



# Global Governance of Public Goods: Asian and European Perspectives

*12th edition*

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## Sessions summaries

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1-2 October 2015

France Stratégie, 18, rue Martignac, 75007 Paris, France

## SESSION 1 - THE RETURN OF GLOBAL IMBALANCES

Chair: *Naoyuki Yoshino, Dean, ADBI*

### Giancarlo Corsetti, Professor, Cambridge University

The return of global imbalances?

#### 1) The landscape of the international financial system

If we focus on the global view of the international financial system some interesting facts emerge. First, we notice a growth of gross assets and liabilities (stocks) of which most are non-contingent debt contracts. An enormous increasing of international and global banking which increases the risk of global liquidity pushes these contracts forward. Furthermore, the institutional investors and asset managers have a portfolio strategy that is often constrained by institutional rules and market practice. We find little evidence of increasing cross-border risk sharing. In fact, we observe the opposite: accumulation of imbalances and debt financed bubbles, and increasing endogenous risk.

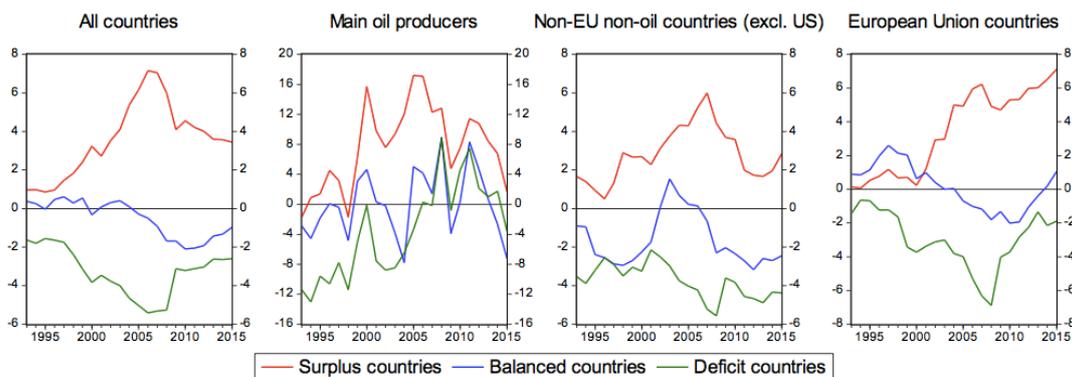
A second fact is related to the composition of countries portfolio. It differs by maturity, currency of denomination and type of assets. Only few countries can issue debt in their own currency and therefore have to borrow in dollar or euro (original sign). As a result, in most deficit countries, exchange rate depreciation may not foster adjustment to negative current account shocks. The adjustment happens rather via employment and income.

#### 2) What about global imbalances?

In its original formulation, global imbalances were related to concerns with persistent US deficit vis-à-vis EME (mainly Asian) countries, foreshadowing a run on the dollar. This assumption of a dollar crisis has been either discarded or proved wrong.

Furthermore, as the graphs below illustrate, deficits (flow) fell sharply with the crisis.

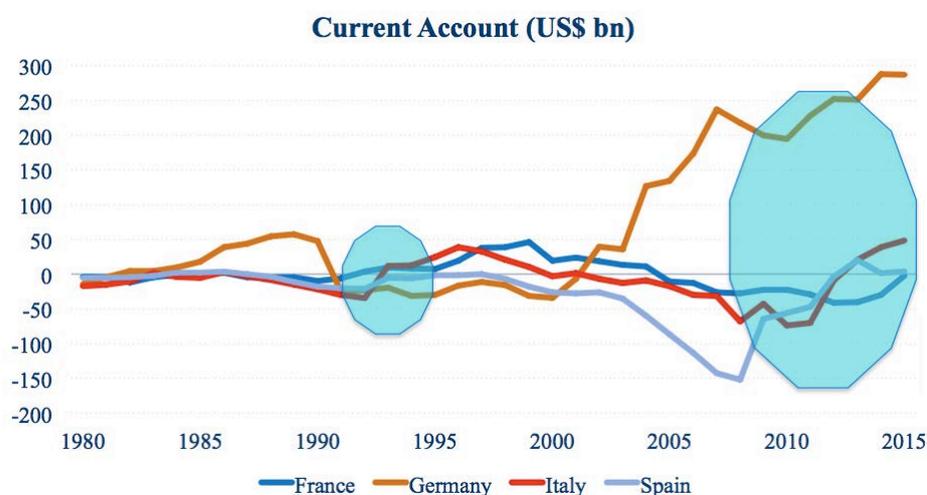
**Figure 1: Global current account balances (% GDP), 1993-2015**



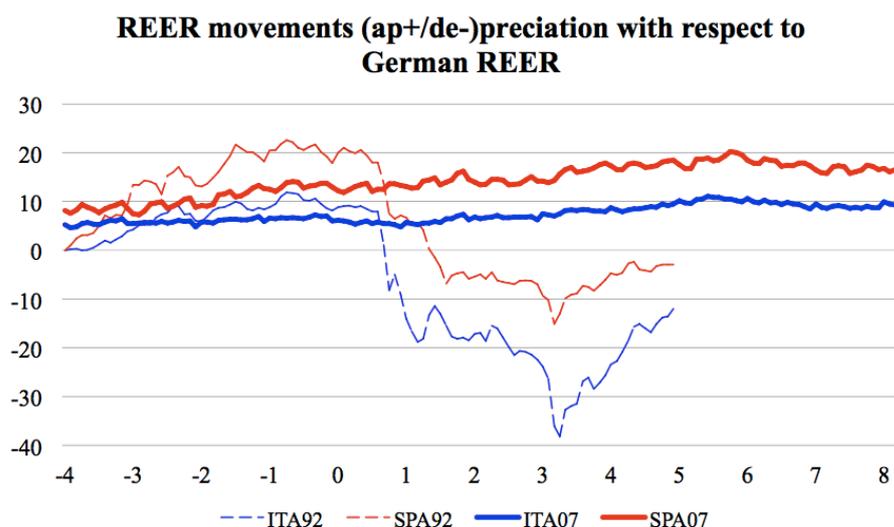
Today global imbalances are a stock not a flow problem, which implies debt over-hang, financial fragility and fiscal sustainability issues. We can identify two main issues: a reduced stabilization capacity and a lack of institutional development at both national and international levels.

3) The Eurozone: a tale of two crises of imbalances 1992-93 (or 95) currency crisis vs. current crisis

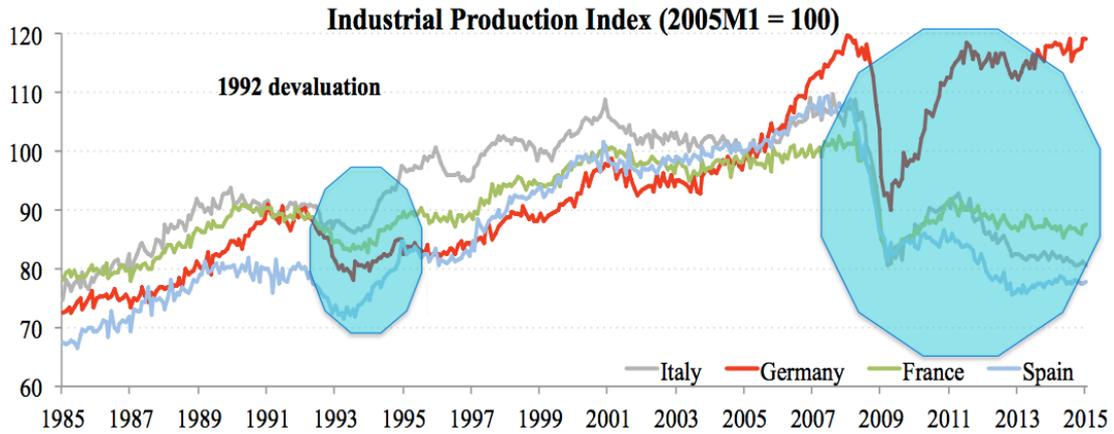
The graph below illustrates the current account evolution of France, Germany, Italy and Spain. We observe that the amplitude of the imbalances in the 92-93 period was much lower than today's.



The graph below shows the real effective exchange rate (REER) movements of Italy and Spain with respect to the German REER, O the x axis represents the time of the crisis with the negative (positive) numbers being the years before (after) the crisis. As we can see, only during the 92/93 crisis, Italy and Spain had deep real exchange rate devaluations.

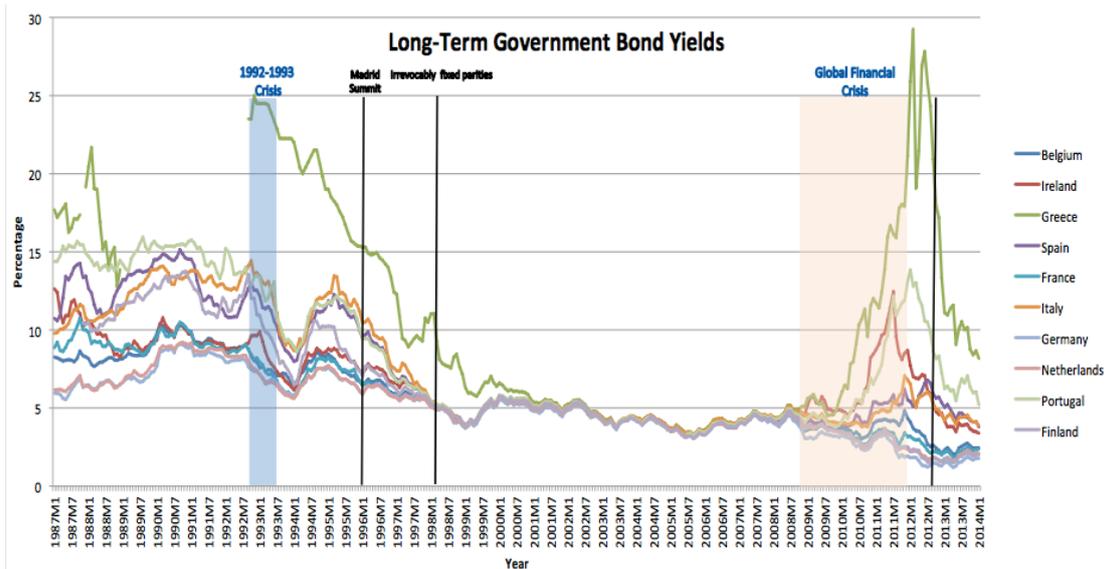


Furthermore, oppositely to the current crisis, it does not seem that the 92/93 crisis had any impact on the industrial production.



In sum, during the 1992-1993 (95) crisis there was a better EZ stance, with Germany running large deficits post-reunification. There were also more adjustment margins with the possibility of exchange rate adjustment, moderate inflation allowing wage and spending adjustment and large banks bailouts. These instruments aforementioned were, nevertheless, costly to use demanding high interest rates to fight currency instability and enormous fiscal retrenchment to help financial stability, finance costs of crisis and correct imbalances. However, these domestic adjustments following the 92/93 crisis, which were helpful, could not end the crisis itself. Only in December 1995, with the Madrid summit, a renewed political cohesion was established and the crisis solved.

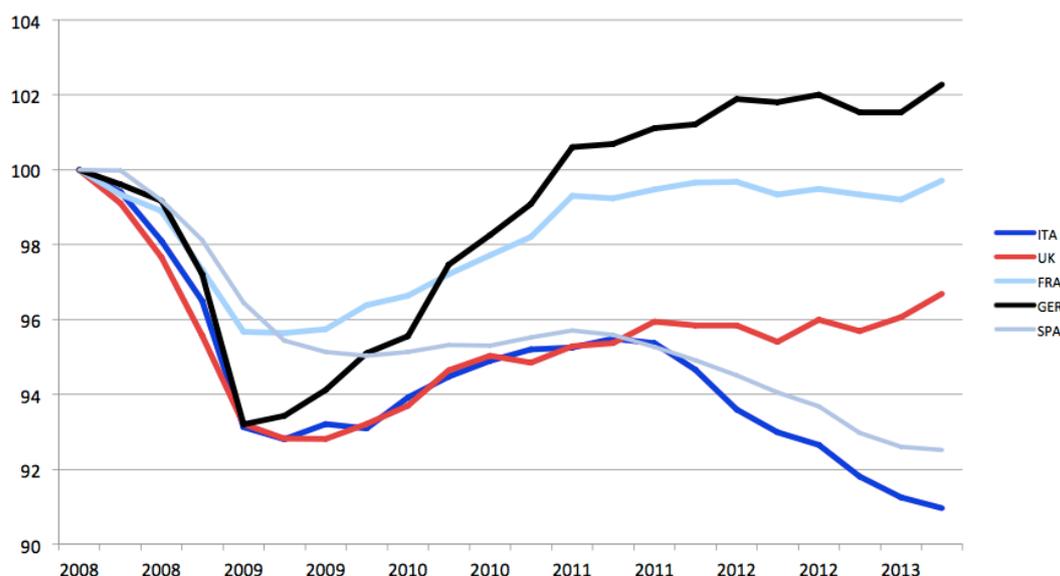
The graph below illustrates the impact of the political cohesion on the long-term government bond yields of different European countries.



The current EZ crisis has different aspects. First, Germany runs large surpluses. Second, because of the common currency no exchange rate adjustment is possible. Third, debts are denominated in euro, hence a fall in prices help competitiveness but worsens debt burden. Finally, the inflation is closer to zero than to the 2% target.

The paradox of an “incomplete monetary union” raises the benefit from coordinated policy. As a matter of fact, incomplete institutional development worsens the conflict among states worsens and raises the temptation to pursue opportunistic

policies. The current problem is institutional and has been costly to Europe (see graph below of the GDP evolution of five European countries, 2008 = 100).



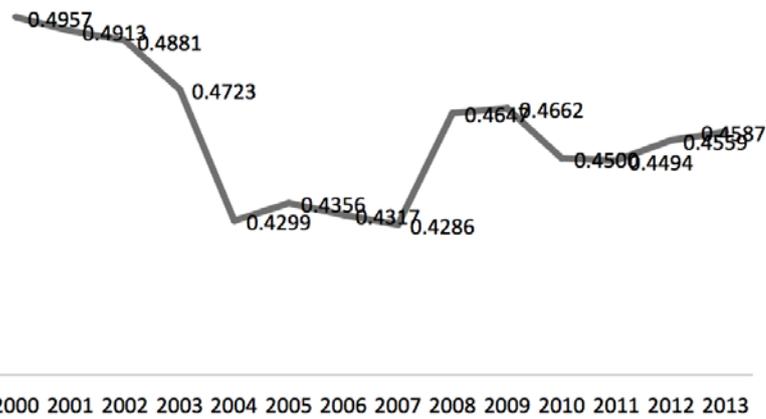
**Zhang Jun, Director of the China Center for Economic Studies, Fudan University**

China rebalancing

China's growth is expected to be less than 7% this year - its lowest level since the financial crisis. In fact, as a response to the 2008 financial crisis, the Chinese government set a stimulus package of fixed-asset investment that resulted in 9% GDP growth for two years. However, after 2011, stimulus was no longer sustainable and turned to macroeconomic tightening, causing investment growth to plummet, from a nominal rate of over 30% to about 10%.

