Economic Globalisation and the Need for International Cooperation

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A. What is meant by economic "globalisation"?

Globalisation has both a "real" component and a "financial" component. Over the last few decades, markets for goods and services and financial markets have expanded beyond national borders to encompass many countries and, in some cases, virtually all the largest countries. The driving forces have been technological developments, which have enabled such expansion, and also regulatory measures (essentially deregulation) which have allowed the newly possible to actually happen.

The integration of **real**, national systems for producing goods and services into a global whole has had a number of manifestations. Perhaps most important has been the re entry into global markets of economies that were previously closed and governed by socialist principles. Another has been the growing integration of production processes in the form of value-added supply lines. These imply that parts from everywhere are being assembled for sale everywhere by firms with global reach and often presence. Closely allied to these developments has been an increase in the international flow of labour, especially skilled labour. As well, these developments have fuelled the relative expansion of Emerging Market Economies (EMEs)relative to the Advanced Market Economies (AMEs).

The global integration of **financial** markets also has many manifestations. Perhaps the most important has been a massive increase in international financial flows, not only of direct investment but also portfolio flows. Major financial centres like New York and London now have clients from all over the world. Moreover, new financial centers are emerging (eg Hong Kong and Singapore) that also cater to international clients. Large financial firms (like HSBC, Citi Group and Standard Charter) now have branches almost everywhere, and in some countries (eg in Eastern Europe and in Latin America) the banking system in almost totally owned by foreigners.

In many respects, recent developments have recreated the world as it was prior to World War 1. However, what is different today is that the international links are far more complex and prone to much more rapid changes that were common in earlier eras. The international economy has become an archetypal “complex adaptive system”. As is clear from research in many disciplines, the governance of such systems poses many difficult challenges. Indeed, the political science literature refers to them as “wicked problems” for which there might be no optimal solution.

B. What have been some of the consequences?

The good effects clearly outweigh the bad ones. Not least, in the last few decades there has been an astonishing increase in living standards in the EMEs. Literally, billions of people have been lifted out of poverty with all the advantages that entails. Life expectancy in the EMEs has noticeably benefitted, not only due to better food and housing but also the availability of better medical care and imported medical technology. Moreover, in most countries, rising living standards have led to declining reproduction rates. This will eventually lead to lower populations and less pressure on natural resources and the global eco-system.

That said, there have been some downsides that pose challenges to both national governments and the international community. Declining death rates imply rising populations before the subsequent reversal due to lower reproduction rates. As a result, world population over the last hundred years has gone from 2 billion to 8 billion and will not peak (at 9 billion) for some years hence. In the interim, this will continue to put increasing pressure on the **stock** of planetary resources, perhaps threatening the sustainability of current production levels and certainly threatening the potential for future growth.

While globalisation has contributed to faster growth in average living standard in EMEs, and perhaps even AMEs, inequality within nations has widened over the last 20 years even as the inequality across nations has diminished. Widening inequality within nations is known to contribute to many social ills, and can have important and undesirable political implications. This is particularly the case in many AMEs where large parts of the population have seen their incomes stagnate as a small proportion of the population has grown extremely wealthy. Perceptions of “unfairness” invite a search for scapegoats (globalisation itself?) and raise questions about the political legitimacy of existing orders.

Another downside to globalisation is that the resulting complex, adaptive system is subject to the problems that characterize all such systems. Complexity theory and empirical evidence indicate that all such systems are subject to periodic crises whose occurrence follows a Power Law. That is, small crises occur frequently and large crises more infrequently, but they do still occur. Moreover, accurately forecasting such events is literally impossible even if indicators of growing systemic instability can still prove useful. As well, underlying problems in such systems can be triggered by events of inherently little importance. This implies that resources spent on trying to identify such “triggers” are essentially wasted. Finally, no two crises are ever exactly the same, implying that even careful historical analysis has its limitations.

