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Proposals for "shadow G 8" discussion, February 9

The considerable and still growing degree of global interdependence in contemporary world economic relations provides a strong rationale for a well-structured system of global economic governance. Self-centred national economic policies, if left unchecked, generate adverse international spill-over effects. Moreover, global economic interdependence provides an opportunity for policymakers in influential economies to deliberately adopt beggar-thy-neighbour types of policies. They are tempted to employ commercial, macroeconomic, financial or exchange-rate policies in pursuit of certain national economic objectives – such as attaining mercantilist goals or postponing the adjustment of internal or external imbalances – which may harm the economic performance of other countries. In the absence of multilateral disciplines and cooperation, retaliatory action by adversely affected countries could lead to instability and disruptions in international economic relations that might leave all countries worse off.

The G 7 or G 8 have less than ever before been able to formulate policy responses or policy options dealing with these challenges. At the same time, the development dimension of international economic decisions has to be brought back to the forefront.

However, for global collective action to be acceptable to all parties, it must result from a consultative process based on full, equal and voluntary participation of all the parties concerned. Any perception that multilateral disciplines extend too far and constrain the attainment of legitimate national development goals threatens consensus of nations with different structural characteristics and levels of development. There is no single quantifiable balance between multilateral disciplines and national policy autonomy that would suit all countries or apply across all spheres of economic activity.

The multilateral trade regime overseen by the World Trade Organization contributes to certainty and predictability in international trade, as it provides a framework for an orderly, rules-based system of international trade, with appropriate checks and balances, arbitration of inter-State disputes and determination of the sanctions to be applied. This regime has been under increasing pressure to expand the number of areas regulated by multilateral disciplines and to move towards the establishment of a homogeneous regulatory framework. However, such changes are unlikely to take adequate account of the asymmetries existing between different powerful actors in the world economy. In order to avoid a deadlock in multilateral negotiations, the multilateral trade regime must have a sufficient degree of flexibility to reflect the power imbalances and the specific needs of its members.

An appropriate balance between national policy space and international disciplines and commitments requires not only strengthening the development dimension in the multilateral trading system but also an improvement in the global governance of international monetary and financial relations. At present, this balance is not warranted largely because of another asymmetry. Contrary to the existing institutional structure in international trade, current international monetary and financial arrangements are not organized around a multilateral rules-based system that applies a specific set of core principles to all participants. This asymmetry has particularly strong adverse impacts on developing countries, because self-centred national monetary and financial policies can have much more damaging effects than those caused by trade and trade-related policies.

Taken together, these asymmetries result in international rules and practices that seek to deepen economic integration in a number of areas crucial to the interests and priorities of developed countries, and reduce the degrees of freedom for national economic policies in areas crucial for industrialization and economic catch-up in developing countries. Thus, in qualitative terms, and from the perspective of development, the scope of multilateral disciplines in the current pattern of global economic governance appears to be too narrow in the area of international monetary and financial relations, but may well be too broad in the area of international trade (UNCTAD, TDR 2007).

Above all, efficient management of the global imbalances requires a new and multilateral approach to the management of the most important international price – the exchange rate. A new or reformed institution that promotes a system of stable but adjustable exchange rates to ensure a predictable trading environment is needed as the corner solutions (absolute fixing or free floating) badly failed. The new multilateral approach in negotiations about global imbalances tried by the IMF is insufficient as long as no binding rules exist. The main objective of such negotiations should be the prevention of systemic financial crises based on a close monitoring of the reasons for trade imbalances and global exchange-rate misalignments in both surplus and deficit countries. Actually however, governments do not even agree on the very nature of imbalances (saving-induced or price- induced, see annex 1).

Economic areas of political interest in 2007

- Global imbalances will remain the hot topic for some time to come. We should reflect different theoretical positions and try to find an approach beyond the mainstream view of “too low savings in the US” story. (see my position in the annex)

- The same in a different dressing: The paradox of capital flowing from poor to rich countries and the piling up of reserves by developing countries is still a matter of much international interest and the discussion about fiscal and other costs and benefits of that strategy is a big political topic. A view built on the systemic roots of the paradox would attract much attention.