Additionally, China's surplus has shrunk to 2% reaching its lowest level in nine years. In the third quarter of 2014, China presented a more stable balance of payments with its external surplus (\$81.5 billion) almost matching its capital and financial account deficits (\$81.6 billion).

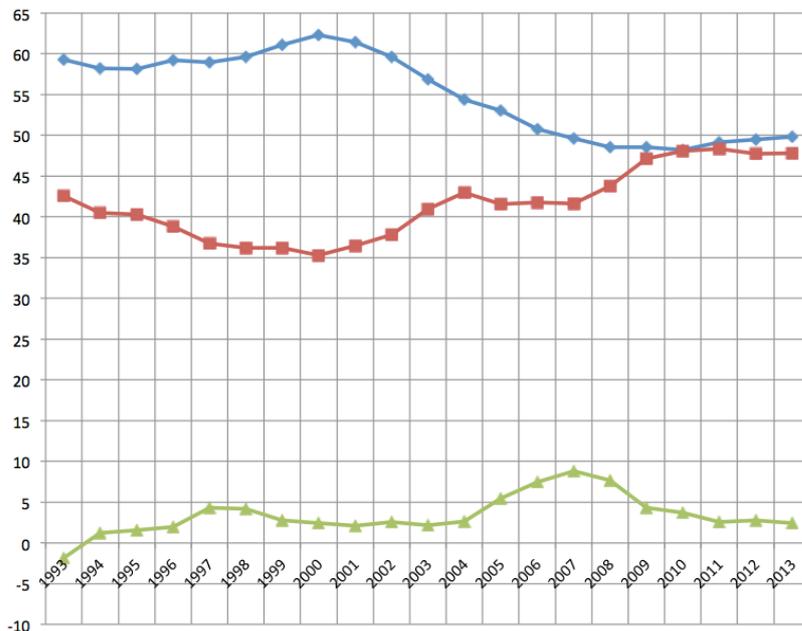
This rebalance can be explained by different factors. First, over the last two years, developed countries have been pursuing re-industrialization to boost their trade competitiveness. Nevertheless, China's wage costs are rising and its labor-intensive manufacturing industries are facing increasingly competition against other emerging economies. As a result, the recovery in the advanced economies is not returning Chinese export demand to pre-crisis levels.



China is also undergoing an internal rebalancing of investment and consumption. The expansion of middle class is having a major impact on consumption. Last year, the country surpassed Japan to become the second-largest consumer market in the world, after the US.

Chinese imports remain focused on intermediate goods, with imports of raw materials like iron ore having surged over the last decade. But, in the last few years, the share of imported consumption goods and mixed-use (consumption and investment) finished products, such as automobiles and computers, has increased considerably.

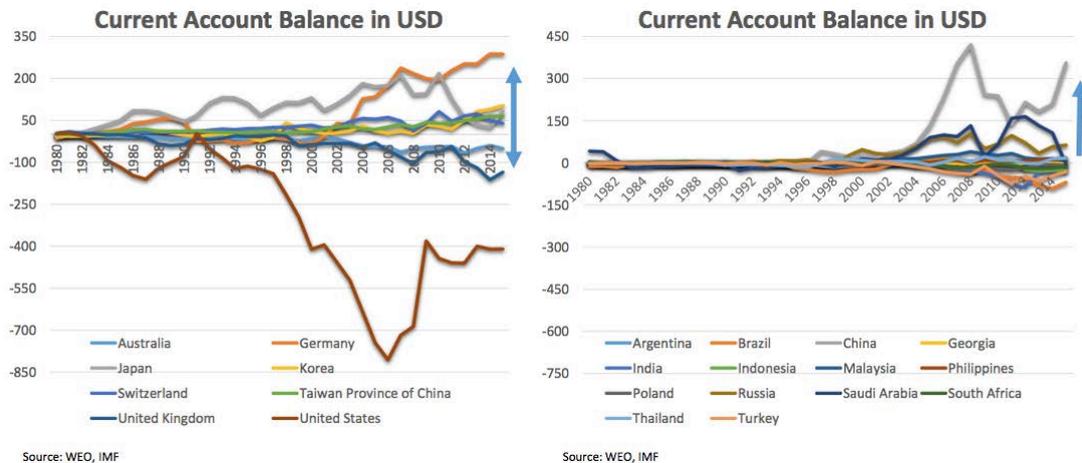
The graph below illustrates the evolution of China's expenditure components of GDP. The blue line represents the investment, the red line the consumption and the green line the balance of trade. As we can observe, over the past years consumption has been increasing, investment decreasing, and the balance of trade stabilizing.



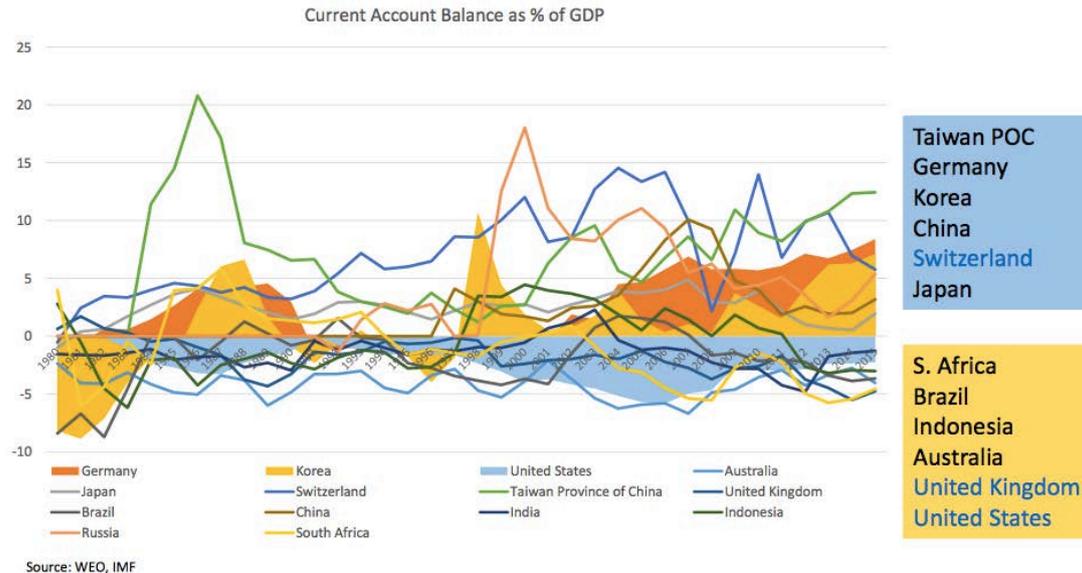
## Il Houg Lee, former G-20 Sherpa for Korea and President, KIEP

### Resurgence of Global Imbalance

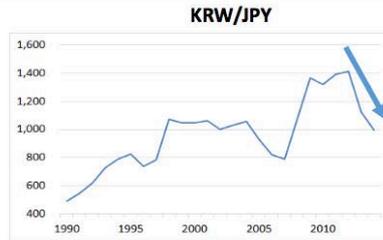
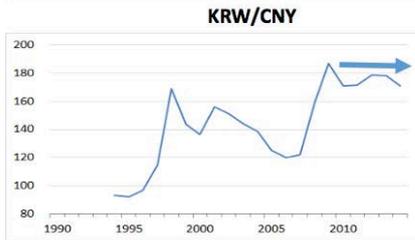
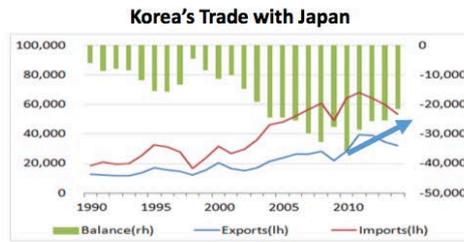
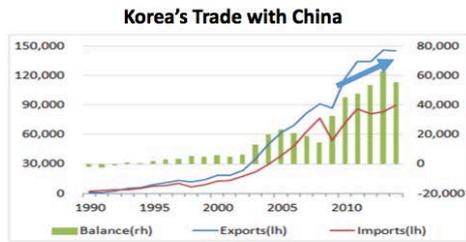
As the graphs below illustrate, for different advanced and emerging economies, current account imbalances appear to be widening.



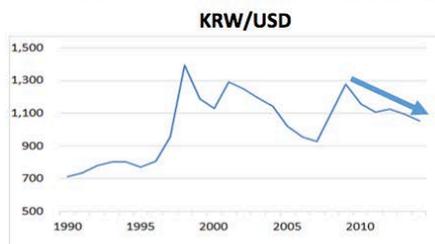
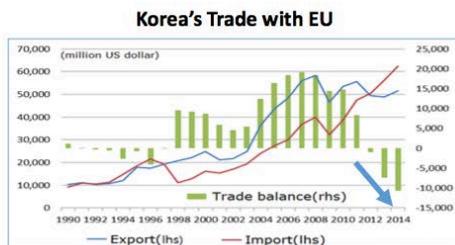
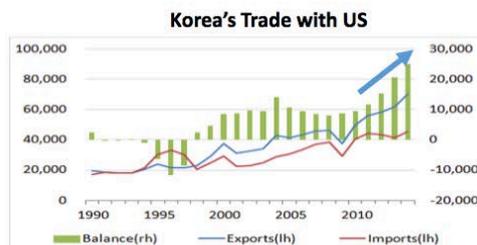
There is a possible contribution of commodities prices to ampler imbalances. As a matter of the fact, prices of raw materials have declined sharply relative to manufacturing products. We observe that manufacturing (blue box) and commodity exporting (yellow box) countries seem to have deficits and surpluses, respectively.



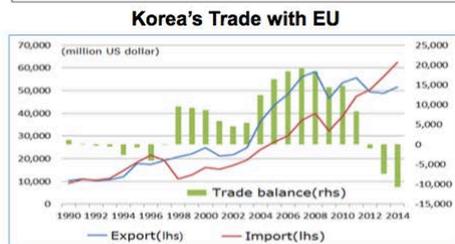
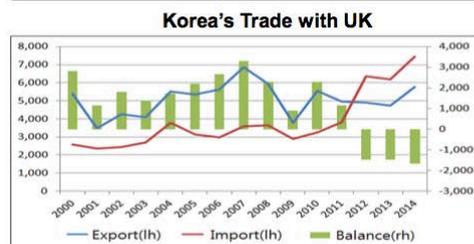
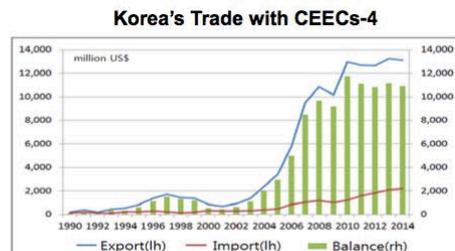
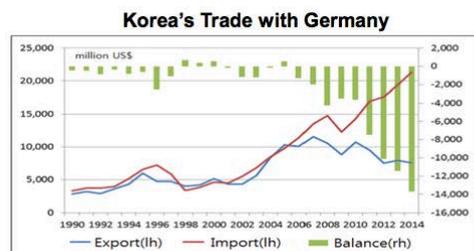
The trend in the last few years does not show a clear linkage between exchange rates and imbalances. In fact, bilateral current account balances reflect trading partner's characteristics to have played a more important role. As the following graphs illustrate for Korea, trade surplus with the US and trade deficit with the EU widened both during won appreciation relative to the USD and the Euro. Even within the EU, divergence of trade balances reflects the nature of trade relations in the country.



Sources: Korea International Trade Association, CEIC, and author's calculation

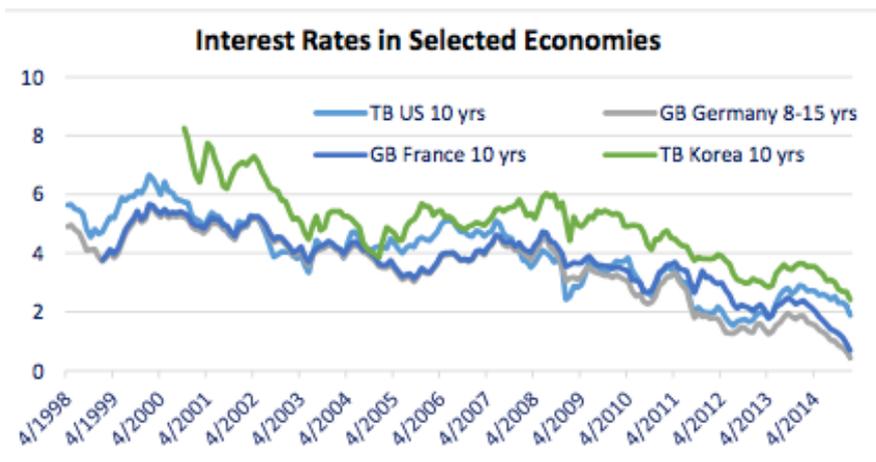
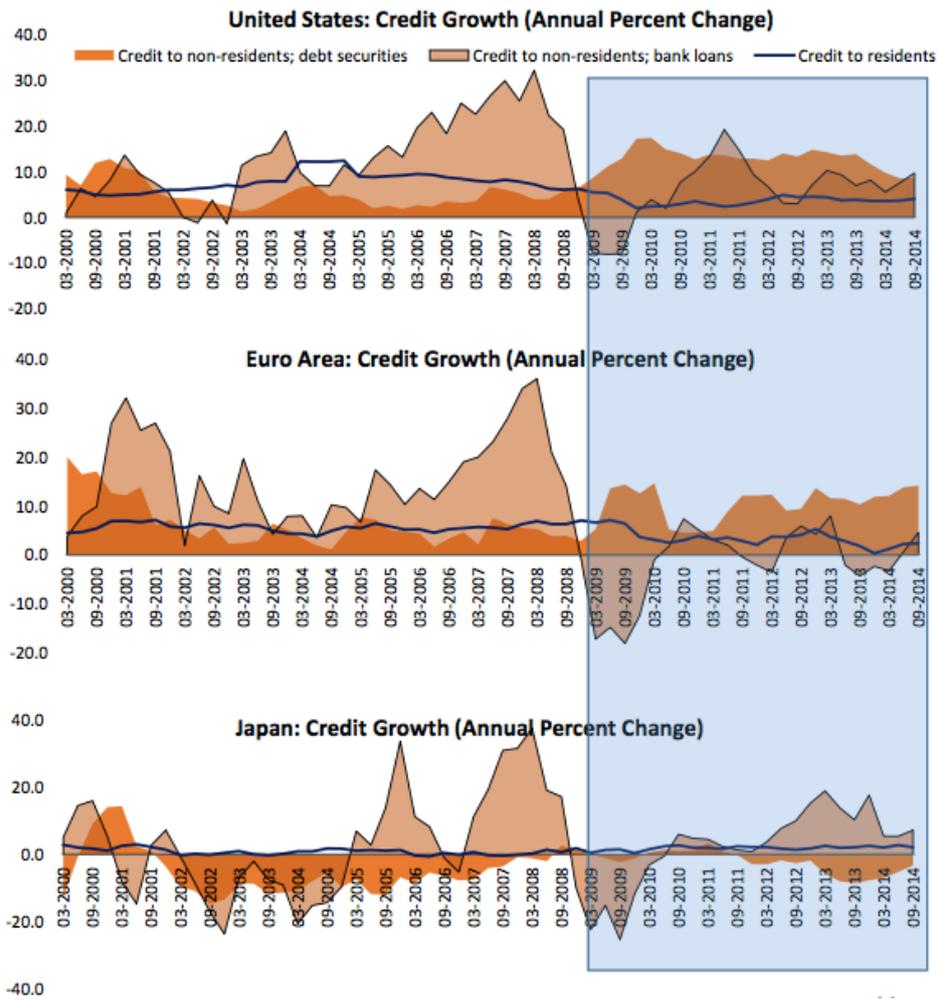


