This PDF is a selection from a published volume from the National Bureau of Economic Research

Volume Title: Globalization in an Age of Crisis: Multilateral Economic Cooperation in the Twenty-First Century

Volume Author/Editor: Robert C. Feenstra and Alan M. Taylor, editors

Volume Publisher: University of Chicago Press

Volume ISBN: cloth: 978-0-226-03075-3

eISBN: 978-0-226-03089-0

Volume URL: http://www.nber.org/books/feen11-1

Conference Date: September 15-16, 2011

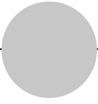
Publication Date: December 2013

Chapter Title: Introduction to "Globalization in an Age of Crisis: Multilateral Economic Cooperation in the Twenty-First Century"

Chapter Author(s): Robert C. Feenstra, Alan M. Taylor

Chapter URL: http://www.nber.org/chapters/c12574

Chapter pages in book: (p. 1 - 10)



Introduction

Robert C. Feenstra and Alan M. Taylor

It was very soon apparent that the global economic crisis of 2008–2009, aside from its painful economic costs, also raised fears of worrisome prospects for the smooth and harmonious conduct of international policy-making. As has been seen in other large recessions and depressions in times past, it was not long before new policy initiatives started to emerge that placed national concerns at the forefront, even if that went against the grain of seemingly established principles, worked against globalization, irritated specific economic partners, or undermined international economic cooperation more broadly. Whether in fiscal and monetary policies, the control of currencies and capital flows, approaches to protectionism and barriers to trade, or in the regulation of finance, national economic interests are starting to be asserted, often at the expense of commitments (explicit or implicit) to preserve the integration of world markets and to solve problems through cooperative policy actions.

Several broad questions thus began to resonate among scholars, policy-makers, and economic actors. Is globalization in retreat? What are the economic causes, political channels, and ultimate consequences of these changes? And how can applied economic research (based on theory, history, and empirics) respond to the challenge of making sense of these developments, and offering wise counsel for the future?

Robert C. Feenstra is professor in the Department of Economics at the University of California, Davis, where he holds the C. Bryan Cameron Distinguished Chair in International Economics. He is director of the International Trade and Investment Program of the National Bureau of Economic Research. Alan M. Taylor is professor of economics and finance in the Department of Economics and the Graduate School of Management at the University of California, Davis, and a research associate of the National Bureau of Economic Research.

For acknowledgments, sources of research support, and disclosure of the authors' material financial relationships, if any, please see http://www.nber.org/chapters/c12574.ack.

Prompted by these historic shocks to the global order, and the damage and uncertainty they have imposed on economies and policymakers, we organized this conference to consider the major questions that need to be faced going forward. We saw that there was little in the way of new analytical frameworks for considering such questions in light of current events. We felt there was an acute need to consider some of the critical linkages between many of the pressing issues (for example, exchange rates, global imbalances, and financial regulation). We also saw the need for thinking that embraced the long sweep of history and considered the political and economic outcome of past multilateral economic policies, and the prospective role of such policies in the future path of the global economy.

The goal was to advance debate about how the mostly successful multilateral post–World War II global economic order should not merely continue to function, but also now evolve and improve to address the strains created by the pressures of rapid globalization in the last two decades, and now deeply exposed and exacerbated by the crisis. Whilst there are ongoing processes and institutions in each sphere (e.g., Doha Round, UN, IMF/G20, Basel), we also need "blue skies" thinking on new agendas for the next century that will bring research directly to policymakers in ways that are useful to them. The nine chapters in this volume, with comments from leading policymakers, are intended to be a first, important step toward this end.

Lessons from History

The proceedings begin with two papers that take the long view. International cooperation on economic matters on a significant scale dates back to the nineteenth century. The best-known example was just about 150 years ago, when Britain and France concluded the Cobden-Chevalier trade treaty (1860) which formalized the "most favored nation" (MFN) concept, thus extending tariff reductions by any pair of countries to other partners within the growing web of similar treaties that came to pass in Europe in subsequent years. Even though trade policies were to become restrictive at times, notably in the interwar period, the same principle was later revived and has been central to the operation and success of GATT/WTO (General Agreement on Tariffs and Trade/World Trade Organization) in the postwar era.