The current global economic and financial situation provides a good example of this kind of crisis, one which builds up under the surface over long periods and then suddenly and unexpectedly erupts. As global supply expanded in the 1990s, due to globalisation in the real economy, growth rose sharply even as inflationary forces receded. This led to rising confidence and a willingness to borrow more. Simultaneously, financial globalisation led to a greater capacity to lend. Debt levels, relative to GDP, began to rise and credit standards started to decline. Asset prices, particularly equity prices and property prices also rose sharply. Against a backdrop of low inflation, central banks failed to “lean” against these developments. Moreover, when the equity market collapsed in 2000, low inflation meant there was no impediment to central banks sharply easing monetary policy to mitigate the fallout on the real economy.

Unfortunately, while these easy monetary policies did lead to more spending and a more rapid economic recovery, they did so by encouraging yet another “boom” in borrowing and debt accumulation and further increases in asset prices. In effect, these policies set the scene for the still more disruptive “bust” that emerged in 2007 and 2008. While the trigger was the implosion of the sub-prime mortgage market in the United States, the downturn revealed many other financial “imbalances” that had built up under the surface; the dependence of European banks on dollar funding, the dependence of peripheral European countries on funding from the core countries, and the dependence of many EMEs on capital inflows. Each of these “imbalances” proved to be stress points when the system went into crisis.

Again, the central bank response to the 2008 crisis has been policies that are essentially “more of the same”. This is unfortunate in that it threatens “more of the same” debt accumulation and still more financial imbalances that will eventually threaten the sustainability of the weak recovery that is only now beginning to emerge.

C. What global economic challenges do we now face?

The G20 has recently stated that the objective of policy is to achieve “strong, balanced and sustainable growth”. While this might seem clear enough, questions are already being raised about whether “inclusive” should replace “balanced” and whether “sustainable” should be replaced by (or be complemented by) “resilient”. “Sustainable” implies avoiding **endogenous** processes that might bring growth to an end, while “resilient” implies cultivating a system that can rebound from **exogenous** shocks. There is clearly a need for more precision here.

However, the current G20 statement does make at least two things clear. First, policy has more than one objective and this logically implies the need for tradeoffs. It also implies that policymakers need better analysis of what those tradeoffs might be, empirically, so that value judgements can be applied to policy choices. Second, policy must have an intertemporal component. Policies must take tomorrow into account as well as today. Note that saying this also amounts to an inditement of past policies, which seemed to take no account of the longer run implications of policies designed to stimulate aggregate demand over the relatively near term.

The immediate near-term challenge for policy is to renormalize monetary policy and begin the process of deleveraging of household and corporate balance sheets. However, this process (the Keynesian “paradox of thrift”) is likely to slow economic growth in the absence of any other positive shocks to aggregate demand. An alternative approach to debtor austerity would be for creditors to restructure or forgive debts, but the legal and judicial procedures to do this are wanting in many respects. In any event, to the extent that creditors are harmed, there might still be negative effects on overall spending.

In these circumstances, of needed private sector restraint, much more reliance might be put on fiscal expansion by the public sector. Unfortunately, there is again a problem. Ratios of government debt to GNP are already at record levels in many economies, and off-balance-sheet obligations are many times higher. The recent problems faced by governments in a number of countries on the periphery of the Eurozone show that market financing of Government debts (at manageable rates) cannot always be counted on. This implies that governments might become increasingly reliant on financing by their central banks. While this might seem sensible in an initially disinflationary world, history shows that uncontrollably high inflation often follows.

Beyond near term problems, there are a number of longer-term global challenges. The most important need is to deal with environmental problems. While these can have immense social and political implications, dealing with their economic impact is a good place to start. Global warming could render large parts of the world uninhabitable and result in mass migrations. More extreme weather events (eg Hurricane Sandy) are already proving very costly. Wars over water rights (China dam-builders versus downriver countries in South East Asia) could become more common. And the loss of biodiversity on land and sea threatens food sustainability and other economic problems.