Sources: Korea International Trade Association, CEIC, and author's calculation



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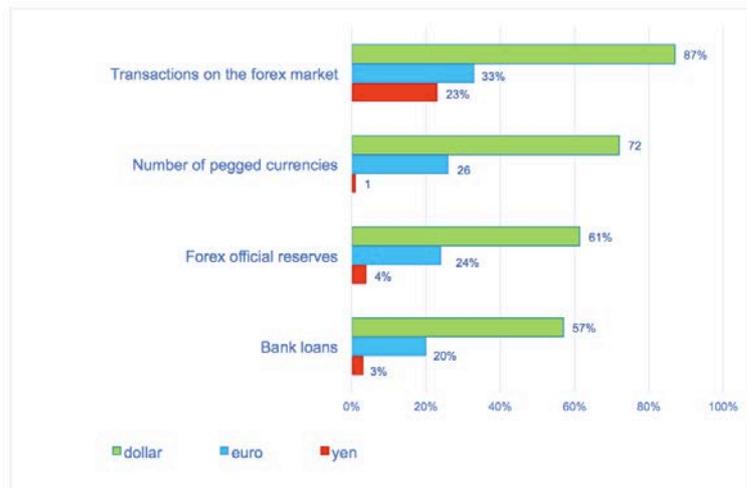
The evidence suggests that advanced economies' monetary policy stance have strong spillover to other countries not only through interest rate channel but also in actual flows. We observe that aggregate demand (AD) expansion of money in the US is matched by others advanced economies' AD expansion. Even Korea, for instance, that is a small country started to have its long interest rate in line with the US.



Finally, demographic aspects, such as ageing, should be considered when analyzing global imbalances. In fact, under the life cycle hypothesis of consumption, young households borrow against their future income, middle-age households save for relinquishing debts and retirement, and old-aged households spend their savings. Therefore, countries with a relative young or old population are more likely to run current account deficits, meaning that some imbalances are “inevitable”.

## Natacha Valla, Deputy Director, CEPII

We have a conjunction of policy ideas on how to deal with global imbalances such as: bank union, capital market union (see Commission 30<sup>th</sup> September report), and investment plan. These ideas are conceived independently from each other. In fact, they address the common perception that there is a lack of market, infra structure, heterogeneity for the euro, which is a main international currency. As a matter of the fact, when we analyze the importance of the euro in the world economy, we observe that it represents roughly 25% of the global reserves. Additionally, it accounts for 33% of the transactions on the foreign exchange market, is the anchor currency for 26 countries and constitutes 20% of bank loans.



Source: Aglietta and Coudert (CEPII Policy Brief, forthcoming)

Is the euro going to be a residual to the USD and also to emerging market (EM) currencies?

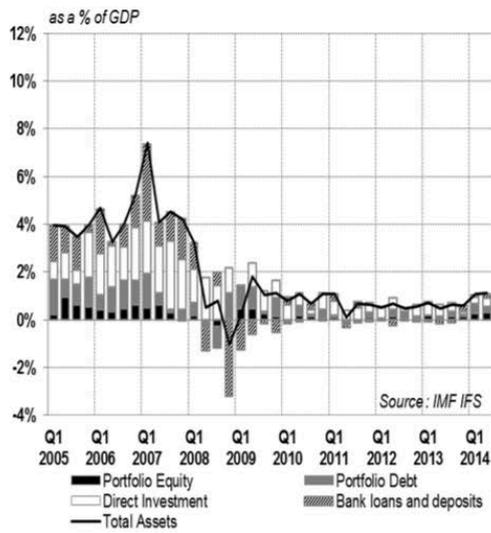
We have seen that there are some limits to the USD system. First, due to geopolitical reasons there is mistrust with regards to the dollar. Second, the expansion of the EM-EM trade has diminished the overall importance of the USD. Third, few tools support EM currencies: currency swap agreements (i.e. China and Russia), own macro initiatives (i.e. financing of large scale investments projects, AIIB), genuinely strategic approach to international role of the FX (i.e. offshore RMB platforms), etc. Nevertheless, there are still vulnerabilities (Fed monetary policy spillovers, RMB internationalization, etc.).

Where does that leave the EUR 16 years on?

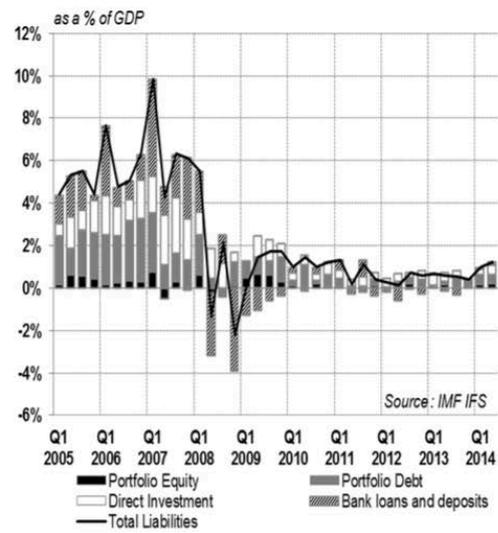
First, we have known a constellation of interest rates that would favor the greater role for the EUR as a funding currency. There is a cross stance between the ECB and the Fed low rates, sovereign spreads in the euro area are attractive (risky companies find it cheaper to fund in euro) and euro is a cheap currency thanks to the low interest rates.

To analyze global imbalances we gathered different data on the global finance. The first thing we note is a persistent shrinkage of international positions since the financial crisis.

World financial account assets



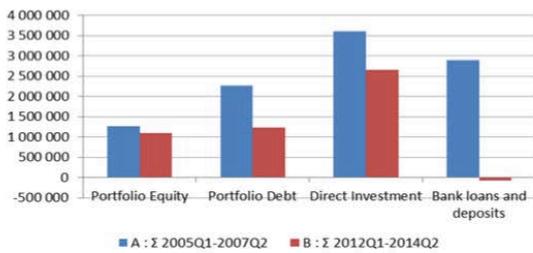
World Financial account liabilities



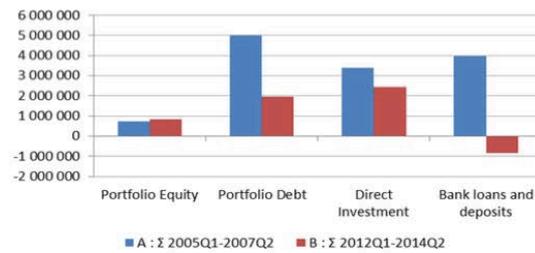
www.cepii.fr Source: Bussière, Schmidt and Valla (mimeo 2015)

We also see that flows have decreased and almost disappeared in bank loans and deposits.

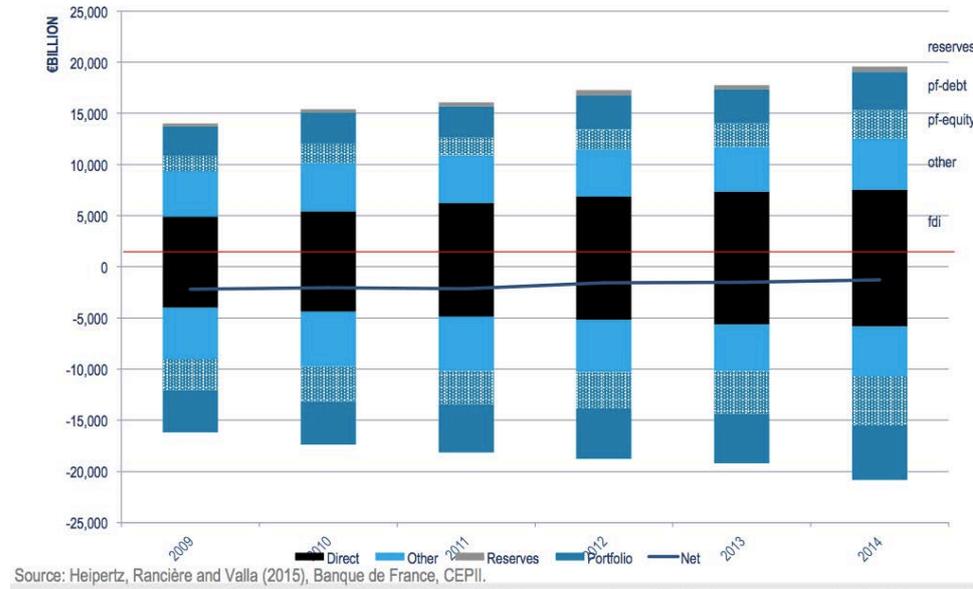
World : Assests



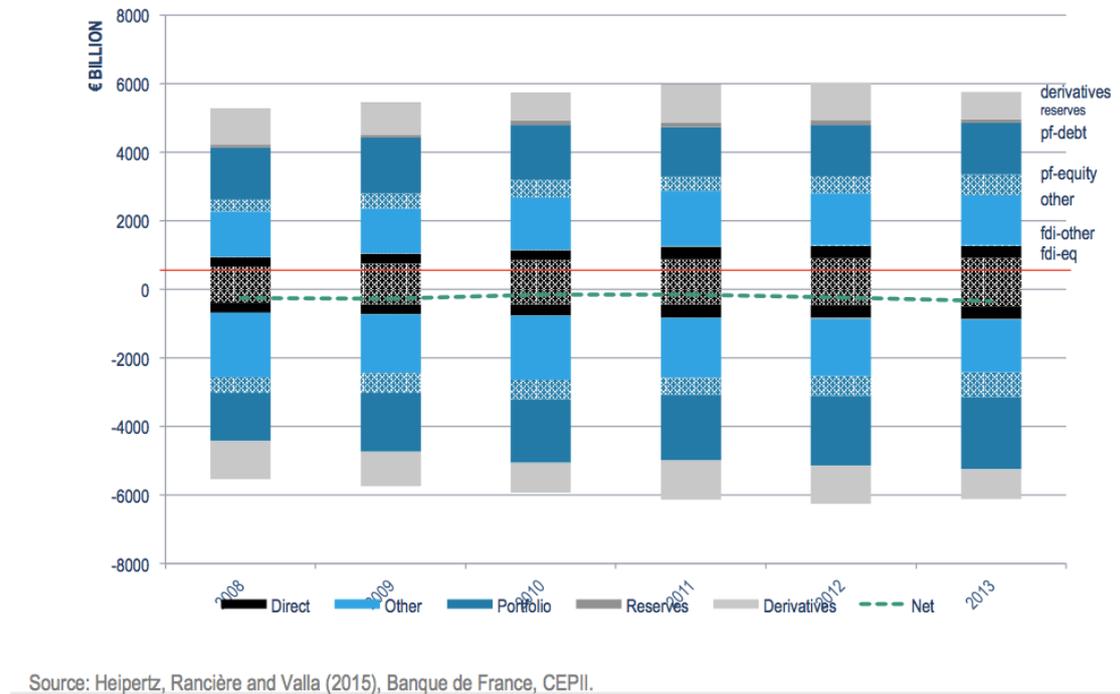
World : Liabilities



We can present some stylized “currency” facts from portfolio invest, taking the Euro area IIP as a background.



In the French economy, the share of direct investment is lower than the Euro area, whilst the derivatives is greater.



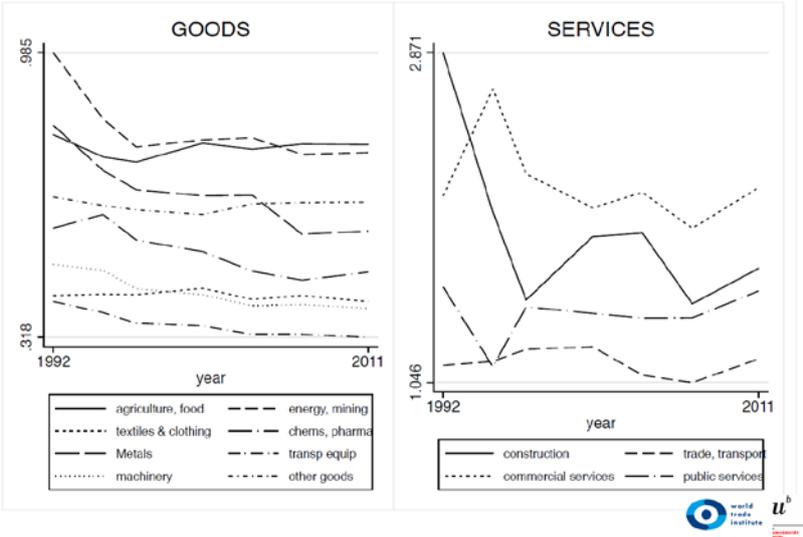
## SESSION 2 - SLOWDOWN IN INTERNATIONAL TRADE

*Chair: Yung-Chul Park, Distinguished Professor, Korea University*

Thursday, October 1st the Cepii hosted the 12th edition of Asia Europe Economic Forum (AEEF). This conference aimed at discussing the global governance of public goods from Asian and European perspectives. The second session of the debate addressed the global slowdown in international trade. Recent downward trends in international exchanges rose concerns from trade economists. Indeed, post-crisis global trade did not recover its pre-crisis level. In that context, the causes and the possible policy responses have been investigated and debated. In particular, the discussion led by Yung-Chul Park, differentiated the cyclical from the structural component with a specific focus on the latter.