- Closely related, “carry trade” is not a new phenomenon but has grown recently into a quantitative dimension that has alerted G 7 finance ministers – although some in the wrong direction (Hank Paulson is quoted to have said that the decline of the Yen is “caused by fundamentals…but that he is frustrated with the pace of remnimbi reform and wants to see floating”). In this case it is clearly the market that is systematically destabilizing the international financial relations by appreciating currencies with high inflation and vice versa. …would be a very important contribution to the discussions of ministers.

- The role of private equity firms (“locusts”) in takeovers in developed countries is more and more discussed in a critical mood. The role of these firms in developed and in developing countries might be a worthwhile exercise, at least in Europe.

- Political and economic pressure on wages, on the wage level in general and on the wages of the low skilled. Much of this is not to be attributed to the anonymous forces of the globalized market but results from kind of anticipatory obedience of policy makers with a very limited understanding of markets. We should focus on the question whether “my wage is set in Beijing?”

- Tax competition, in particular in corporate taxation, is still high on the agenda in Europe. Even the total abolition of corporate taxation in Europe is possible in a couple of years with further severe consequences for income distribution. This kind of race to the bottom deserved much more attention than it actually has.

- Climate change: A primer on costs and happiness (**not** benefits in the traditional economic sense) involved in any kind of change.

Annex 1:

How to unwind the global imbalances

The challenge for developing countries

The ongoing process of globalisation is changing the framework of national macroeconomic policy, offering new opportunities, challenges and constraints for developed and developing countries alike. For many developing countries and economies in transition, however, integration into the globalizing economy has not been a smooth exercise. Many countries with fully open borders to international trade and private capital flows have experienced crises over the last quarter of a century that were triggered by instability and turmoil in the international financial markets.

Deregulation of domestic financial markets, including the elimination of credit controls, deregulation of interest rates and the privatization of banks, was a key element in the reform agenda of the 1980s and 1990s. It was firmly based on the belief that lifting "financial repression" and freeing prices on the capital and money markets would improve the inter-temporal resource allocation, enhance willingness to save and attract additional resources to the banking system. Combining this with a liberalized capital account, developing countries would attract financial savings originating in more prosperous and more capital rich economies and thus overcome a major barrier to growth.

Consequently, the liberalization of international trade and finance in developing countries during the 1980s and 1990s was undertaken under the heading of “getting the prices right”. At the same time, however, a clear concept of how the most important international price, the exchange rate, and the closely related interest rate, should be determined or regulated, was lacking. Having learned the hard way that reliance on supposedly benign capital inflows rarely pays off as a sustainable development strategy, a growing number of developing countries have shifted to an alternative approach that relies on trade surpluses as one of their engines for investment and growth.

Most of the countries affected by the storm of the financial crises in Asia and in Latin America decided to use the opportunity of a low valuation of their currencies and the swing from current account deficit to surplus to unilaterally fix their exchange rate or – at least – to frequently intervene in the currency market to avoid the rapid return of their currencies to pre-crisis levels. The most striking example is China where the authorities, after the traumatic experience of an overvaluation and a large devaluation in 1994, absolutely fixed the value of the renmimbi against the dollar. However, the strategy to maintain trade surpluses by defending the competitive positions that were achieved in the wake of financial crises presupposes that at least one country in the global economy accepts to run the corresponding trade deficit.

Other developing countries and transition economies have used the windfall profits of rising revenues for oil and other primary commodities to improve their balance of payments positions and to pile up reserves. For many of these countries interventions in the currency markets were intended to stem a concomitant strong rise of the real value of their currencies and to avoid a kind of “Dutch disease”, the loss of competitiveness in manufactures induced by trade surpluses and/or net inflows of capital with the potential to push up the value of their currency.

