciprocal tariff reductions and as a means for dispute settlements and agreement on trade rules. The GATT/WTO served the world so well that many countries, now successful emerging markets after having followed protectionist policies in earlier years,

liberalized unilaterally in the past two decades.

However, there is a great deal more to be done. As the global economy has progressed, business services have become increasingly important, and there are huge gains to be made if services trade can be significantly liberalized. This presents a challenge because many of the barriers to trade in services (licensing requirements, domestic regulation of insurance companies, etc.) are not border measures. But the scope for gains is great indeed.

Likewise, while trade in manufactures is now fairly open (although there remain tariff peaks and some countries that have retained fairly high walls or protection), world agriculture is in disarray. The restraints on domestic subsidization, price supports, and other interventions are few. Most agricultural economists believe that this results in great inefficiencies in world agriculture. This in itself is a serious problem for the world economy, but with the emerging concerns about rising food prices and possible food shortages, there is a real risk that, in the absence of international agreements committing exporting countries to continue exporting in times of high prices and importing countries to reduce or remove their barriers to imports, protection in agriculture will actually increase. That would not only exacerbate problems for consumers, but it would likely reduce the growth potential of the overall global economy.

The undoubted potential gains from liberalizing trade in agriculture and services still further were a major reason for starting the Doha Round of trade negotiations under the WTO in 2001. But those negotiations have foundered to date. With the negotiations dragging on (there was a ministerial meeting in Geneva at the end of April with no evident progress), the authority of the WTO itself is eroded just at a time when it needs enhancement.

Moreover, there are looming problems that will require multilateral solutions that will greatly affect the world and the world economy. Chief among these is concern about the environment. This is intimately linked to trade because of the costs imposed on producers of various mitigation activities. Unless agreements can be reached universally, producers in countries whose producers experience higher costs because of mitigation requirements will understandably seek protection from foreign imports, arguing that foreign producers have an unfair cost advantage when not subject to the same regime. Attention needs to turn to these 21st century issues, but failure to complete the Doha Round stands as a roadblock to focusing on those important concerns.

It seems evident that the Doha Round should be completed not only because of the gains to be had (including those already negotiated) under the agreement but to move forward to the next set of issues, which will be especially difficult.

Finally, I come to the role of the World Bank. Its greatest contribution lies in supporting efforts by low income

countries to achieve self-sustaining economic growth. For those countries, private capital markets are not willing to invest, often for reasons pertaining to the absence of an appropriate legal framework or because safeguards for investments are inherently unreliable. While, as I said at the beginning, the world economy has been enormously successful over the past sixty years, some countries have been left behind or left out. The challenge for the World Bank (and for the countries themselves, bilateral donors, and all the multilateral organizations) is to improve understanding of the barriers to more rapid development, and to extent the types of support that can accelerate growth in the low-income countries. Success in that endeavor would in itself be a desirable outcome but, in addition, would spur global growth.

Before concluding, let me turn to the two challenges that confront all three multilateral international economic organizations for the 21st century. They are crucial for successfully addressing the challenges, I have already outlined.

The first, and more concrete, is the problem of governance. As China, India, Brazil, and other countries have achieved more rapid rates of growth, their share of global real income and trade has increased. Yet their shares of the votes in the World Bank and the IMF remained unchanged for a long period. (The WTO is in a different category here because, to date, WTO decisions must be unanimous). Changes are taking place, but relatively slowly. The need for voting power to reflect more appropriately the relative importance of the various member countries is evident.

A cry has also been raised about the traditions under which the heads of the IFIs have traditionally been American at the World Bank and European at the IMF. Many have called for an opening of the selection process to nationals of all countries.

Doing this is clearly desirable if a means can be found for insuring that the selection proceed is designed to find the best qualified person, and not simply a person from a given region or nationality. The Bank, the Fund, and the WTO, have survived as well as they have in significant part because they have been, and are, meritocracies. Finding a selection mechanism under which candidates are screened on the basis of qualifications and aptitude for the job, rather than simply on the basis of geographic origin, is eminently desirable, but may be difficult.

However, I have saved the biggest challenge until last. I hope, I have said enough to convince everyone that growth in the 21st century will be much more satisfactory if the multilateral institutions can meet the issues associated with financial regulation, global imbalances, capital flows, trade in services and in agriculture, and much more. Those problems will be difficult, if not impossible, to address satisfactorily in the absence of multilateral agreements and undertakings.

But addressing these issues requires a commitment on the part of countries

and their citizens to the multilateral system. At the present time, and perhaps in part because of the Great Recession, there appears to be considerable disenchantment with multilateralism and a tendency to blame the international economy for many ills.

While the international economy and its governance is far from perfect, the world, and almost all the people in it, are far better off than they were fifty, a hundred, or two hundred years ago. I once attended a meeting where a representative of an African country complained that his great grandfather had moved to work on a plantation in the late 1800s, and that the family's livelihood had come from that plantation ever since; however, because globalization had hurt the country's terms of trade, the ten members of the current generation employed on the plantation had had one month's less work that year than in the past and it was the fault of globalization. Without knowing the particulars, one was left wondering how well off that entire generation – the ten plus their families – would have been had the country's economy remained entirely concentrated on subsistence agriculture, as had been the case before plantations and would probably have happened in the absence of globalization! To be sure, they would have been better off still if the terms of trade had not deteriorated, but that only says that the gains from globalization had been somewhat reduced, not that they had been negated.

Many of the complaints about globalization seem to be of a similar nature: Things could be better. And that is surely true. But they will be better when globalization is made to work better, and the problems confronting us have been solved.

They will not be better if globalization is reversed. Multilateral solutions and policies have served the international economy very well over the past two hundred years. One can only hope that recognition of this, and support for multilateralism, will enable the international economic institutions to resolve the key issues I have discussed and be prepared to address the future issues that are sure to arise with continued successful world economy growth.