The need to lower income and wealth inequality and to promote "inclusiveness" in labour market and elsewhere is another longer-term challenge. History shows long swings in which unequal distribution of income and wealth is always redressed. The fact that this typically occurs through the arrival of one (or all) of the Four Horsemen of the Apocalypse indicates that it is imperative to seek a better solution.

Finally, once the current problems of excessive debt are, somehow, dealt with, thought should be given to how the current monetary and financial system might be reformed to avoid similar problems arising in the future. Suggested **moderate** reforms range from changes in how macroeconomic polices are conducted (more leaning against the credit cycle?) to policies designed to change behaviour (jail terms for senior bankers?) to policies designed to change the structure of financial markets(less globalisation, less consolidation and less securitisation?). More **extreme** reforms range from "free banking" to "narrow banking" to wholesale reform of the international monetary system. Proposals in this last regard start with the recognition that, in fact, we have an international non-system. It puts no constraints on potentially damaging behaviour by national authorities acting solely in their own, perceived, best interests. Put otherwise, "Sauve qui peut" is not a system.

D. Why do these global challenges require cooperative solutions?

In some broad sense, the answer to this question is intuitively obvious. Global economic problems need global solutions. That said, more convincing arguments can be used to support the need for international cooperation in responding to virtually every one of the challenges just outlined. Let us begin with the near-term challenges and then go on to the longer-term challenges.

If we are to come out of the current crisis in a sustainable way, the private sector in the AMEs, above all households in the English-speaking countries, must delever. However, this could threaten global growth and perhaps lead to a prolonged recession. One solution is to foster faster growth in the EME's to compensate. There is no question that EME citizens would welcome higher consumption levels. This latter possibility applies particularly to countries like China, where the income growth of households (and consumption) has been purposefully repressed to free up resources for investment to stimulate exports and longer-term growth. The Chinese leadership has itself repeatedly said that the time has come to replace this growth strategy with one relying more on domestic consumption. This would seem to be a global win-win approach. Indeed, since 2010 the Chinese authorities have engaged in massive fiscal and semi-fiscal stimulus, even if not always focussed on increasing consumption.

To facilitate this global adjustment, we will also need a decline in the currency value of AMEs (especially the US dollar) and a similar rise in the currency value of EMEs (especially the Chinese remimbi). In practical terms this implies that EME countries must stop intervening to "semi-peg" their currencies to the US dollar. As EME currencies are allowed to rise, consumers in China and elsewhere will see their purchasing power rise as imports become cheaper. More spending, and more spending on imports in particular, will raise consumption and cut the trade suplus of China and EMEs more generally. As the dollar falls, the opposite effects will be seen in the USA and other AMEs. Cooperating to let this happen would be in the best interests of AMEs and EMEs.

Given that this is a European audience, let me also make a few comments about international cooperation within the Eurozone. The peripheral countries are in the process of deleveraging to correct credit cycle extremes and to lower their current account deficits. The pain involved in this process would be alleviated to some degree if the core European countries were to take steps to expand demand and imports from the periphery. Moreover, since the debts of the peripheral countries (generally owed to core country creditors) have grown very large, everyone might gain from an orderly (ie negotiated) restructuring of those debts. Unfortunately, the core countries seem fixated on the false belief that austerity on the part of debtors will be relatively painless and will suffice to resolve all their problems.

Dealing with environmental issues is the most important longer-term challenge. Global warming and atmospheric change is by definition global. Pollution has no respect for borders. Moreover, unless everyone commits themselves to paying a domestic price to solve these problems, those who would otherwise commit to do so, might decide not to. The unfairness of a situation in which some “free ride” on the backs of others often derails reasonable solutions to problems requiring collective action.