The piling up of huge amounts of international reserves resulting from current account surpluses and currency market interventions to avoid exchange rate appreciation of their currencies has led to a situation in which developing countries have become net exporters of capital. This has shaken mainstream economic thinking as it is in stark contrast to the expectation of orthodox theory that poor economies with a low capital endowment import the scarce resource from rich countries with an abundant endowment of capital.

For policy makers in developing countries, however, the role of exchange rate movements for the overall competitiveness of their economy is a very important aspect. The exchange rate impacts on the trade performance of the majority of their firms and is a crucial variable for national control over the balance of payments. Indeed, avoiding currency overvaluation is not only a means to preserve or improve macroeconomic competitiveness, but also an insurance against the risk of future financial crises. In this view, the current account surpluses of most of the developing world and the unwillingness of the developed world to consider a multilateral solution for the exchange rate system, including obligations on their side to stabilize the system in a way comparable to the Bretton Woods system, put the main burden of adjustment on the shoulders of the big developed surplus countries Japan and Germany and on some oil exporters (UNCTAD 2006). Unfortunately, so far there appears to be a big theoretical rift among policy makers and experts on the right perspective on the imbalances, leave alone on the policies to correct them.

The big rift

Indeed, general explanations for current account balances are difficult to find. Considering the theoretical positions of different schools of thought, there is not even consensus whether current account disequilibria should be approached mainly from the side of the trade flows or mainly from the side of the capital flows. However, this is a crucial decision for policy considerations. The “trade view” stresses the fact that by definition the current account describes the difference between current receipts and expenditures for internationally traded goods and services and income payments. The “capital view” focuses on the fact that from a national perspective, the current account balance by definition always exactly equals the gap between national saving and domestic investment. Although it should be clear from the outset that this tautological relationship does not provide, by itself, any explanation or imply certain causality, it is normally taken as the starting point for analysis and policy prescriptions.

According to the latter perspective the decision to save a high share of disposable income leads to a current account surplus and a capital account deficit (i.e. net capital outflows) as not all these savings can be put to productive use domestically. The opposite outcome, a current account deficit or a net capital account inflow, in this view is the result of the domestic propensity to invest being in excess of the national propensity to save. Trade and current account balances are then basically the result of the voluntary decisions of national agents to consume now or at a later stage. Consequently, it is not expected that national current accounts will be in balance. Rather, in a world of liberalised financial markets, savings should always flow toward their best use at the global level. Through the arbitrage of capital flowing from excess-saving countries toward countries with more plentiful profitable investment opportunities the global economy achieves a more efficient allocation of resources and higher growth rates than would ever be possible without free capital mobility. However, the supposed outcomes of financial liberalization in general do not find much empirical support even in the "consensus evidence”. Prasad, Rogoff, Wei, and Kose (2003) sum up the existing literature and assess that "…an objective reading of the result of the vast research effort undertaken to date suggests that there is no strong, robust, and uniform support for the theoretical argument that financial globalization per se delivers a higher rate of economic growth…[and] the volatility of consumption growth has, on average, increased for emerging market economies in the 1990's" (Prasad et al. 2003).

The main theoretical problem with this view is its inherent tautological nature and its inability to explain the outcomes of conflicting preferences of national households or national governments at the global scale. In other words, this approach, despite being well founded in micro economic decision making, cannot explain how the autonomous decisions of private households of *n* countries in the world to save more than to invest leads to the necessary result that only *n-1* countries will succeed in generating a current account surplus while one country, although also willing to achieve a surplus, ends up with a huge deficit. In other words, the fallacy of composition systematically excludes an unprejudiced, truly voluntary decision of all participating players. Moreover, the approach has to rely extensively on an "all things being equal" assumption as it does not systematically consider the effects that changes in the saving decisions of one sector or one agent may have on the savings of the company sector whose income is the residual of the market process.