In monetary affairs the launch of the Latin Monetary Union in 1866 by France, Belgium, Italy, and Switzerland (later joined by seven other countries) could be seen as, if not an early precursor to the eurozone, at least an attempt to coordinate monetary policy at a transnational level, even if the project was soon undermined by the contradictions of the bimetallic system it sought to defend, and the bloc ended up as a de facto member of the soon ubiquitous gold standard area, which began to dominate world monetary affairs after the 1870s. Indeed, the gold standard itself may also stand in, for some, as a better example of a multilateral system of monetary coopera-

tion. It depended on adherence for its smooth functioning, within limits, to certain policies and rules in a decentralized context, and on its ability to deliver price stability; ultimately it failed when, in the 1930s, noncooperative behavior in a deflationary environment tore it apart.

Against this backdrop, the first two chapters use the tools of comparative economic history to survey the variety of institutional formats, policy experiments, and their associated economic outcomes over the last two centuries, drawing attention to the success and failures, the political economy forces driving the historical process, and, most importantly, drawing out lessons for our present postcrisis challenges.

In chapter 1, "Coping with Shocks and Shifts: The Multilateral Trading System in Historical Perspective," Douglas A. Irwin and Kevin H. O'Rourke present a panoramic view of the multilateral trading system over the last two postmercantilist centuries, and explore how its sustainability in different historical epochs has depended on its ability to cope with disruptive adjustments. At some catastrophic moments ("shocks") when the system has lacked shock absorbers capable of handling large macroeconomic, financial, or political disturbances, the trading system has proven to lack resilience, in the sense that political economy forces have then tended to emerge intent on using protectionist devices as an alternative tool to offset, or at least cushion, such shocks. But equally important, lower frequency perturbations ("shifts") have also from time to time strained the commitment to free trade, as when more gradual but no less powerful trends in comparative advantage (whether for technological or geopolitical or other reasons) have eventually forced dramatic changes in trade patterns, industry structure, and factor rewards, creating a political backlash. They also argue that institutions matter: even if unilateral policymaking could in theory deliver a free trading system with adequate shock absorbers, historical observation of such regimes expose the perils of beggar-thy-neighbor actions and a prisoner's dilemma outcome. The parallels with the present are clear, and whether we think at the level of the prospective fallout from a possible eurozone crisis or the dim prospects for further progress in the WTO/Doha process, or how trade with emergent China and India has and will yet affect the advanced countries, the chapter draws attention to the important but often neglected linkages between the sustainable success of free trade regimes and the political and technocratic ability of countries to manage the pressures that openness expose.

In chapter 2, "International Policy Coordination: The Long View," Barry Eichengreen takes a long view of the evolution of international coordination in macroeconomic policy areas. The historical record shows a great deal of variation, and in general suggests that there are often constraints on what can be achieved, probably more so than in the area of trade policy: coordination is more likely in limited technical areas, when there is institutional support, when it is needed to preserve an existing regime from failure,

and when nations are not in conflict on other issues. For example, as the classical gold standard matured, central banks engaged in mutual support operation, often of a technical nature, and although policymakers had not overtly created the regime, once it was there they increasingly had a stake in its continued smooth operation. It was the outbreak of war in 1914 that derailed the gold standard, and despite desperate efforts made in the 1920s to try to rebuild and shore up a patched-up version augmented with reserve currencies, its credibility was weakened as much by increased scarcity of gold as decreased goodwill. Only in the wake of these failures, and the Depression and a second war, did more serious efforts take hold as conflict abated and the costs of earlier mistakes loomed large, with the creation of the International Monetary Fund (IMF) and, following the Marshall Plan, the start of European cooperation ultimately leading to the European Union (EU) and European Monetary Union (EMU). Nonetheless, as financial integration progressed in the late twentieth century, more often than not it would take crises—some severe—to prompt coordinated actions even where institutional structures were in place; examples of reactive rather than proactive efforts being responses to the Asian Financial Crisis, global imbalances, the Great Recession, and notably Europe's attempts to shore up monetary and fiscal arrangements after a crisis, be it in 1992 or today. In these cases, the gaps between the technocratic solutions and political realities, in the United States, Europe, China, or elsewhere, have often been a key stumbling block. Facing a global disaster in 2008–2009, central bank and G20 cooperation showed that grave enough dangers could focus minds, but once the cliff edge receded, problems of collective action resurfaced. International macroeconomic cooperation remains as fragile as ever.