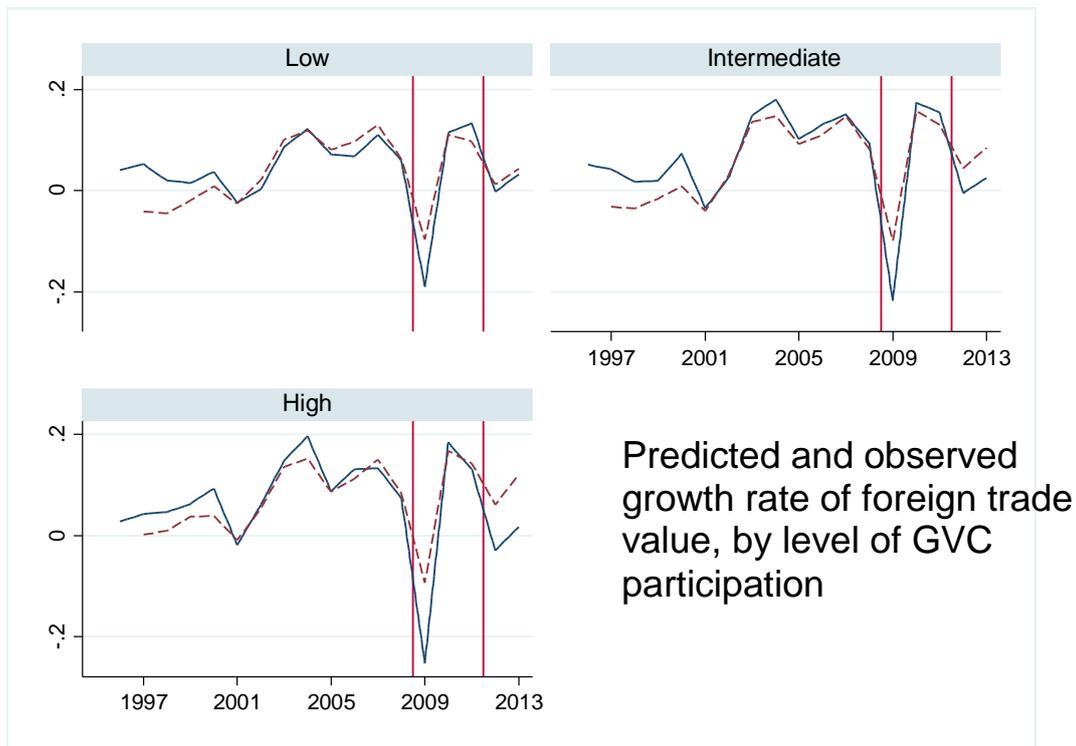
To begin with, global trends in international trade have been introduced by **Joseph Francois, Managing Director at the World Trade Institute**. Simple ratio between world trade and GDP volumes translate in leveling off tendency after the financial crisis period, while its evolution was constantly increasing since 1980. These global movements find an explanation in the increasing complexity of the production process. As a consequence of production's fragmentation, goods crossed several borders before reaching their targeted market, leading exchange flows growing faster than value-added. This is well depicted by the declining value-added share in exports value since 1990 (see graph 1 from Joseph Francois). This increasing production of fragmented goods raises the question of the cost in term of CO2 embodied. Extensive margin of trade have been addressed and quantified through social network theory. Again, a stabilization process seems to be at play after 2008 for big traders. While trade slowdown appears to be driven by the global financial crisis, the possible coincidence between both movements has been suggested. As a conclusion, the World Trade Institute director underlined the need to focus more on firms' regulation and cooperation than trade slowdown described as "a new normal".

**Graph 1 - Total VA exports relative to gross export value**



After a comparison of the pre and post crisis trade evolutions, **Sébastien Jean, Director of CEPII** underlined a phenomenon fitting the trade situation of most countries. The world trade slowdown is puzzling because it does not fit predictions. This is highlighted by the need for WTO to update its projections of trade volume within a year. Behind this fact, the relationship between trade and GDP is challenged. Declining gains of global value chains and China’s rebalancing have been proposed as main causes of the situation. The global value chain has been one of the main drivers of trade growth during the 1990-2000 period. Taking advantages of differences between countries (in term of skills, wage, etc.), this production process led to an increase in international trade. However, most of the GVC gains have already been made and the marginal benefits of the vertical specialization are not as large as they used to be. Estimations realized on the pre crisis-period (1995-2008) have shown positive and high trade elasticity to income. Based on constant trade elasticity to output, predicted global trade growth for the post-crisis period (2012-2013) presents higher value than actual one. The gap between actual and predicted trade growth is very large and seems to increase over time, especially for Asian players and US. In order to test the global value chain’s hypothesis, a decomposition of the world trade growth rate according to their global value chain participation have been considered (graph 2 from Sébastien Jean). Trade flows driven by high and intermediate global value chain participation display huge gap between predicted and observed flows during post crisis period. At the contrary, the predicted trade growth involving low GVC participation appears to be very close to the actual one. Build on a previous work with Charlotte Emlinger and Mathieu Crozet, results are consistent with the idea that the low hanging fruit of GVC has already been eaten.

**Graph 2 - The gap between observed and predicted trade growth is larger where GVC participation is higher**

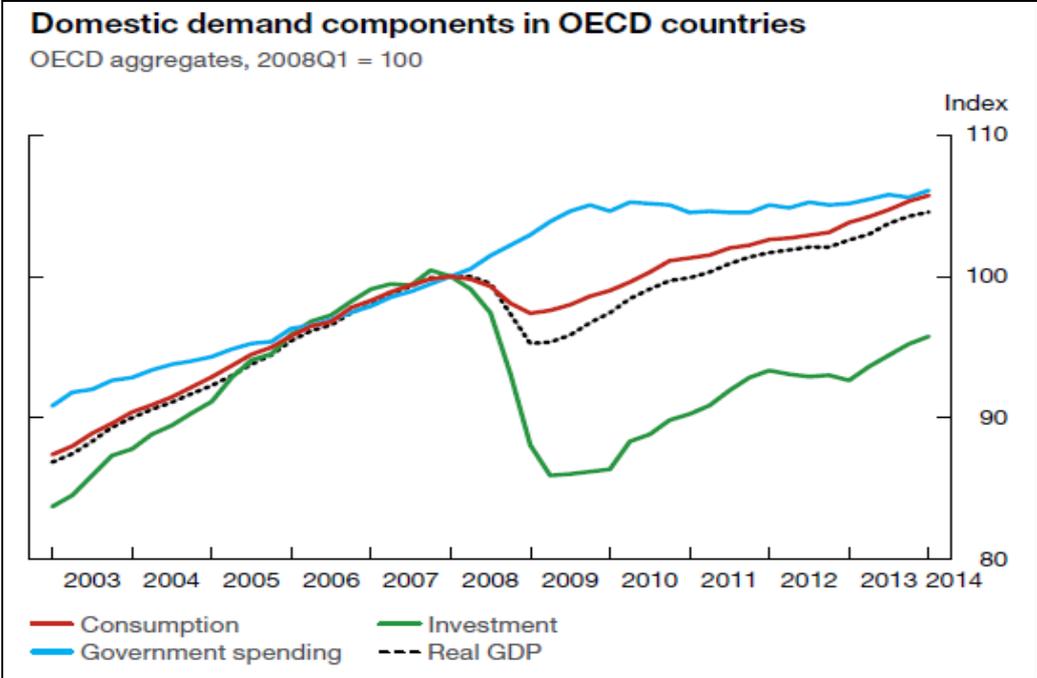


12 Source : Crozet, Emlinger and Jean, 2015.

The global financial crisis (2008-2011) has initiated new evolution perspectives for world trade as reported by **Masahiro Kawai, Senior Research Advisor at RIETI**. This caesura is illustrated by a post-crisis level of global trade much more below the pre-crisis period. Simple descriptive statistics comparing output and trade volumes show that the latter seems to be less responsive to variations of the former. This decreasing elasticity of global trade with respect to GDP can find explanations in both cyclical and structural factors. The low level of investment since 2008 can justify a downward trend in the short-term but cannot be a sufficient explanation (graph 3 from Masahiro Kawai). Structural explanations deal with China's rebalancing. The varying path of China's economic model is likely to reveal part of the trade slowdown. First, China goes progressively from an economy driven by export and investment to a consumption-led growth. Because of parts and components flows engendered by the former, this transition leads to less trade-intensive activities. A second factor related to China's changing pattern is the shift from a growth based on manufacturing activities to a services-driven growth. Again, this change is likely to bring less trade-intensive activities. Possible policy response to the global trade slowdown has been investigated through the gravity model. In particular, the role of Free Trade Agreements in promoting international flows and foreign direct investment has been examined. Data from emerging countries between 2002 and 2012 displayed a positive and high elasticity of export flows to FTA's. As a consequence, necessity for emerging economies to continue the liberalization process has been discussed. This could either be implemented through further tariffs cut or reduction of non-tariff barrier. The signature of new Free Trade Agreements is a possible way to increase trade flows between emerging economies. Hence, a special focus on actual negotiations' fulfillment (RCEP, TPP, FTAP or ASEAN-EU) has been privileged by Masahiro Kawai. The possible enlargement of the global

value chain process to emerging economies, which are not already integrate (Sub-Saharan Africa, South America, South Asia), could be another mean to benefit once more from vertical specialization.

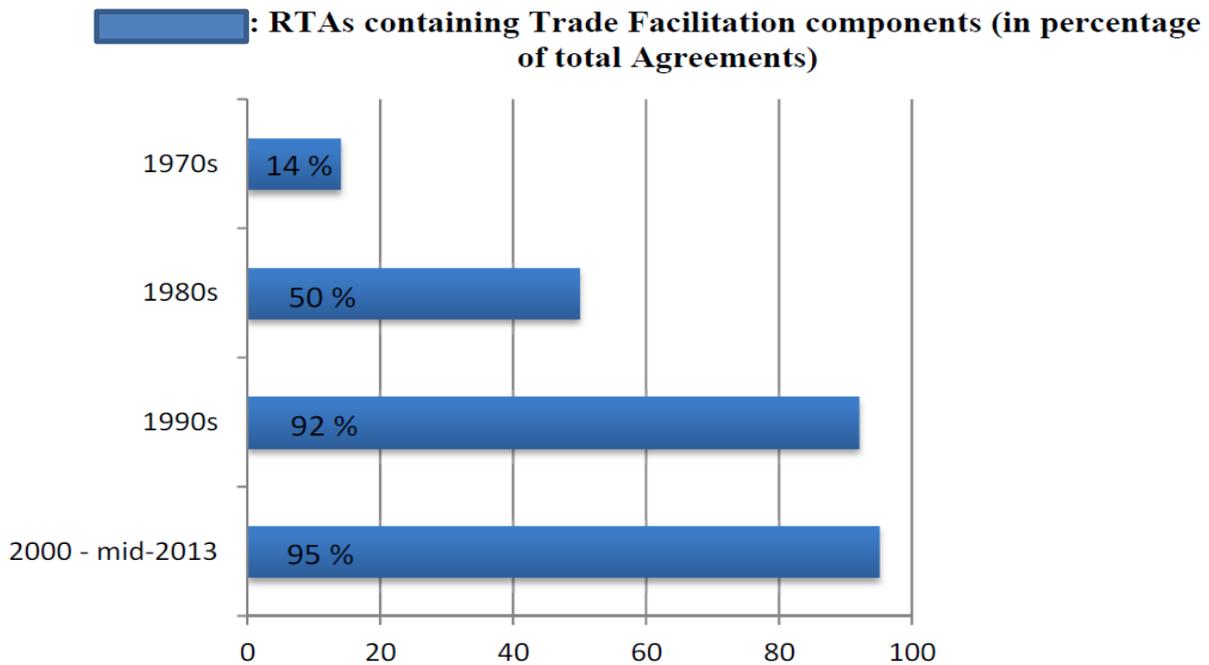
**Graph 3 - Change in the composition of global demand**



Note: Investment is gross fixed capital formation and comprises business, residential and government investment.

Source: Francis and Moreal (2015) from OECD *Main Economic Indicators*

To go further in the possible policy responses of the global trade slowdown, **Innwon Park, Professor at Korea University** purposed a focus on the combination of FTA's and Trade Facilitation provisions as a mean to benefit more from the FTA. This is a growing concern according to the Trade Facilitation provisions' evolution within regional trade agreements (see graph 4 from Innwon Park ).Conclusions from previous works have been discussed before integrating RTA's and Trade Facilitation in a gravity model. Results suggest stronger trade-creating effect by combining both of them, according to data from 170 countries between 2000 and 2010. Moreover, the trade facilitation provisions do not divert international flows from efficient and non RTA's members to non-efficient and RTA's members, as it is the case when the effect of Regional Trade Agreements is taken on its own. In that sense, this trade policy appears as non-discriminatory. The presentation further differentiated trade effect between intermediate and final goods, underlying a higher impact on the former's flows in presence of Trade facilitation provisions. At the contrary, when Regional Trade Agreements do not contain Trade Facilitation provisions, the trade effect is stronger for final goods. According to the lecture, Trade Facilitation provisions have been effective in boosting trade without diversion effect. In that sense, it appears as a desirable policy option to complement Free trade Agreements in order to counteract declining trend in global trade. Finally, the presentation turned to the determinants of Regional Trade Agreements by assessing the importance of socio-political linkages .Taking the specific example of the Asian-pacific region, professor Innwon Park called for closer political and cultural integration in order to benefit more from Regional Trade Agreements.



Source: Neufeld, Nora (2014), "Trade Facilitation Provisions in Regional Trade Agreements: Traits and Trends," *Staff Working Paper* ERSD-2014-01, Economic Research and Statistics Division, World Trade Organization.

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To conclude, participants asked some questions and made remarks according to the presentations. The possible enlargement of the global value chain process to emerging economies, which are not already integrate (Sub-Saharan Africa, South America, South Asia), could be a mean to benefit once more from vertical specialization according to Masahiro Kawai. This argument is in line with Bernard Hoekman's comment about the potential of Africa. However, Sébastien Jean pointed-up that these possibilities will not find equivalent gains compared to China's integration in GVC. Productivity gains through GVC are faltering because of governments becoming aware of the cost of such organization and a willingness from them to control GVC appears progressively. Moreover, the future expansion of the 3D printing, which has not been addressed during the session, will allocate goods around the world without creating trade at all, as reported by Joseph Francois.