Another longer-term challenge is dealing with rising domestic inequality. While technological change has more to do with rising wage inequality than globalisation, international cooperation is still required to deal with many related problems. The capacity of international corporations to transfer profits to low tax environments must be addressed. The capacity of companies and individuals to profit corruptly and then to transfer the money abroad (often through numbered accounts) is another important issue requiring international attention.

Finally, reforming the current monetary and financial system must also have an international dimension. Unilateral action, particularly by large countries, could have important implications for others, not least on their exchange rates. Cooperative solutions (remember the Prisoners Dilemma problem) can offer better outcomes than those motivated by narrow self interest. Finally, without common approaches, in the area of financial regulation especially, there is the great risk of a “race to the bottom”. Firms have moved and will move to jurisdictions with the easiest regulations.

E. **What institutions and processes currently support cooperation**?

There are a whole host of **public sector** institutions that promote international cooperation in the realm of the economy. At one end of the spectrum are organizations based on international treaties, signed by sovereign nations. At the other end are organizations that are more like clubs, made up of members with shared values and interests in common topics. When organizations based on international treaties make decisions, they are legally binding on their members. In contrast, when clubs make decisions, they are not legally binding but only “recommendations” that must be turned into law by domestic legislation. This latter approach is commonly referred to as “soft law”.

By way of example, the United Nations, and in turn the Bretton Woods institutions (IMF and World Bank Group in particular), base their legitimacy on international treaties. So too do the regional developments banks, and all the European Union and Eurozone institutions. Organizations that are more like clubs include the OECD, the Bank for International Settlements, the Financial Stability Board, the Group of Seven, and the newly formed Group of Twenty.

Soft law has gained in importance in recent decades. The crucial role played by the G 20 in formulating a response to the crisis of 2008 attests to this. As to how the process works, a good (indeed, almost seminal) example is provided by the Basel Committee on Banking Supervision which meets at the Bank for International Settlements where I used to work. The Committee is made up of national experts, supported by a Secretariat provided by the BIS. It is crucial to note that it is the national experts that drive the Committee’s work, and make all the important decisions, and not the BIS nor the Secretariat which it provides and pays for. This is very different from the way the IMF works, though rather similar to the OECD.

The process begins when one or a few national experts (traditionally the US, UK and EU play a big role) identifies a problem. Others agree and then sub committees are set up to comment on different aspects of the issue. The sub committees report to the full committee and agreement is reached on some policy proposal. These proposals are then sent out to those affected (here the commercial banks) and they prepare comments which then lead to the originals proposals being amended. This iteration can go on multiple times before final recommendations are agreed upon. Subsequently, national governments are informed who can draw up identical (or altered) proposals for domestic legislation. Alternatively, though not often the case, they might choose not to participate at all.

In addition to all these public sector bodies, there are also hundreds (perhaps thousands) of **private sector** groups set up to facilitate international economic interactions or to actively encourage them. Many groups set technical standards. For example, UN/EDIFACT and SWIFT set standards for the exchange of data. Other groups establish Codes of Conduct (for example, for dealers in foreign exchange). Still other international groups seek to harmonize rules for accounting, auditing and disclosure. A discussion of all these groups would never end, since new ones are coming into existence all the time. Globalisation reveals the need for new groups and new groups foster further globalisation.

In spite of all these efforts to promote international cooperation to solve economic problems, there is often a sense that the process is not working very well. Efforts by the United Nations to combat climate change have not succeeded in slowing the accumulation of Green House Gases. The International Monetary Fund cannot discipline creditors in the international financial system, because they do not need to borrow money from the Fund. Nor can the IMF discipline the world's biggest international debtor (the US) because the US exercises hegemonic influence and can issue US dollars (the global reserve currency) to pay its bills. In the Eurozone, the crisis continues without resolution almost three years after it started. After eight years of trying, there is still no globally agreed set of accounting principles.