Trade and Environment

In chapter 3, "Can the Doha Round Be a Development Round? Setting a Place at the Table," Kyle Bagwell and Robert W. Staiger explore whether the current WTO round (now already in progress for more than ten years) can really deliver on one of its main stated objectives, namely to improving the trading prospects of developing countries. They argue that certain features in the design of the current round, as well as a number of path-dependent conditions inherited from past trade rounds, may make this objective difficult to attain. First, they note that the attempt to maintain a "special and differential treatment" (SDT) regime in the negotiations for developing countries—that is, an exception to the usual norm of reciprocity as in the case of developed countries—may prove to be a significant barrier to the achievement of successful negotiations. Qualitatively, by trying to free ride on others' MFN commitments, the SDT provision may limit the "voice" of these countries in deciding which products actually get included in liberalization; and quantitatively, theory shows that the reciprocity between a pair

of developed countries can induce terms of trade changes which, though mutually beneficial for them, in the end leave the developing country with no change in trade volume. Lerner symmetry proves to be strong under reciprocal MFN tariff bargaining: the tariff cut boosts export for the negotiating pair, but not for the outsider. Worse still, the developing countries face the problem of being "latecomers" to such negotiations, meaning that developed nations have already removed (and given MFN status) to tariff cuts on a wide range of manufactured goods: but in reciprocal bargaining, where "large" sectors feel the pain of foreign tariffs, the political process and bargaining equilibrium depends on the ability to identify such potential gains on both sides. If developed countries have eliminated most such distortions already then a mutually beneficial deal is harder to find, and history reveals evidence of such problems even in the early postwar GATT rounds.

Another design problem in the Doha Round concerns agriculture, where the setup tries to encourage reductions in home agricultural subsidies in exchange for partner import tariff cuts. But the economic logic is weaker here: for example, if the foreign import tariffs are "optimal" (in the terms of trade sense) and if the agricultural subsidy makes their food imports cheaper, the proposed deal may appear lose-lose for the partner; at home, farmers lose subsidies and might gain on exports, but the net effect might be ambiguous. In this setting, unlike symmetric market-access bargaining over tariffs, the gains may be small, hard to identify, or nonexistent. Thus, the authors conclude, significant changes in the design on the Doha Round may be needed if negotiations, stalled for a decade, are to move forward.

In chapter 4, "Preferential Trade Agreements and the World Trade System: A Multilateralist View," Pravin Krishna considers the long-standing trend of creating discriminatory regional or bilateral preferential trade agreements (or PTAs, such as free trade areas, customs unions, etc.) and assesses to what extent this process is compatible with a healthy multilateral world trading system: that is, one might ask, are the two substitutes or complements? To answer this question is, ultimately, an empirical challenge, but with two decades of experience since the proliferation of such agreements began on a large scale, we have a reached a moment when a reasonable assessment can be made using evidence drawn from a broad sample of experiences. The results are mixed, but one can be skeptical that PTAs are, as yet, a big factor. The PTAs currently cover only a small fraction of trade in terms of the actual amount of liberalization achieved (that is, above and beyond multilateral agreements): most PTA trade takes place under zero MFN tariffs. Intra-PTA trade shares are small in most cases, and studies find that the welfare impacts are not clear cut. In addition, the institutional aspects of "deep integration" do not seem to be advanced all that much by PTAs relative to WTO norms. It is not clear that preferential agreements can impair the multilateral negotiation process in general, but there are signs that PTA members may use subtle yet diversionary nontariff

trade policy more aggressively against nonmembers. That said, some studies do show that, despite this, there are in many cases significant signs of trade diversion resulting from such preferential deals, so they do have some impact at the margin. In addition, as noted in chapter 3, the sequencing of market access to developed countries via special preferences for some developing countries can vary considerably and those with existing access may have very divergent interests compared to those who have no deal in place, a factor that could complicate deal making in the WTO process. The conclusion drawn is that PTAs have not achieved as much as might be thought, and that the multilateral process has been, and remains, central to the trade liberalization process.

In chapter 5, "Trade and Industrialization after Globalization's Second Unbundling: How Building and Joining a Supply Chain Are Different and Why It Matters," Richard Baldwin asks why so-called high development theory has thus far failed to give a plausible account of how emerging poorer countries can succeed in growth and development, and narrow the divergence in income per capita or productivity between themselves and the rich world. On the one hand, he argues that the actual experience of the last two decades has only served to emphasize the shortcomings of older generations of theories, but that distinct transformations in the workings of trade created by today's globalization may serve as the foundations of a newer and more accurate theory. The key, he argues, is to note that in its previous workings, the globalization of trade only enabled a "first unbundling" via the separation of the locales of production and consumption, notably after the revolutionary decline in shipping costs in the nineteenth century; this naturally led to highly localized and specialized production as predicted in old trade theories, and led to the division of the world into manufacturers and nonmanufacturers. Once it was technologically feasible and economically worthwhile, the factories were "unbundled" from consumers. But the last twenty years has witnessed the rise of a completely new trade mechanism, the supply chain, where the different parts of the manufacturing process can be split up and along with it, the location of one or more intermediate steps of value creation. Baldwin argues that this "second unbundling" facilitated by even lower transport costs and other logistical developments (like ICT and the Internet) is as revolutionary as the first, if not more so. Creating such niche opportunities can allow all countries to compete for a slice of manufacturing on a more even playing field: for example, instead of requiring an entire and "lumpy" vertically structured automobile industry, built on a huge manufacturing base ranging from basic inputs and parts all the way up to final assembly, the supply chain allows many different value added slices to be produced in myriad different locations. Now that it is technologically feasible and economically worthwhile, the factories themselves are being unbundled. Baldwin sketches this out as a new development theory, which could explain the much more