Other factors have been tackled as possible ways to enhance international exchanges. The cyclical factors have been underestimated in the analysis according to Bernard Heckman, for whom investment could be an important part of the story. In that sense, trade flows may recover their pre-crisis growth in the future. He further highlighted the persistence of trade cost nowadays, letting professor Innwon Park insist on the need for a better quantification of them. Hence, speakers discussed the importance of improving the quality of infrastructures, business climate and regulatory coherence.

## SESSION 3 - MONETARY POLICY, GROWTH AND EXCHANGE RATES

Chair: **Zsolt Darvas**, Senior Fellow, Bruegel

### **Chong en Bai, Chair, Department of Economics and Associate Dean, School of Economics and Management, Tsinghua University**

Interest rates in China have been growing steadily since 2009. Labor costs have been growing faster than GDP. As a result, corporate profits have been negatively affected. In the first 8 months of 2015, profits were 8% lower than last year's. In China there is a policy support sector - such as the construction sector, market sector,

If we divide investment in three types: machinery, residential and non-residential. In the first 8 month of this year, infrastructure investment increased 20%, whilst overall investment increased only 10%. The market interest rate is too high, which causes capital inflows and pressures the renminbi to appreciate.

Chinese trade surplus has decreased, going from 9% of the GDP in previous years to 2% last year. Household consumption and income have increased only a bit. This means that there is no way the Chinese economy's growth can be fully supported by household consumption at the moment.

The government has started to reform the structure of investment in China. In this context, the ability to finance infrastructure investment has been constraint since 2014 when the budget law was signed. As a matter of the fact, tax revenue has not increased and government investment is limited. Consequently, activity slows down, and accommodative expansionary monetary policy appears as an option in order to avoid deflation pressure.

### **Michel Houdebine, Chief economist, French Treasury**

#### **Improving global financial safety nets and macro-prudential policies**

We identify a 3-layer approach with ideas coming from G20 Ministers' communiqués and which aims to provide the best conditions for growth and monetary policy action: multilateral global financial safety nets; national macro-prudential policies; fiscal policy and structural reforms.

*"As markets react to various policy transitions and country circumstances, asset prices and exchange rates adjust. **This might sometimes lead to excessive volatility that can be damaging to growth.** While many economies are prepared for this, **our primary response is to further strengthen and refine our domestic macroeconomic, structural and financial policy frameworks. Exchange rate flexibility can also facilitate the adjustment of our economies.** (...) We will consistently communicate our actions to each other and to the public, and continue to cooperate on managing spillovers to other countries, and **to ensure the continued effectiveness of global safety nets.**" (February 2014)*

*"Monetary policies will continue to support economic activity consistent with central banks' mandates, but **monetary policy alone cannot lead to balanced growth.**" (September 2015)*

A lot of instruments were designed at global (IMF), regional (agreements) and national (macro-prudential tools, FX reserves) levels, for improving global safety nets and the international financial system. Nevertheless, we realize they are not properly coordinated nor calibrated. In fact, better monitoring and coordination would avoid situations of insufficient or excessive coverage.

### Combining fiscal policy and structural reforms with monetary policy

The question we should address is the following: how to combine structural reforms with fiscal and monetary policies?

Evidence suggests that the effectiveness of reforms depends on the macroeconomic environment, which can be presented in 3 scenarios:

- Normal conditions: even in these conditions, short-term impact of reforms is not well known, especially on demand.
- Weak demand
- Weak demand and constrained macroeconomic policies (ZLB/public deleveraging)

We are currently on the last case – weak demand and constrained macroeconomic policies. Even though there is no clear-cut result, it seems that this scenario is the most complex to lead reforms. In practice, we should therefore pay attention to: the packaging of reforms and its sequencing by starting with the ones that less hamper demand.

Traditionally, we can identify two helpful channels when leading reforms. The first is to implement other growth-friendly policies (including monetary policy) to go along with the on-going structural reforms. The second is to anticipate future wealth coming from reforms in order to favor wealth effects.

In the current situation policy makers often ask two questions:

- 1) How to choose the packing of reforms given the monetary policy situation?

We observe that structural reforms (i.e. French competitiveness improvement reform) tend to have disinflationary impacts but with a one-off effect on prices. With effective communication, it is possible to disentangle transitory and underlying components of inflation, thus implementing structural reforms that do not affect inflation expectations.

- 2) How to find the best pace for reforms: gradual or frontloaded?

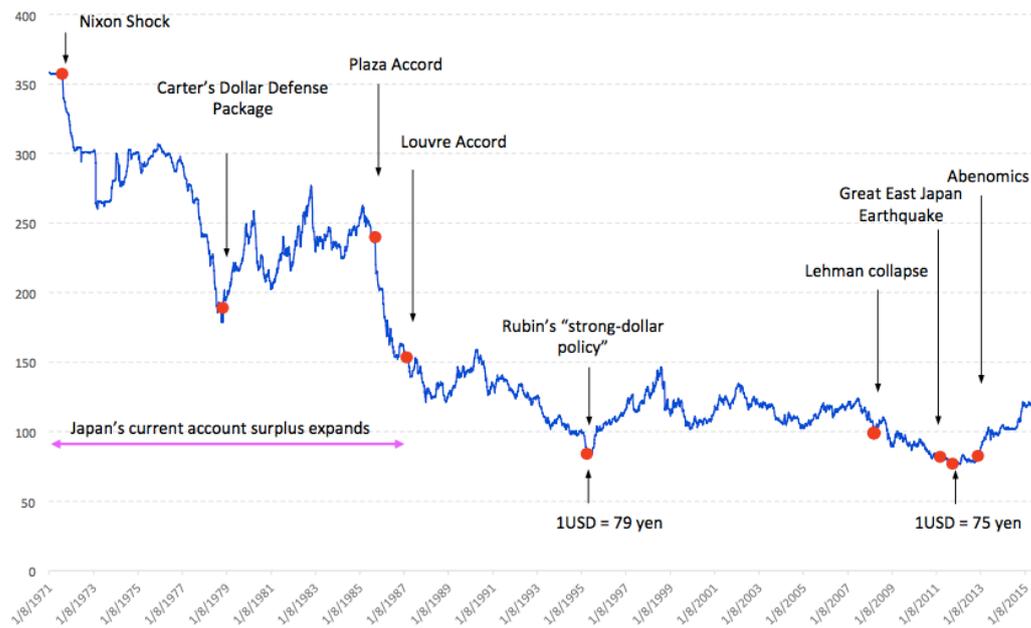
Following the need to well anchor expectations, frontloading a bundle of reforms is supposed to be beneficial for wealth effects. The conclusion seems less clear regarding precautionary effects, which could be related to uncertainty (or even fear). This is specially the case when a lot of reforms are implemented at the same time or if they are not well announced. Here also, communication is the key.

One could finally ask: in the short run, how can policy-makers and central bankers deliver the best policy-mix? It is clear that accommodative monetary policy would help fiscal consolidation (in particular in the case of deflationary pressures coming from spending cuts).

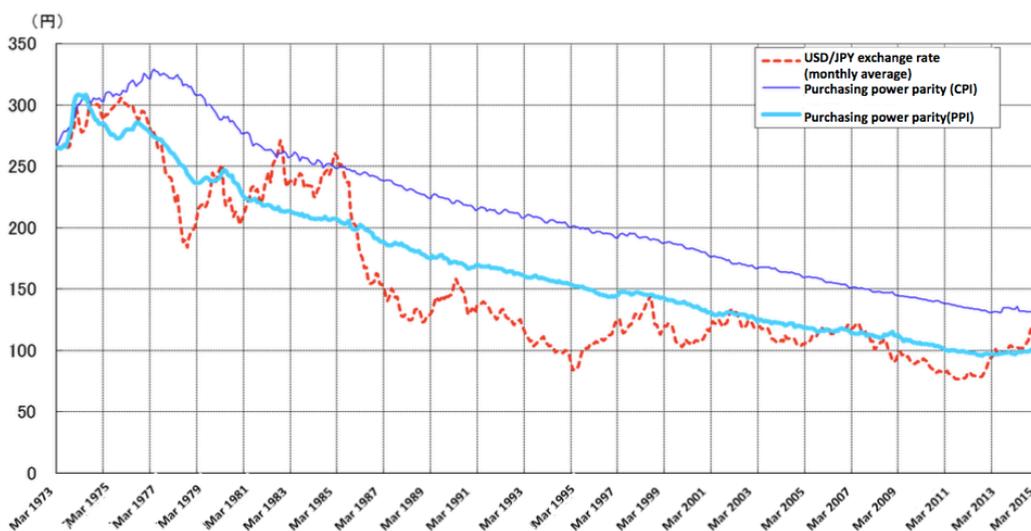
## Kiyoto Ido, Vice Chairman IIES and former Executive Director Bank of Japan

### Trends in the USD/JPY Exchange Rate & QQE of BOJ

Over the last four decades the exchange rate USD/JPY has been showing a downward trend as the JPY appreciates against the USD. In fact, from the early 70's until the late 80's, the Japanese current account has expanded, hence appreciating Japan's currency. After the 90's this appreciation trend becomes steadier with the USD/JPY oscillating between 150 and 75. The following graph illustrates the USD/JPY exchange rate evolution and indicates major historical events that affected its course.

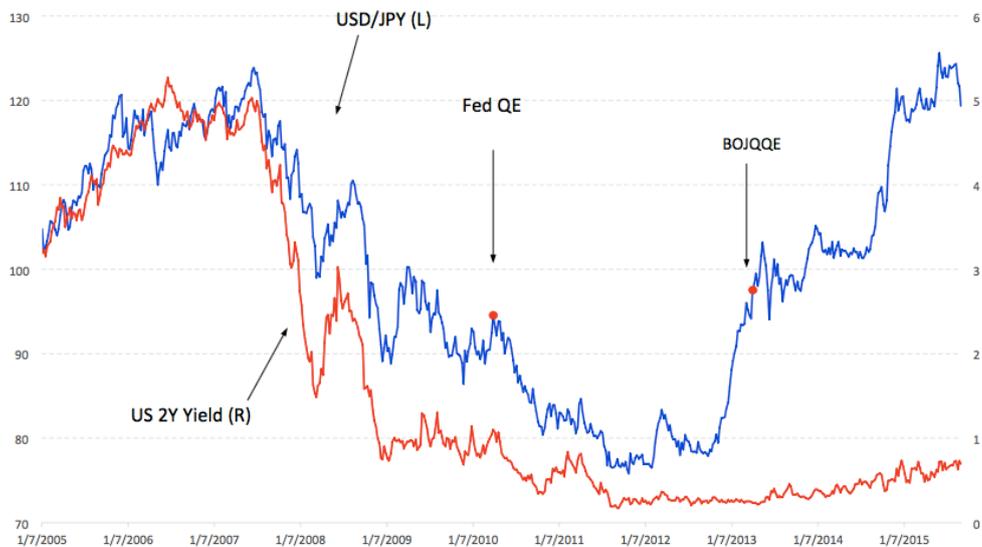


Furthermore, we observe that the USD/JPY is usually beyond the PPP CPI and the PPP PPI, suggesting the currency is somewhat undervalued.

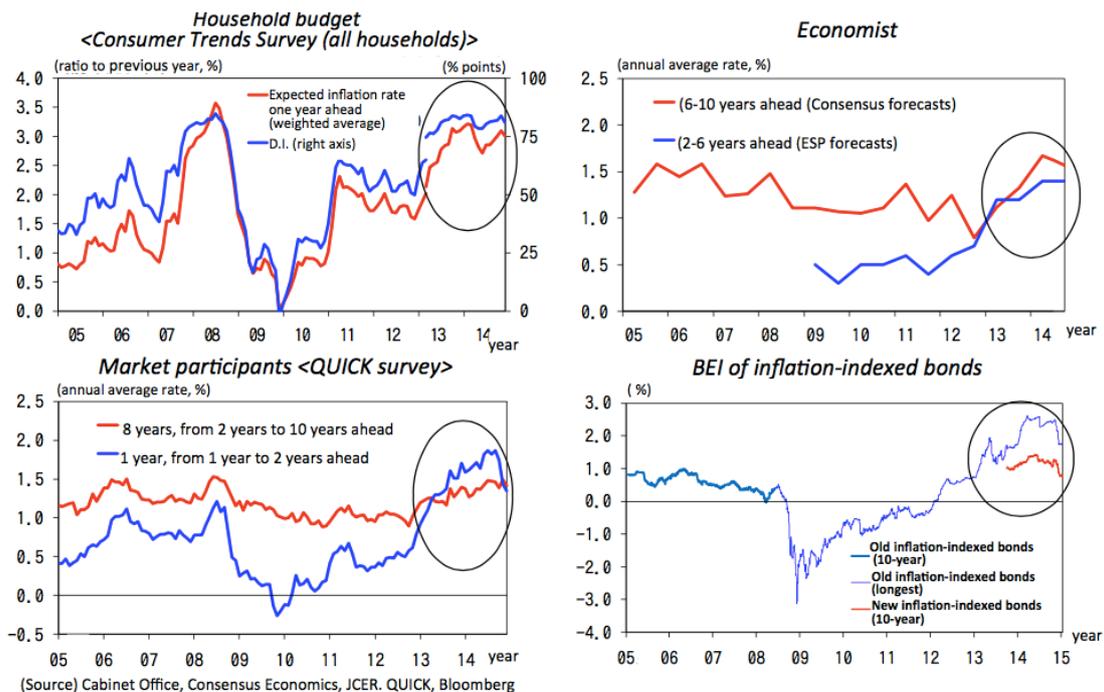


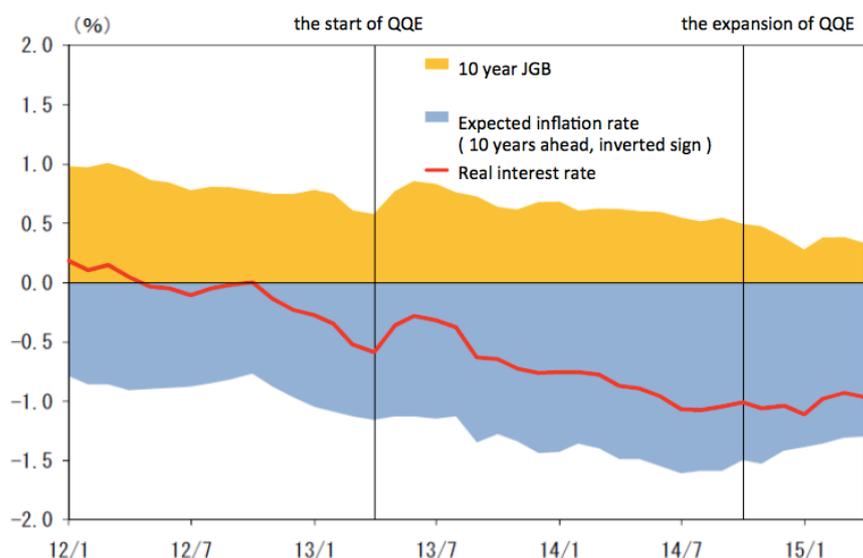
(Source) Consumer Price Index (CPI): Ministry of Internal Affairs and Communications of Japan; US Department of Labor; Producer Price Index (PPI): Bank of Japan, US Department of Labor; USD/JPY exchange rate: Bank of Japan  
 (Notes) Based on monthly average exchange rate for March 1973 (265.3 yen per US dollar)

Until the Fed QE, as the graph below shows, the US two-year treasury notes yield and the USD/JPY exchange rate tended to commove.