The trade-based explanation of imbalances is more substantive in its main message as it does not just describe movements of imports and exports as result of voluntary decisions of economic agents but points to shocks in trade flows induced by big and unforeseen changes in the relative prices between tradable and non-tradable goods and services and in the international competitiveness of countries. For example, it stresses commodity price changes to explain current account swings of producers of important commodities like oil and exchange rates overshooting the fundamental determinants of overall competitiveness. In this view, the decision of private households to save less does not affect the trade balance as long as the additional demand can be satisfied by competitive domestic production. The decline in the private household savings rate could also be compensated by increases in saving of other agents: business profits in the first place, but also by higher government saving or lower government de-saving resulting from higher tax receipts. Hence, in the approach focussing on the causes of trade flows, the relationship between national saving and the trade balance is much more complex than in the capital account approach, as it involves decisions by all the relevant agents in one country and all agents in all the other countries including policy makers.

In the latter view, the global benign outcome is owed mainly to the pragmatism of macroeconomic policy management in the United States. As the US authorities have not tried to fight the quickly rising current account deficits early on, the systemic deficiencies in the global economic order have not led to global deflation yet but "only" to these imbalances. However, even with US macroeconomic policy pragmatism the resulting global pattern of production, trade and finance has become precarious. It seems that sooner or later the United States will become overburdened in playing the role as global growth engine and as the creditor of last resort for all too long. The United States could largely ignore its external imbalance as no serious conflict with sustaining full employment at home has arisen up to this point. With a less brisk growing US economy such a conflict may become a key risk soon. But even without a major slowdown in the US economy the world economy will have to do without the growth stimuli from that economy to which it has got used to over the past fifteen years.

Globally rising concerns among financial market participants about the sustainability of the US's still growing external imbalance is another pending big risk. Slow progress in the unwinding of the imbalances may trigger a strong speculative wave towards dollar depreciation, and this could also generate pressure on some major currencies. Such a depreciation of the dollar would help re-balance the United States economy, but given the pattern of global growth and its dependence on US demand stimuli, a marked slowdown in exports to the US would have global deflationary repercussions. This could quite easily unravel the momentum in development progress and poverty reduction seen in developing countries in recent times without any fault of their own.

The main reason for the United States's perhaps increasingly unmanageable global burden is not so much the rising number of developing countries running current account surpluses. Rather, it relates primarily to the fact that other key industrial countries have failed to play their corresponding global part in stimulating global demand. Even worse, they have decisively added to the global burden of the United States by improving their overall competitiveness at the expense of others by deflationary policies and real depreciation. Mainly Japan and Germany are now called upon to live up to their global responsibility by reversing past trends. The required competitiveness gains of the United States economy should mainly come at their expense; this would compensate for the gains in competitiveness that these countries have achieved over the past few years by unjustified belt-tightening policies.

China can also play an important part in a benign unwinding of global imbalances, albeit in a different way. Since the beginning of the 1990s China's domestic demand and its imports have grown very strongly, and the country has played a vital role in spreading and sustaining the growth momentum throughout the developing world; a process which must not be derailed. Therefore, renminbi revaluation should continue gradually rather than abruptly, taking due account of the regional implications. More recently, oil exporting countries have also come to play a significant part in the global imbalances. Oil producers should generally use favourable terms-of-trade developments to step up productive investment and accelerate diversification of their production structure. Should elevated oil prices persist, their contribution to a correction of global imbalances would thus consist of a stronger domestic demand and import growth in line with higher incomes.

The case for a multilateral effort

Crucially, what is needed for a benign unwinding of global imbalances in the short term is a responsible multilateral effort of developed countries rather than pressure on parts of the developing world. A well-coordinated international macroeconomic approach to stimulate domestic demand in developed surplus countries would reduce the current account deficit of the United States considerably over a number of years and enhance the chances of all countries to consolidate their recently improved growth performance. Without a mutually beneficial approach for developed and developing countries there will be no success. Any attempt to put the burden of adjustment on the shoulders of one group only will end in political stalemate. Under pressure, developing countries will have to defend their strategically favourable competitiveness positions and use the still favourable monetary conditions to invest more and to further reduce their dependence on the international capital market.