rapid (and disruptive) ability of emerging countries today to compete and converge with rich countries.

In chapter 6, "Facing the Climate Change Challenge in a Global Economy," Lee Branstetter and William Pizer discuss the global economic challenge posed by mitigating the predicted adverse economic and ecological effects of climate change in the decades to come. Evidence suggests that we are already behind the curve, in that the ongoing stocks and flows of anthropogenic greenhouse gas (GHG) emissions are so substantial as to have already placed us on a trajectory far worse than the agreed and supposedly achievable targets that have been the focus of past international negotiations and treaties. This reflects the historical problems in this domain, where progress, such as it is, from declared objectives to substantive economic policy action has been at a glacial pace—problems that, in turn, reflect the problems of intergenerational and transnational collective action. The first problem is that the full, cumulative benefits of mitigation action today will not be felt until far into the future, and those costs are, to some degree, uncertain; and the second is that, unlike most "local" pollution forms, GHG is by its nature afflicted by a global externality problem, but we live in a world where the locus of political decisions is national. The latter problem is exacerbated by the fact that a large share of future emissions growth will be in latecomer emerging economies, for whom sacrificing economic growth will appear not just costly but inequitable, in that the advanced economies past stock of emissions was not so restrained. In light of these problems, the authors discuss the preferable but unlikely first-best policy solutions to the climate change problems we face, and why current global institutions are not up to the task. For the moment they conclude that negotiations based on "top down" global approaches, like the Kyoto Protocol, may not be fruitful in the near term, although some progress may yet be made in "bottom up" frameworks where countries, or perhaps regions, may implement mitigation commitments more unilaterally. However, if such policies progress at different speeds, comparative advantage could shift, with the possibility of "carbon tariff" policies that protect costly and cleaner energy-using sectors at home from cheap and dirty producers in overseas havens with weaker pollution controls. While in theory such trade barriers might be economically suited to solving the externality problem, they are likely to be politically problematic and could create serious trade tensions for the global economy.

Macroeconomics and Finance

In chapter 7, "Multilateral Economic Cooperation and the International Transmission of Fiscal Policy," Giancarlo Corsetti and Gernot J. Müller consider the case for fiscal policy coordination across countries, an aspect of macroeconomic policy that has been thrust into the spotlight since the

start of the Great Recession once conventional monetary policies reached their limits. Indeed, the global response at the 2009 London G20 summit demonstrated how, in extreme circumstances, such coordination can be achieved, above and beyond the automatic stabilizers. But even if it is feasible, can it be argued to be effective? And in particular, are international spillovers large enough to matter and to justify treating this as a potential coordination problem? The authors attack this question using both theory and empirics. Empirically they use a vector-autoregression model with US and European/UK data, and find evidence that, using standard identification methods, US fiscal shocks do generate quite large spillovers across the Atlantic. To try to explain this, the theoretical model is a fairly standard quantitative two-country business cycle model, with nominal rigidities, a Taylor rule monetary policy, and fiscal policy guided by a debt-stabilizing rule for taxes and spending (so deficits today imply reversals in the future). In this setup it is quite hard to generate large cross-border spillovers, although qualitatively the impacts are present. But the model highlights that the "financial channel" matters, so that anticipated future reversals of policy can deliver lower interest rates in the present. Still, in this setting, any doubts about solvency would undermine the mechanism, implying that sovereign stresses in various countries could weaken the power of fiscal policy tools, and in that case international coordination to create "fiscal space" could be needed to ensure that truly solvent countries avoid self-fulfilling sovereign crises.