The US and Japanese monetary easing lower real interest rates through different mechanisms. In fact, the US quantitative easing pressures down the nominal interest rate, whilst the Japanese quantitative and qualitative monetary easing (QQE) exerts upward pressures on the expected inflation rate. The graphs below compare different surveys on the expected inflation rate for the Japanese economy. In fact, expected inflation rate has been increasing after the expansion of the QQE.





Finally, the table below gives us an overall comprehension on the effects of the QQE for the Japanese economy.

(Changes in financial economic variables from 2013/1Q to 2014/4Q)

	Macroeconomic model-based estimates		Performance
	[Estimate 1]	[Estimate 2]	
<b>Real interest rate</b>	- 0.8% Points	- 0.8% points	[ Up to -1% points ]
<b>Equity Indices (TOPIX)</b>	+ 18%	+ 40%	
<b>Currency exchange rate (dollar/yen)</b>	+ 8%	+ 25%	
<b>Supply-demand gap</b>	+ 1.1% points	+ 3.0% points	+ 2.0% points
<b>CPI, (YOY) (less fresh food)</b>	+ 0.6% points	+ 1.0% points	+ 1.0% points
<b>Employee wages</b>	+ 2 Tril. yen	+ 5 Tril. yen	+ 6 Tril. yen
<b>Corporate income</b>	+ 4 Tril. yen	+ 9 Tril. yen	+ 12 Tril. yen

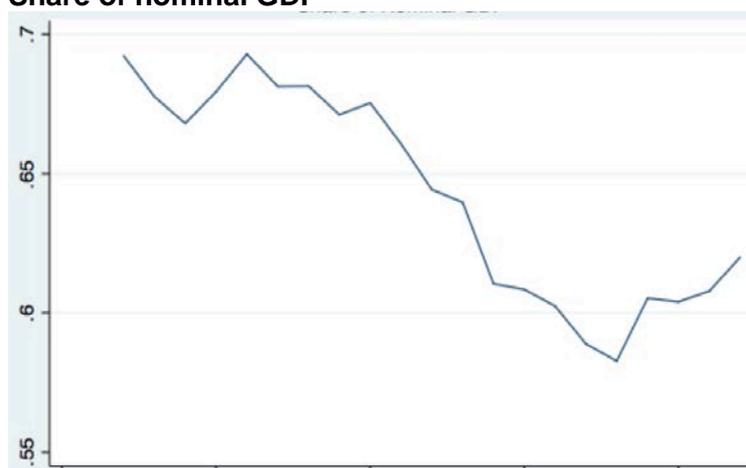
**Keyu Jin, Lecturer in Economics, London School of Economics**

In response to the financial crisis, the Chinese authorities have adopted an aggressive stimulus package. Since November 2014 the Chinese Central bank has already cut interest rates four times and is expected to cut interest rates further. Additionally, China has had an active fiscal policy and credit expansion in the last few years as a way to counter the slowing external demand from the rest of the world. It is important to analyze the effectiveness of these policies.

In China, credit is often directed to large companies and state-owned enterprises, which are inert to changes in the interest rate. Small and medium sized companies, however, are severely capital constrained being sensitive to higher borrowing cost. This financial market distortion combined with a lethargic business environment creates a deep disconnection between credit in the financial system and how it is channeled into the real economy. Consequently, loose monetary policy may not work that well in China, and may be doing the opposite of what is supposed to do – that is, to lower the effective cost of capital to firms, and to raise producer price inflation.

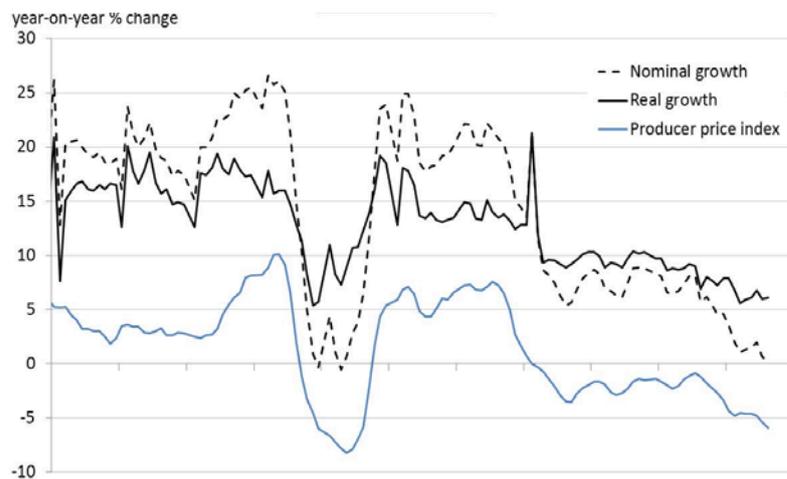
Two aspects of the Chinese economy make it somewhat different from others in their responses to monetary policy shocks. The first is related to the Chinese households. In the past few years, inflation expectations have been catching up. In response to expected inflation, rather than raising current consumption, the Chinese households are saving more to protect against expected decline in their purchasing power.

### Share of nominal GDP

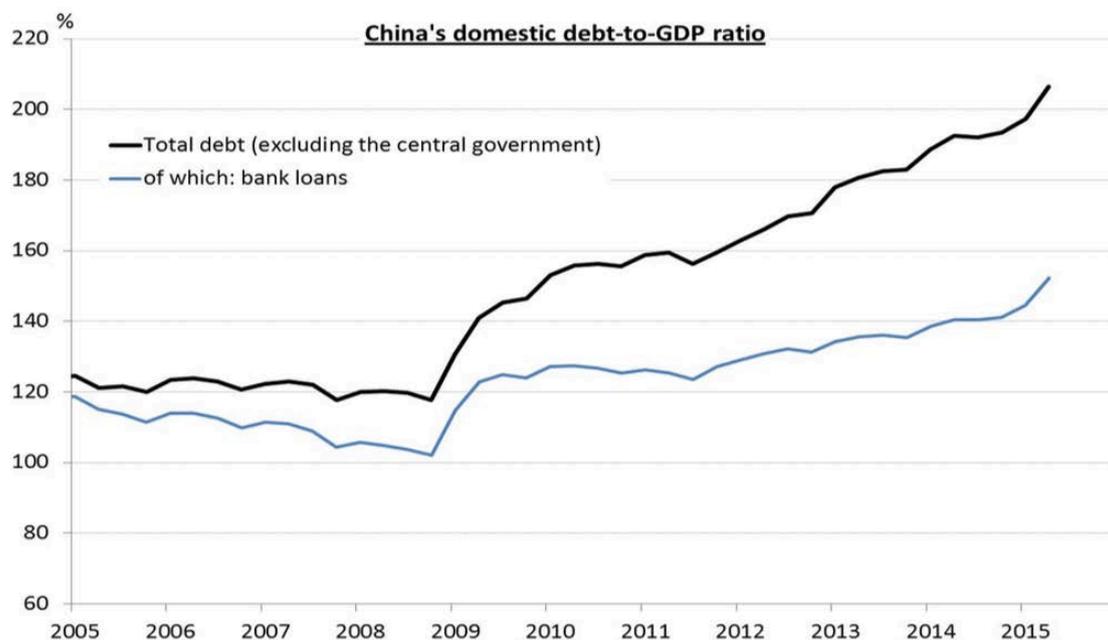


They are also concerned about old-age resources, as they have fewer children to provide support with China's strict fertility policies. Wealth accumulation and the search for high rates of return have thus become a primary goal. With long periods of financial repression, where the real return on deposits have been near zero, Chinese households are shifting their saving out of bank deposit into equity markets and trust funds.

So the result of an easy monetary environment is not to raise product price inflation but higher and higher equity and property prices. In fact, producer prices have been slipping continuously for more than three years on end. The producer price index (PPI) after a 41 months straight fall has reached its lowest level since October 2009. Falling producer prices harm corporate profits, which further exerts pressure on Chinese firms.



Additionally, capital has flown towards financial markets rather than the goods market, and consumer inflation has also remained at 1.6 percent. Thus, the assumption that expansionary monetary policy can induce higher consumption by Chinese households reflects an oversight that inflation expectations are catching up in China. In fact, domestic debt levels have steadily increased since 2009.



The second factor relates to the dynamism of Chinese firms. The original aim of the stimulus was to lower the effective cost of capital for private enterprises – small and medium sized companies that need the capital. But in fact, the opposite may be occurring – with the effective cost of capital rising rather than declining. First, the search for yield in the economy, as well as the gradual withdrawal of deposits from the banking system by the Chinese households, has exerted upward pressure on financing costs. Second, large enterprises with sizeable collaterals can obtain bank loans but meet difficulty in finding good investment opportunities, and therefore channel credit through the shadow banking system to lend to small and medium sized firms at high interest rates. And because the firms are facing increasing profitability problems with the sluggish economic environment combined with producer deflation, default risk is on the rise.

The easy monetary environment may mean that much of the credit is bottled inside the financial sector: banks are not eager to lend with the accumulation of bad loans and because companies are perceived to be risky in the current economic environment. In order to preserve shareholder value, they have channeled much of the funds to the equity markets and trust funds. Very little of the credit actually flows to the real economy.

The distorted financial market has created a vicious loop. As private firms face severe financing constraints, borrowing at high interest rates and often short-term, they are perceived to be even more risky by banks – which slap on an additional risk premium and in turn raise their borrowing costs further. The consequence is that rather than lowering the effective cost of capital for the small and medium sized firms that would benefit the most from funds, the opposite is effectively happening.

The disconnection between the financial sector and the real economy significantly hampers credit flows and much of the intended objectives of monetary policy. Chinese enterprises, in an increasingly difficult business environment, are turning to investing in the financial markets as a primary activity rather than focusing on their core business. But the lack of economic fundamentals underlying a high equity market valuation supported by leverage is unsustainable and cannot be a reliable source of profit – neither for Chinese firms nor for the households.

The vicious cycles and key distortions are at the heart of the problem. And it is not something that a stimulus-driven environment can do much to help, not least because it may not have the benefits it intends to deliver, but especially because it may be doing just the opposite. Structural reforms are ultimately the necessary preconditions to make monetary policy more potent at a time when China needs it most.

## SESSION 4 - THE ECONOMICS OF CLIMATE CHANGE AHEAD OF COP21

Chair: **Andreas Esche**, Director, Bertelsmann Stiftung

### **Thierry Schwarz (Department Director, Asia-Europe Foundation)**

The main role of the Asia-Europe Foundation (ASEF) is to involve governments, Civil Society Organizations (CSOs), businesses, cities... in a debate to facilitate a political consensus between Asian and European countries on global issues. On climate change issues, the Asia-Europe Foundation has undertaken a program together with the Asia Centre, organising a series of events in China (on coal and climate change), Kazakhstan (sustainable use of oil) and Thailand (in Bangkok, on climate finance), culminating in an Asia-Europe pre-COP21 conference in Paris at the end of September.

### **Mitsutsune Yamaguchi (Special Advisor, Research Institute of Innovative Technology for the Earth)**

The so called “2 degree target” is mainly political and aims to limit global warming to less than 2 degrees above pre-industrial levels. As outlined in the 5<sup>th</sup> Assessment Report made by the Intergovernmental Panel on Climate Change (IPCC), reaching this target requires countries to achieve net zero emissions, implying de-carbonisation, i.e. negative emissions, by the end of this century.

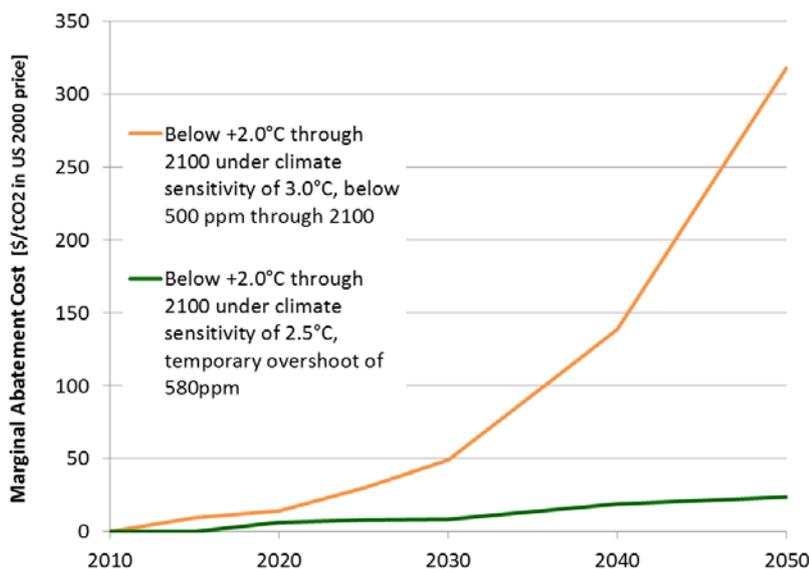


Figure 1: Marginal abatement cost and climate sensitivity  
Source: Research Institute of Innovative Technology for Earth

One of the main questions linked to this target is the discounting of climate change damages. How can we share responsibilities between the present generations, who bear the costs, and the future generations, who will benefit from the efforts made by the previous ones? Article 2 of the UNFCCC specifies that the greenhouse gas (GHG) concentrations should be stabilized at a level not dangerous for ecosystems and food production but also not dangerous for the economic development. But the estimated costs to achieve the two degrees

target are very large: they have been calculated as 4.8%–3.8% of global GDP in 2100, under ideal conditions (i.e. all countries participating, uniform carbon tax all around the world, and all technologies made available), meaning that actual costs will be likely higher.