For developing countries that are not members of a regional monetary arrangement to deal with the vagaries of the global financial markets is to resort to controls of short-term capital flows or to strictly follow a strategy of undervaluation and unilateral fixing (UNCTAD 2004). In the words of Martin Wolf (FT, September 13, 2006) "By accident the world has found a way to make the crisis-prone world of financial globalization work". This strategy, based on policy space and control over the relevant monetary instruments, can only be replaced by a multilateral effort or multilateral surveillance if the big developed economies are willing to play a more proactive role in the steering of the international monetary system, including direct intervention to allow for orderly depreciations for countries in trouble. Past experience has demonstrated that developing countries with strong current account positions are able to avoid destabilizing capital in-and outflows, either by taxing those flows or by limiting their impact through direct intervention in the market. In these cases the hardest choices and the gravest misallocations due to erratic exchange rate changes have been avoided; but neither the resort to controls nor to permanent intervention can be a substitute for an appropriate exchange rate system at the regional or – preferably - the global level.

A long run solution for the international financial system has to start with the observation that the exchange rate of any country is, by definition, a multilateral phenomenon, and any rate change in open economies produces externalities and multilateral repercussions. That is why the idea of a cooperative global monetary system is as compelling as the idea of a multilateral trading system. In the same way as multilateral trade rules a well designed global financial system has to create equal conditions to all parties involved and help to avoid unfair competition. Indeed, most of the ideas on which the International Monetary Fund was founded more than 60 years ago are still valid - including the idea of supra-national money replacing the US-dollar as the global medium of exchange. Avoiding competitive depreciations and other monetary distortions that have negative effects on the functioning of the international trading system is more important today's highly interdependent world than at any time in history.

In a well-designed global monetary system the advantages of exchange rate changes of one currency has to be balanced against the disadvantages of other affected countries. As changes in the nominal exchange rate deviating from the fundamentals in terms of inflation differentials affect international trade in exactly the same way as changes in tariffs and export bounties do, such real exchange rate changes have to be subject of multilateral oversight and negotiations. Reasons for the deviation from the fundamentals and the necessary dimension of the deviation have to be identified by an international institution and have to be enforced by a multilateral decision-making body. If such rules apply, the real exchange rate of all the parties involved, their overall competitiveness, will have to remain rather constant, notwithstanding permanent structural change and huge variations in competitiveness on the company level.

Annex 2:

The Doha Round and Development

Following the suspension of negotiations under the Doha Work Programme (DWP) in July 2006, it has frequently been claimed that that there will be sizeable adverse consequences for the world economy and especially the developing countries if the WTO negotiations are not rapidly brought to a successful conclusion. This view reflects the fact that the negotiations have been termed the ‘Doha Development Agenda (DDA)’ and the ‘Development Round’. However, analyzing the evolution of the negotiations and the major proposals that are on the table indicates that there is little development content. Indeed, while most developing countries would enjoy few benefits there would be substantial costs – including the further loss of policy space – in many areas.

The description of the negotiations as a ‘development round’ is largely empty rhetoric. For example, developing countries had succeeded to incorporate two direct ‘development issues’ in the DWP. However, negotiations on ‘implementation issues’, such as the clarification of how to better classify agricultural subsidies into different categories with diverging reduction obligations or procedures related to the increased use of anti-dumping instruments, have in the meantime been abandoned, while negotiations on Special and Differential (S&D) treatment have led to commercially only insignificant results. Indeed, many developing countries considered that where the Uruguay Round agreements had expressed S&D treatment in terms of best endeavor clauses, there would be a need, before negotiations on the DWP started, to assess the extent to which the expected benefits had actually materialized in practice. In addition, rather than looking at S&D treatment as something like a grant or charity, many developing countries consider that the provisions on S&D treatment for developing countries should be an integral part of the rights and obligations in WTO-rules and not be treated as exceptions as at present. This would apply in particular to the creation of supply-side conditions which developing countries require to take advantage of trade opportunities that arise from trade liberalization.