In chapter 8, "The International Monetary System: Living with Asymmetry," Maurice Obstfeld examines the problems facing the international monetary system as a result of the growing asymmetry between advanced and emerging nations, which in many key respects echo the travails of the late Bretton Woods system in the 1960s. For one, in an increasingly financially integrated world, where capital controls cannot be perfectly watertight, emerging countries facing the threat of sudden stops (or sudden flight) of capital, unwilling or unable to rely on IMF or other external assistance in times of crisis, have resorted to self-insurance via foreign reserve hoarding in order to maintain a liquidity buffer. At the same time, many of these countries also have "fear of floating" and wish to limit exchange rate volatility through intervention to support currency regimes that range from dirty floats to firm pegs, possibly for competitive export reasons, and/or to avoid boom-bust economic cycles associated with speculative capital inflows and currency overshooting. The author argues that at a fundamental level, this configuration of the world economy is most likely inefficient, resulting from coordination failures and institutional weaknesses. For example, a narrow and rational interest in self-insurance can lead a country to develop a huge war chest of foreign AAA reserve assets, but this creates a negative externality; clearly, not every country can pursue this strategy, and the pool of safe assets is increasingly limited on the supply side, exploding

on the demand side. Indeed, the configuration may self-destruct if a fiscal variant of the 1960s Triffin paradox eventually undercuts the creditworthiness of the shrinking set of safe haven government, as they either lever up nondeficit finance (gross debt) for risk transformation, or overborrow with deficit finance (net debt) for current expenditure. Moreover, this asymmetry problem is likely to be exacerbated by the growth acceleration in emerging countries relative to advanced economies of late. Gross foreign asset positions have thus expanded on both sides of the emerging versus developed country divide, but with very different composition, resulting in risk shifting more than risk sharing. And within the advanced world, the explosion of gross foreign asset positions has already been problematic, with the foreign-currency components held on bank balance sheets requiring cross-border lender of last resort action during the recent crisis (routed through central bank swap lines). The chapter then goes on to discuss how these problems could be addressed by a better multilateral cooperation: the need to redesign the role of lenders of last resort nationally and globally rather than via the ad hoc use of swap lines; the case for a more efficient way for emerging countries to access emergency liquidity than costly and potentially destabilizing reserve accumulation; the case for coordinating emerging countries' exchange rate policies to avoid currency wars; the ways in which the IMF could support these goals with enlarged facilities, redesigned conditionality, oversight of capital flow imbalances, and emerging country currency and capital control surveillance; and the deep political challenge posed by the risk of communal fiscal losses in any such cross-country risk-sharing architecture in cases where illiquidity turns out to be insolvency.

The volume concludes with chapter 9, "Global Macroeconomic and Financial Supervision: Where Next?" by Charles A. E. Goodhart. This chapter argues that there are two key challenges to further progress in improving oversight, one political and one analytical. The political problem is the clash between national sovereignty and policymaking and the international cross-border linkages brought about by the unprecedented degree of financial globalization in the last decade. The analytical problem is that macroeconomics has made slow progress, with little consensus: models of financial sectors with plausible frictions, incompleteness, or imperfections, are as of now still in their infancy. On the former, the prospect of any global governance structure is remote, so Goodhart argues that after the crisis, we should expect to see more national-level control and supervision over finance. A key testing ground is the euro area, where the treaty commitments to capital mobility are forcing, belatedly, rapid efforts to create cross-border supervisory structures. Yet key architectural problems stand in the way, such as the lack of a fiscal system to back the monetary union, a sluggish and asymmetric adjustment mechanism between surplus and deficit regions, no well-articulated lender of last resort role for the European Central Bank (ECB), the national nature of most banks, and the fact that such banks

disproportionately hold the public debt of the subsidiary sovereigns where they are domiciled. In moments of financial crisis and downturn, a subsidiary sovereign may be faced with self-fulfilling bank or sovereign crises, and the one may cause the other (given the codependence caused by the public debt on bank balance sheets). On the macro side, the author argues that to prevent or mitigate crises, some authorities, most likely the IMF, may need to be more assertive in warning about debt-augmenting imbalances ex ante, or even dissuading them by issuing binding risk-weighting changes. And, once solvency is the issue, the IMF or some other arbiter may need greater powers in helping to quickly resolve crises and restructure debts ex post. On the banking side, the author notes that, despite major changes since the 1980s, the crisis shows that the Basel banking regime remains a work in progress. There are substantial concerns associated with the laxness and procyclicality of the current rules. Weaknesses remain in that the regime has no sanctions and defers to nations, that the safe capital ratios may be higher than the current minima, that other tools such as convertible bonds or taxation remain unexplored, and that risk-weighting and stress test concepts are still in play despite their dubious value in the last crisis. Thus, the tasks ahead for macroprudential policy design remain challenging.