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Nevertheless, a large uncertainty surrounds these cost estimations. One of the main sources of uncertainty is the value of the equilibrium climate sensitivity (ECS). The ECS is defined as the response of the global temperature given a doubling of the concentration of carbon dioxide in the Earth's atmosphere. The coming negotiations in Paris are based upon an estimation of ECS that ranges from 1.5 to 4.5°C. Though a "best estimate" within this range was not shown by the IPCC because of the disagreement among experts, IPCC used 3°C in its calculation. But ECS has a great impact on emissions trajectory to achieve the agreed goal. With an ECS of 3°C (best estimates of the ECS proposed by the previous IPCC report in 2007), for example, there would be a significant gap between projected GHG emissions from the submitted Intended Nationally Determined Contributions (INDCs) and the GHG emissions that would be required to achieve the 2 degree target. On the contrary, under an ECS of 2.5°C, the two degree target is still within reach with the present INDCs. Furthermore, as shown in Figure 1, the marginal abatement cost would amount to \$318 per additional tCO<sub>2</sub> in 2050 under an ECS of 3°C, whereas under an ECS of 2.5°C, this cost would be dramatically lower, at \$24.

To sum up, policymakers should be made aware of the huge uncertainties surrounding climate change, especially in climate sensitivity, and that a 2 degree target is still plausible, in particular if the climate sensitivity is below 2.5°C. During the UN Climate Change conference to be held in Paris in December 2015, it would be important to reach a "strong weak agreement" rooted in realistic feasibility rather than "weak strong agreement". To pursue a "strong strong agreement" may bear the risk of ending up with the collapse of negotiations. The role of the scientific community, moving forward, should be to narrow the uncertainty in measuring ECS.

#### **Discussion with Panel Chair:**

The issue of responsibility in climate change emissions is complex. For example, the share of greenhouse gas emitted, and therefore the burden of each country, is not the same whether the base year considered for calculations is 1990 or 2000, the emissions of China increasing in the last years. Common but Differentiated Responsibility (CBDR) is a real issue that we cannot ignore. Developing countries argue that it is the responsibility of developed countries to tackle climate change. However, to achieve a 2 degree target, developing countries would need to reduce their emissions by 70%; as a consequence, every country should cooperate in mitigation.

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#### **Guntram Wolff (Director, Bruegel)**

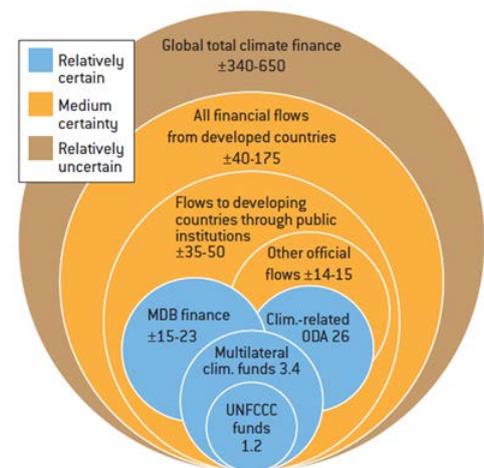
There are two key points to take away with regards to the EU and climate finance. Firstly, it is in the interest of the EU to reach a strong deal in COP21. Secondly, EU investment in climate finance would make such a deal more likely.

It is important to note that climate change is already affecting our environment, and that most of the observed increase in global average temperatures is very likely to be a result of anthropogenic increase in greenhouse gas concentrations. To address climate change, both adaptation and mitigation are needed. Adaptation is essentially dealt with by national policies whereas mitigation needs global coordination. Indeed, without an agreement where all countries participate, general equilibrium effects would lead to a situation where any reduced consumption of carbon would have a

downward impact on the price of carbon, leading to an increase in the quantity of carbon consumed and emitted by non-participating countries.

To achieve the 2 degree target, global emissions need to be drastically cut in order to reach a CO<sub>2</sub> concentration in the atmosphere of less than 450 ppm. This goal requires the total decarbonisation of our economies by the end of the current century and, therefore, a complete change in the investment profile, with an increase, for example, in green infrastructure, energy production sites, clean vehicles, etc. The International Energy Agency (IEA) estimates that the investment needed in the next 20 years in favour of energy supply and energy efficiency amounts to USD 53 trillion. Most economists agree that appropriately pricing emissions (carbon pricing) would be the most efficient way of achieving decarbonisation. Then, part of these resources could be channelled to climate finance.

Climate finance is the financial flow that is targeted at mitigation or adaptation in developing countries. In the Conferences of Parties (COP) held in Copenhagen and Cancun, parties agreed that developed countries would contribute USD 100 billion per year by 2020 to developing countries. Total international climate finance can play an important role in the ongoing climate negotiations, since its potential amounts are significant (see Figure 2).



International climate finance, \$ billions  
 Source: Bruegel based on OECD (2015) and Standing Committee on Finance (2014).

Why should the EU contribute to climate finance?

1. Without a global agreement, existing EU climate policies (the Emission Trading Scheme as well as national schemes), which represent large amounts of money, are futile. In 2013, the EU spent EUR 14 billion in climate-related Official development Assistance (ODA), and in 2014, EUR 5 billion in public R&D to generate low-carbon energy. If the EU were to establish a feed-in tariff on green energy and committed to keep the tariff for the next 10 years, this would accumulate to roughly EUR 10-70 billion. Without a global agreement, these efforts will be ineffective in fighting climate change since, as shown before, a global approach is needed.
2. Climate finance is the best EU bargaining chip in the international negotiations. Indeed, EU is a small player in climate change (in 2012, its emissions represented 11% of global emissions) while a global deal needs the participation of developing countries. Then, supporting and contributing to climate finance in order to provide predictable future finance flows to developing countries would increase the incentive for them to commit.
3. Climate finance can make decarbonisation cheaper. Abatement costs are much lower in developing countries. Then, if subsidies for the deployment of low carbon technology were used in Africa, rather than in the EU, there would be a larger benefit on decarbonisation, as the marginal effect for each Euro invested would be much larger in Africa.

It is also important to note that the EU has competitive advantage in low carbon technologies. If there is a global agreement, important choices about standards and systems will need to be made. Cooperation among EU countries will make it easier to take some European standards globally.

Given the fact that it would be beneficial for the EU to contribute to climate finance, what kind of resources could be generated? One way would be to allocate a fixed proportion of the ETS revenues to climate finance. Another source of funding may be to apply a carbon tax on sectors currently not covered by the ETS.

**Discussion with Panel Chair:**

Mr Wolff is sceptical about the ability to reach a serious deal in COP21 and to decarbonise our economies the way we need to in order to achieve the 2°C target. Moving forward, adaptation, endurance and geo-engineering should be the priority areas.

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**Bjorn Conrad (Associate Vice President for Research & Director of the Research Area on Innovation, Environment, Economy – Mercator Institute for China Studies)**

China is a crucial player in addressing climate change. There are three main questions that should be asked regarding China and its position in climate change discussions.

*Given the recent good media on China's efforts in addressing climate change, is China turning around and embracing environmentalism?*

Media depict China as changing its strategic position towards climate change mitigation. They have widely commented the big US-China climate deal in November 2014, the submission of Chinese INDC to prepare Paris conference to be held in December 2015 and Xi Jin Ping's visit to the US in September 2015 to discuss cooperation in climate change. There is also the 2017 plan for a national carbon cap and trade system. In the media, it makes for a nice story that "China is turning around." However, Mr Conrad would argue that China's climate change policy has been consistent for the past 15 years. Chinese had a gradual, determined attitude towards climate change since Hu Jintao. The country has considerable renewable energy capacity, energy efficiency, clean technologies, and research on reducing CO<sub>2</sub> emissions. China has also experimented innovatively with market-based mechanisms (including carbon trading and tariffs). What is new is China's willingness to put these national targets into an international/bilateral framework. However, it is important to note that China is not making international commitments, then changing their national policies. They will always make commitments that align with their own prior national policy agenda.

*In the light of past trajectories, how credible are the commitments that China is making lately with regards to climate change?*

They are credible – the reason for that is because China's climate change policy is very little about climate and very much about economic and investment opportunities. The structural policies of China to shift towards a more value-added, consumption-driven growth model have positive outcomes in terms of climate change. The transition to less energy-heavy industries has a positive effect on global warming. Increasing renewable energy capability creates a fantastic market for high value-added technology. Transitioning towards high-tech and service industries is not necessarily only done to reduce CO<sub>2</sub> emissions, but also to move to a higher labour cost economy. China's climate change policy has been intricately embedded into its economic long term strategy. They are almost indistinguishable.

*Are China's international commitments going to be credible given the economic environment that China is entering into (i.e. lower economic growth)?*

First of all, when investments go down and capacities are shrinking, this leads to lower CO<sub>2</sub> emissions. Low economic growth is always good for the climate. But the main question is how will China address a prolonged downturn in its economy? There are two possible scenarios to consider. In the first scenario, the good one, China's government reacts by pushing reforms towards more sustainability and channelling stimulus policies into clean production. But this scenario is not very likely to happen as its gains would not be immediate – for example, the issue of unemployment would require faster action. The second scenario would consist in stimulus policies that, in the next couple of years, go into infrastructure and heavy industry, which could address growth and employment quickly, but would have a very bad carbon impact. China's course of action in the next few years will probably be somewhere in between these two scenarios.

#### **Discussion with Panel Chair:**

China has done one thing better than EU with regards to the carbon trading system: China has the guts to experiment. China has launched 7 different pilot programs in a number of provinces. This element of flexibility, adaptation and adjustment is important to creating market-oriented mechanisms for carbon trading. For example, Chinese authorities noted that their feed-in tariff rate for renewable energy was miscalculated, which was met with quick response to adjust the rate.

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#### **Jean-François Di Meglio (President, Asia Centre in Paris)**

##### *Short response on China*

Even though the fact that the second scenario concerning Chinese response to a lower economic growth is 60-70% probable is a concern, Mr Di Meglio considers that China has the ability to run the middle-of-the-road approach and is confident that balance will prevail. He disagrees that China has always had strong climate change policymaking because China couldn't have achieved such rapid urbanization with such policymaking.

It is important to identify the usual gap between the federal and provincial level as a limitation to the move to a cleaner energy mix. For example, wind farms need a good coordination between the local level and the centralized state energy grid, difficult to manage. Indeed, a traditional power plant is needed to send power into the grid when wind falls. As a result, notwithstanding the large number of wind farms built in China, renewables do not work well.

##### *Climate Finance*

A whole turnaround of the financial world is needed to achieve our goals for climate finance. The annual needed global investment to be "green and resilient" amounts to USD 16 trillions. We have enough money in our financial system to reach this target: the issuance of bonds alone accounts for USD 100 trillion in financial assets. But the financial system is not geared to use this money towards climate change. Then, the question is "How to change our financial system?" Carbon markets and the clean development mechanism (CDM) can work but we failed to bank them. Indeed, markets currently do not incentivise greater ambition and opportunities for investment in green growth.

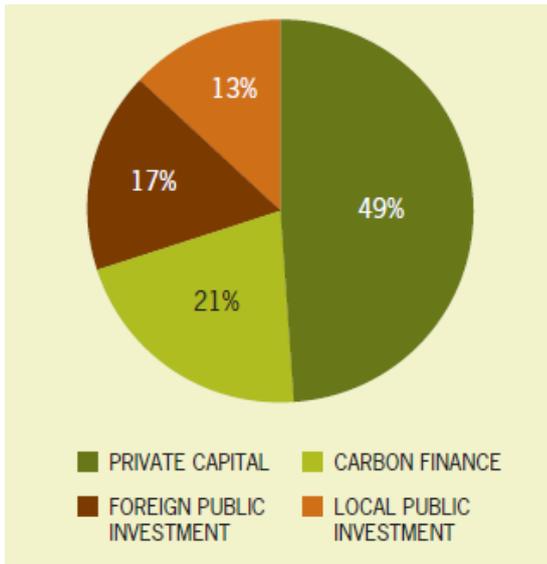


Figure 3: Origin of capital financing in World Bank CDM projects  
 Source: World Bank, 2010

More narrowly speaking, “carbon finance” is defined as credits in clean project mechanisms and green bonds. This can come either from markets regulated by public bodies or from “voluntary markets,” which are commitments by sectors, corporations, or individuals to reduce their emissions. Private capital already plays an important role: for example, for the last 10 years, CDM projects in the World Bank were funded, for the most part, by private capital from voluntary markets (see Figure 2). Then, given the importance of private capital in climate finance, it will be important to set up the right mechanisms within the financial system to incentivise private investment in green technologies.

It is also important to consider carbon finance as an “enhancer” for the rollout phase of clean technology. Specifically, CDM can facilitate investment in green

technology but the investment conditions external to carbon need to be favourable for businesses and relevant stakeholders to integrate this technology into their own operations.

Moving forward, short-term actions to make carbon finance more viable will be to simplify and standardise CDM processes and rules, in order to reduce transaction costs due to financial, technical and regulatory barriers. In the long term, markets need to be set up to create robust, reliable demand for green technology. Countries should be aware that after COP21, they will need to revisit climate finance. The real agreements will be reached in the financial world.

## Questions from the Floor

### Mitsutsune Yamaguchi - absence of cap and trade system in Japan

How successful was EU’s ETS? To achieve the 2°C target, it would never be enough. We definitely need technological innovation to achieve this target. The Japanese pledge now is that the carbon price does not rise to more than \$300 in 2030. Presently, low priced carbon can be bought on carbon markets. But if we want long term prosperity, rather than buying lower priced carbon, Japanese companies themselves need to develop their own clean technology, for which they, at least partially, still have the economic incentive to develop. Indeed, Japan’s energy efficiency is one of the highest in the world.

### Guntram Wolff – private funding in climate finance, and the EU’s ETS

Private funding is determined by return on investment. If you look at the main issue, you need 53 trillion in terms of investment for decarbonisation. Under what conditions will the private sector invest in green energy? I would say that private investment would flow in only if there is a serious credible commitment by the global community to price carbon.

The current ETS price allowances are so low because the markets don’t believe in the current European commitment of a downward path in carbon allowances in the coming years. As a result, the

effective private consumption and investment patterns have not changed. The same thing can be said about investment in green engineering and adaptation.

### **Jean-François Di Meglio**

Concerning the absence of cap and trade system in Japan, it is worth noting that Japan was able to adjust post-Fukushima with tremendous energy savings.

As far as climate finance is concerned, public-private partnerships are the way to go.

Concerning China, the problem is that, as in many issues in climate finance, you don't have the right references and benchmarks to assess whether the public sector will commit and whether the private sector will get sufficient return on investment.