In the realm of financial regulation and supervision, shortcomings are also in evidence. The US refused to ratify the Basel 2 Accord, and now is delaying action on Basel 3. Suggestions were first made in 1994 (by the G 10 Governors and Ministers) that all sovereign bonds should contain Collective Action Clauses to facilitate restructuring. The IMF and international banks only agreed in principle in 2004, and only for new bonds. Old bonds without such clauses will continue to impede the orderly restructuring of sovereign debt. Indeed, the legal problems faced by Argentina in New York courts, facing suit by "vulture funds", threaten the whole concept of orderly restructuring.

F. What are the impediments to international cooperation?

Human beings cooperate in uncountable ways every day. Indeed, cooperation seems hard-wired into human beings as an evolutionary survival strategy. However, cooperation is based on trust, and in particular the trust that the counterparty will act fairly in repeated encounters. However, the more the number of people involved in the cooperative process, the greater the likelihood that someone will opt not to cooperate and to become a "free rider' benefiting from the cooperation of others. Since even a two year old can recognize when "it's not fair", this perception of unfairness can threaten the whole cooperative process.

Beyond this process issue, surveys indicate that trust in national governments is now at all time lows. Consider the phenomenon of low and falling voter turnout almost everywhere, and the spread of the Arab Spring and Occupy Wall Street movements. At the international level, we now have important countries with markedly different histories and control structures: compare the US, Russia, China and the EU. This greatly impedes trust building. Moreover, the failure of the advanced market economies to recognize the growing economic importance of the emerging markets deepens that mistrust. The failure of the World Bank and IMF to deal with the "seats and shares" and succession issues is a case in point.

A far back as the ancient Greeks, it was recognized that effective public policy involves overcoming three problems. First, the "should" problem. What does good analysis say we should do? Second, the "could" problem. Do we have the legal powers and other instruments to allow us to do what we should do? Third, there is the "would" problem. Do we have the will to do what we should and could do? While these are difficult problems at the national level, they are even more formidable impediments to international cooperation.

There are many examples of the **"should"** problem at the international level. Different countries have different views about what the real problem is and what is the best solution. For example, when it comes to fostering macroeconomic stability, the Germans worry bout a return to high inflation, whereas the US is more preoccupied with a return to high unemployment. Each bias reflects the countries own history; Germany's experience of hyperinflation after each of the two World Wars, and the US experience of the Great Depression. On climate change, some countries (the US?) still deny the problem is man made. On solutions, some focus on mitigation and others on adjustment. Even among those focussed on mitigation, there are a variety of views on how this might best be done.

The **"could"** problem also restricts international cooperation. Again, by way of example, national governments often have laws that restrict data exchange. The monetary policy of the US has spillover effects everywhere in the world, yet US legislation demands that the Federal Reserve focusses on achieving only domestic goals of full employment and price stability. Finally, the German government is bound by decisions of the German Constitutional Court as to whether cooperative efforts undertaken by the European Stability mechanism are legal or not.

The **"would"** problem is likely even more serious. The will to do what should be done for mutual benefit is often impeded by a lack of trust. Another issue is when popular emotion (the popular will) takes over, as is the case in resolving the ownership of the disputed islands in South East Asia. No one can compromise.Another can be seen in Europe, where many people in core countries believe the indebted Greeks are lazy and need to be punished through austerity. Indeed, the root word (studen) for debt and sin in German are the same. The Greeks in turn feel oppressed and some demand retribution for damage done in World War 2. Finally, national leaders are more prepared to compromise internationally when their own country is strong and united behind them. Unfortunately, this is less and less the case as separatist movements, for nations within states (Wallonia in Belgium, Catalonia in Spain etc.), so vividly illustrate.

G. How might these impediments be removed?

The short answer is that I do not know. A longer answer would require another presentation, or perhaps even a whole series of presentations. In the interim, I leave possible answers for the Q and A to follow, and for future meetings of the United Nations Association at St Gallen and elsewhere.

Thank you for your attention.