But the term ‘development round’ has remained empty rhetoric also because following the move towards methods and assumptions that reflect the current conditions of the global economy much better, simulation models on the welfare benefits from the Doha Round now predict considerably lower estimates for the overall benefits of trade liberalization than earlier simulations that were published just after the launching of the Doha Round. Moreover, the estimated share of developing countries in those benefits has declined. The estimate of likely Doha scenarios anticipate benefits equivalent of less than a per cent per day for those living in developing countries, or expressed as a share of GDP, these scenarios would lead to an overall rise in income of just 0.16 per cent in developing countries. Moreover, the bulk of these benefits would be concentrated in just a handful of developing countries, and some would even stand to lose.

The potential adjustment costs in terms of employment and output losses, as well as losses in tariff revenue, associated with trade liberalization and the unequal distribution of benefits that is likely to arise from new export opportunities have been recognized leading to the Aid for Trade initiative, under which increased trade-related international assistance will be made available to developing countries. Ensuring that the revenues provided under the Aid-for-Trade initiative are additional to aid for development more broadly will be crucial for the developmental impact of this initiative.

While much of the negotiations under the DWP has focused on agriculture, the existing proposals on non-agricultural market access (NAMA) are likely to be the least development friendly. These negotiations envisage a system that would remove or reduce the currently remaining policy flexibilities in developing countries' industrial tariffs and risk severely impeding industrialization processes in these countries. The August-2004 Framework on NAMA, supplemented by the Hong Kong Ministerial Declaration, calls for a binding of all industrial tariffs, while at present each country can choose how many of its tariff lines it wants to bind. Moreover, these newly bound rates would be calculated on the basis of currently applied and the tariff reduction formula would be applied to the new bound levels. As a result, the resulting bound rates are likely to be close to or even below the currently applied rates. Perhaps most importantly, tariffs would need to be cut on a line-by-line basis, meaning that tariffs on all industrial products would be reduced. This contrasts with the approach followed in the Uruguay Round where the developing countries had to cut their tariffs by an overall average of 30 per cent but were free to choose by which rate to reduce individual tariff lines as long as the overall average rate of reduction came to 30 per cent. This flexibility is now set to be abolished.

Such a move towards the binding of all industrial tariffs and the reduction of industrial tariffs to low levels would deprive developing countries of the possibility to use industrial tariffs as an instrument for industrialization. A flexible use of their industrial tariffs allowed many now developed countries, notably the United States, as well as successful East Asian economies – such as Japan, the Republic of Korea and Taiwan Province of China – to succeed during their industrialization phase. Moreover, the relative importance of a flexible use of industrial tariffs for industrialization has increased, given that the Uruguay Round agreements have reduced the freedom to use other policy instruments. For example, the TRIMs agreement reduced the scope for imposing performance requirements on foreign investors, the Agreement of Subsidies and Countervailing Measures prohibited making subsidies conditional on export performance, and the TRIPs agreement severely restricted reverse engineering and other forms of imitative innovation. All of these measures played an important role in East Asia's industrialization.

It is also useful to recall that the primary function of the WTO is to provide negotiated, binding and enforceable rules that constitute the multilateral trade regime and whose key benefits are the resultant certainty and predictability of international trade. Upholding such a system based on multilaterally agreed rules outlaws the beggar-thy-neighbor policies that strongly harmed international economic relations during the 1930s. While continually pressing for further trade liberalization may be a worthwhile objective in its own right, it is erroneous to consider it as the WTO's primary function.

A failure of negotiations under the DWP nonetheless also represents a great risk. This is because it would give further impetus to regional and bilateral trade agreements that involve a dominant economy like the United States or the European Union negotiating with one or more developing countries. These agreements often include so-called "WTO-plus" rules as they imply commitments by developing countries that are significantly stricter than the multilateral rules and commitments under the WTO. For example, regional and bilateral agreements with developed countries often foreclose part of the policy autonomy left open to developing countries by TRIPs.