### **Bjorn Conrad – effectiveness of Chinese policymaking**

The very thing that makes China's efforts in climate change also serves as a hindrance. Namely, economic issues will always outweigh climate change issues. Intensity targets and peak targets in China are still far away from what we would need from China to prevent dangerous climate disruption. Measuring, reporting, and verification (MRV) issues are also enormous in China – due to this, China's cap and trade system probably won't work out quickly. But things are probably changing and environmental targets becoming more important. For example, in Chun Qing, efforts to build a hydropower plant near the river had been stalled for a considerable amount of time, due to the fact that it didn't pass the environmental safety test.

## SESSION 5- IS THE MULTILATERAL SYSTEM COLLAPSING? – PUBLIC

*Chair: He Fan, Deputy Director, IWEPI, CASS*

### **Kyung-wook Hur, Visiting Professor, KDI School of Public Policy and Management**

During the 2010 G20 summit in Korea, the Korean government created a research group to propose a global governance reform consistent with the new globalized economy. Global governance can be conceptualized in terms of two structures, the superstructure and the infrastructure.

- The superstructure is composed of major economic players. We defined these economic actors as those whose decisions independently affect the global stability and the global economic development. Europe, China and the US fell in this category, they constitute the core of global governance by determining its structure and its decision making process.
- The infrastructure is composed of numerous multilateral institutions. In this category fall institutions like the IMF, the WTO and the G7 and numerous multilateral agreements. They constitute global governance in a broad way.

It was beyond our ability to deal with the profusion of these types of institutions, we thus decided to focus on multilateral institutions as bureaucracy of the superstructure of global governance. The G20 appeared to be the premium institution of global governance. We focused our analysis on the bureaucracy of the G20. The quality and role of the institutions constituting the operating arms of the G20 must be improved and expanded along three axes:

- Independence
- Accountability
- Transparency

We also emphasized the necessity to democratize these institutions by including emerging countries in their decision making process.

Specifically, we recommended the creation of a secretary for coordination of monetary policies which would exist inside the G20. To monitor every international institutions' activities to achieve coordination, we proposed to split every institutions in terms of the field they are operating in to facilitate coordination. The secretary would engage in macroeconomic policy assessment and propose arrangement for financial stability. Korea was only able to recover after the 2008 crisis thanks to a 30 billion currency swap from the FED, the moment the swap arrangement was announced, the market was reassured and investors decided to stay in Korea thereby stabilizing domestic financial markets and the exchange rate. The secretary would be able to create this kind of safety arrangement.

Surprisingly, the FED rejected our proposition arguing there was no need for a safety net as long as national economic policies were properly managed; therefore it was decided not to create neither the safety net nor the secretariat. Nonetheless, since 2010, the fact that the G20 listened to our idea helped a great deal in stabilizing financial markets and increased the probability of central banks cooperation.

Eventually, the globalized economy will need global institutions: a global central bank, a global financial regulatory authority and many else institutions in other fields. The system we have does not work properly, we need to improve our institutions and I hope our proposition will eventually be taken into account.

### **Francesco Giavazzi, Professor of Economics, Bocconi University**

The multilateral system calls for more international policy coordination. The current system creates many negative demand externalities which are at the core of macro issues and need to be taken care of. Some countries rely too much on net exports which is to say demand coming from abroad. US consumers were the engine of growth before the crisis. When they stopped consuming, it put an end to world growth.

We must try to do what has succeeded during the G20 summit of London. Countries then decided they needed an expansion of domestic demand. Worried that some of them would play the free rider game, they all committed to expand fiscal policy at once, and they almost all delivered. It was a unique situation in 2008, we no longer have the incentives to coordinate. It is worrying that the chairman of the US gave so much relevance to the exchange rate in her remarks when she explains why the lift off had been postponed, implying that even for the US net exports are important despite their strong domestic demand and their relatively closed economy.

China has been trying to rebalance its economy towards consumption but has not managed to do so yet. Germany still opposes the expansive fiscal policies Europe needs. How will we convince China and Germany to do more to spend on domestic demand? We have a unique opportunity to solve the current lack of global demand: the refugee crisis. China and Germany have the same problem: demography. Their population are both reaching an age in which the propensity to save is the highest, this phenomenon weighs strongly on domestic demand. Migrants are the obvious solutions: they are usually young people in their 20's with low propensity to save. By assimilating migrants in their population, Germany and China could rebalance their demography and structurally increase domestic demand.

Germany and China could also solve their lack of domestic demand via investment. Investment in infrastructure appears to have very low effect on potential output, by contrast investment in human capital gives high return to investment. Investing in human capital would be a good way to increase consumption in the short run and potential growth in the long run. Here again, the refugee crisis creates incentives to invest in human capital.

Global demand imbalances are mainly generated by demographic factors, fortunately, the migrant crisis will force us to address the problem, and the humanitarian aspect of this crisis might create the incentive we need for these governments to open up their borders.

### **Bernard Hoekman, Director of Global Economics, European University Institute (EUI)**

There has been a lot of change lately, we've witnessed a substantial increase in the volume of trade partly due to the integration of Eastern Europe and China into the world economy and partly due to a huge policy shift towards liberalization. As a result of that and in conjunction to technological change we've witnessed the rise of global value chains. By providing a rule based system and a framework for trade and investment the GATT and then the WTO have

played an important role in supporting this process. China integrating the WTO was also a huge achievement for the system.

However, nothing has happened in the WTO since 2001, in part due to the fear inspired by the success of the Chinese economy. There has been a change in how governments view globalization and this has reflected in the WTO's functioning. It is now very hard to pass an agreement in the framework of the WTO. Countries have thus turned towards mega regional agreements like the TPP, the TTIP and the RCEP. Much uncertainty surrounds these agreements: How are they going to relate to each other? Are there going to be building blocks? Given the sclerosis of the WTO, can these agreements fill the gap and be multilateralized? There are no guarantees that these agreements are going to be successful: in these framework, rules are often non-consistent like in Korea where rules signed with the US overlapped rules signed with the EU.

There is a revealed preference from governments to act in smaller clubs. However, there is significant scope to act within the frame of the WTO, so why are these treaties not under the umbrella of the WTO? Multilateralization in the WTO can go through two types of agreements:

- Critical mass agreements, a number of countries come together, agree on a subject and then apply whatever they have negotiated to the rest of the world who can just free ride. This type of agreements can work well but it's limited to market access measure. This has not been used for rules that apply on a most favorite nation basis. Lawyers have written these kind of agreements in a way that make those difficult to use in practice however.
- Plurilateral agreements. This allows signatories to discriminate against non-signatories. A group of countries can sign an agreement within the framework of the WTO without having to open to non-signatories countries. As they are signed under the umbrella of the WTO, these agreements have significant advantages, they are more transparent and negotiated in a way that keep the non-signatories informed. The mega agreements currently being negotiated do not display these advantages. They could be negotiated within the WTO framework to gain positive spillovers and to create the opportunity for other countries to gradually join.

Why do countries then prefer to negotiate outside of the WTO? There is a consensus constraint in the WTO, all members must agree to an agreement even if not concerned by it. Plurilateral agreements are heavily constrained by this requirement. To promote multilateralization this particular constraint has to be overcome. This constraint was created because countries were worried they could be affected by negative externalities from agreements between other countries. Creating a code of conduct that actually deals explicitly with these types of concerns could help unlock this constraint.

Another necessary condition to do more within the WTO is to facilitate the scheduling of these type of agreements. The WTO inherited the GATT legal text which does not allow for this type of cooperation to occur. The services agreement that was negotiated in the Uruguay round when the WTO was created actually does that, this need to be implemented in the WTO.

The lack of leadership in the WTO is the last difficulty that needs to be addressed. One country has to take the lead and try to move away or complement what is happening through the mega agreements. It's certainly not going to come from the US, Brazil or India. Asia and the EU should do more in the WTO along these lines and focus on these issues. Countries that have acceded to the WTO after 1995 also have interest in doing this. Newcomers in the WTO have made huge institutional investments in order to be accepted. It is a mystery that these countries do not take a more pro-active role in the WTO, the attitude of China in particular is puzzling.

There is also a big gap in the actual trading system on polylateral agreements. We have seen one example of this in the WTO: the trade facilitating agreement, a number of important innovations have been made creating common rules on trade facilitation. But governments had a lot of flexibility in implementation, being able to decide when to do what. Again, leadership is needed to push these kinds of agreements. Most of these polylateral agreements are not taken at a global level although the WTO creates the incentive for this kind of cooperation. Allowing the private sector and the regulators to opt-in in these negotiations could increase incentives to negotiate these agreements within the WTO.

The shift we observe to mega agreements is dangerous, the WTO should be the institution in which plurilateral and polylateral agreements are signed. Ultimately, the WTO will need leadership and I fail to understand why we don't see more efforts being made by the excluded states and the states that have the most interests in this.

### **Jean Pisani-Ferry, General Commissioner, France Stratégie**

Is the coordination problem we have based on the obsolescence of models underlying negotiations? The backbone of negotiations are procedures and institutions which date back to the 40's. The transformation of global interdependence raises the question of the ability of the existing framework to adapt.

The underlying model for the trade system is the HOS model. Countries negotiate on a multilateral basis to lower tariffs in order to increase trade. Here negotiations are very adequately done at a multilateral basis because this is a very simple framework which only has a few objectives like the level of tariff.

The way we see world trade today is very different because of the rise of global value chains. It has become increasingly hard to identify offensive and defensive interests of each country. The subject of negotiations is no longer tariffs but standards and other dimensions which are hard to deal with in a multilateral framework. Bilateral negotiations have filled the gap, they enable to discuss a wider scope of integration measures but at the price of a narrower geographical scope. Can these bilateral agreements be multilateralized? We do not yet have a structure for holding such discussion at a multilateral level.

If we turn to macro financial interdependence, the basic model underlines the importance of the exchange rate: interdependence occurs through trade and net capital flows, this is very much the model the IMF has been relying on. This model failed to see the risk to stability arising from stock interdependence between the EU and the US which triggered the crisis. It also failed to see that despite the absence of an exchange rate, there was a risk to financial stability created by capital flows inside the EU area.

Our vision of the world strongly depends on the model we use: the Mundell-Rogoff model sees the world in term of flow independence and emphasizes the role of the exchange rate while the Rey-Shin model focuses on gross flows and stock interdependence. The two models provide quite different views about what matter and on the policy actions that would have to be followed. In 2002, Obstfeld and Rogoff wrote that interdependence was quite limited, coordination was desirable but not seen as necessary as countries could address all problems within the scope of domestic policy. In contrast, the last IMF spillover report put the emphasis on the massive importance of coordination because of the strong externalities of countries domestic policies on their partners. The structure of international discussions will be determined by the model we will choose much more than by doctrinal considerations.

On world climate, the problem is different because we did not have any model on the subject of global public goods in the past. Climate is a true global public good, it needs to be completely global. We lack models to address the problems of the sort, the Kyoto protocol and then Copenhagen made an attempt to create a binding framework based on quantity, but the geographical scope did not correspond to the contribution of each country to climate change and it eventually was a failure. The Kyoto protocol also failed to address equity problems.

COP21 is the return of the open method of coordination, method which has failed miserably at the European level. It is good that we see several countries declaring their intention to reduce their emission and partially coordinated commitments which summed up might come close to what is needed. Hard issues are equity, the intertemporal dimension and the means to monitor and enforce implementation. The 1<sup>st</sup> best solution would be a mandatory global tax and a global capping system, but this is very much a multilateral utopia. Climate clubs in which there would be some degrees of trade protection against non-participants like in the trade field seem more likely to be built.

There is a mismatch between agreements based response and the true model of the problem. A system of institutions is easier to modernize than a system based on agreements. The IMF for example has been remarkably adaptable to what has happened in the world. If institutions are to be preferred, we must settle the questions of governance of these institutions and how to make room for newcomers. Open door clubs are another response, they combine flexibility and a universal potential. We could also create a two layer system, on that provide a basis for everyone and another which plugs in new forms of coordination.

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**Question of Sebastien Jean:** One particular feature of present time is the fact that the 1<sup>st</sup> economy is a poor economy on a per capita basis. In this framework, clauses of non-reciprocity are not adapted. Isn't the problem about inventing a degree of reciprocity between non and full reciprocity with gradual obligations depending on income level?

**Response of Bernard Hoekman:** This is clearly a challenge, China has been growing fast but is still a poor per capita country. The software in the trading system was outdated since its creation. It was created hypocritically by OECD countries with the idea that LDCs needed not to be included as their spillover effect did not have any effect on richer countries. But there has been a lot of learning since then which the trade facilitation agreement illustrates. However, so far only 18 countries have ratified the agreement.

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**Question from the floor:** Bernard Hoekman, if you were to become the head of the WTO, what would you do to make it effective?

I thought the Dornbusch model could be introduced into the Mundell-Rogoff model where asset to market could play an important role. In the Mundell-Rogoff spillovers are limited because of exchange rate flexibility, but that would be the case for nominal shocks, for real shocks the exchange rate flexibility cannot absorb so that in a multi country model there would be significant spillover.

**Response of Jean Pisany-Ferry:** What I wanted to emphasize was the fact that this generation of model does not pay attention to stocks and gross flows. Focusing on net flows makes us underestimate the channel transmission of shocks. For emerging countries net flows are not so much different from gross flows, but for developed countries this is a problem we need to address.

**Response of Bernard Hoekman:** Killing the no-round would definitely help a lot although it might not be possible to do. What can be done however is the creation of an infrastructure for these open clubs, it is puzzling that it has not already been done.

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**Question from the floor:** Institutions are undoubtedly more adaptable but pose problems of legitimacy. How can governance of international institutions evolve as to be more legitimate?

**Response of Pisany-Ferry:** Legitimacy of international institutions lies in the mandate that was given to them. Because they are trusted with specialized mandate these institutions are still accountable for what they do, to ensure legitimacy we must not broaden the mandate of these institutions.

**Response of Francesco Giavazzi:** On the flexibility institutions I will take the two examples of the IMF and the ECB. The IMF has a very weak board dominated by the US, if the US agrees, the IMF has the flexibility it needs to act. The ECB is composed of a strong board and a constraining mandate. If we want to add more discretion to the ECB policy, we need more political accountability. It could be introduced by creating a sub-chamber inside the European Parliament that would deal with the Eurozone.

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**He Fan – Chair:** In China, influx of migrants are not much of an issue as migrants can easily be absorbed in the immensity of the territory. In Europe however, the heterogeneity of new immigrants create risks with public opinion. How can European countries address potential costs and risks?

**Response of Jean Pisany-Ferry:** The ability of the EU as an entity to respond is indeed worrying. The refugee highlights differences in attractiveness of labor markets and differences in the attitudes of various countries. The European Union is facing a huge challenge.